

OECD Discussion Draft “Clarification of the Meaning of ‘Beneficial Owner’ in the OECD Model Tax Convention”

Response by John Avery Jones, Richard Vann and Joanna Wheeler

The consultation now being carried out by the OECD in respect of the beneficial ownership concept is an excellent initiative, which we wholeheartedly support, particularly in the light of the confusing case law that has developed in recent years on the concept. We are concerned, however, that the proposals made in the discussion draft to change the Commentaries to the OECD Model Convention will serve to increase the confusion rather than resolving it. In this response our aim is to provide some suggestions for the interpretation of the term in order to provide the greatest possible clarity and certainty. In doing so, we will look at the history of the concept in the OECD Model Convention, as we believe that the reasons for its introduction provide useful guidance on the meaning that should be ascribed to the term.

Problems with the proposed definition

Perhaps the greatest problem of the proposed amendments to the Commentaries is that they look for “the full right to use and enjoy the [income] unconstrained by a contractual or legal obligation to pass the payment received to another person.” This text appears to look for full ownership of the income, whereas the beneficial ownership of income is a primarily an issue in situations at the opposite end of the scale, in which a person has only very limited rights over income. There is a wide range of possibilities between full ownership of income and rights that are too limited to qualify as beneficial ownership, and it is the latter end of the scale that should be the focus of the Commentaries. By focussing on the wrong end of the scale, the proposed Commentaries fail to address the essential factors that distinguish a person who does not have beneficial ownership from a person who has limited rights over income but who does pass the beneficial ownership threshold.

In addition, the proposed amendments potentially introduce a source of tremendous confusion in respect of trusts, as the proposed Para 12.4 in respect of Art. 10 (and the corresponding text in respect of Arts. 11 and 12) appears to exclude all trustees or trusts from the ambit of the beneficial ownership concept (as trustees are under a fiduciary obligation ultimately to disburse the trust income to other persons in accordance with the trust deed), whereas Para 12.1 footnote 1 (and the corresponding footnote in respect of Arts. 11 and 12) states that the trustees of a discretionary trust could be the beneficial owners of trust income. It is also worth mentioning in this context that the OECD’s paper on CIVs introduces a different complication, as it suggests¹ that a discretion to decide on the investment policy on the part of a CIV is enough to make the CIV the beneficial owner of the income it receives, which if applied by analogy to trustees would

¹ "The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles", adopted by the OECD Committee on Fiscal Affairs on 23 April 2010, Paras. 31-35.

suggest that all trustees were beneficial owners. This suggestion, which has found its way into the Commentary on Art.1 Para 6.14, focuses on the wrong aspect, as it should be the CIV's powers to deal with the income it receives that determine whether or not it is the beneficial owner of that income; its power to decide on investments is a different matter altogether. The proposed clarification of the term "beneficial owner" says nothing about this aspect and thus creates additional confusion by proposing quite a different approach.

The Partnership Report suggested that the beneficial owner concept could be used as the basis for adopting the approach to attribution of income suggested in that report, namely that treaty benefits do not flow for a person if the domestic tax law of a Contracting State does not attribute income to a person as a resident of that state.² This kind of thinking found its way into the Commentaries on beneficial ownership in 2003 (for example, current Commentary on article 10, Para. 12.1, sentences 1 and 2). It is evident from the 2003 additions to the Commentaries, however, that the concept is intended to extend beyond such cases and to deny treaty benefits even where a Contracting State regards one of its residents as deriving the income under domestic law and potentially subjecting that resident to tax on the income (for example, current Commentary on article 10, Para. 12.1, sentences 3 and 4). We consider that great care is required in this latter case in applying the beneficial owner concept, as it can lead to denial of treaty relief in the state of source even where the state of residence is taxing the income. The proposed clarification does not draw this distinction but rather seeks to draw a general principle from these quite different cases which leads to an inappropriately broad test as already noted above.

The introduction of the beneficial ownership concept

In considering the meaning to be given to the beneficial ownership concept it is illuminating to look at its history, which has become available relatively recently.³ We have appended to this response the relevant extracts from the working papers of the OECD. Even though this history was not available to the negotiators of most of the treaties in force today, it provides useful guidance as to the meaning originally intended for the term and we cannot see any good reasons for the OECD now to adopt a different meaning.

The minutes of the relevant working party meetings reveal that the beneficial ownership concept was introduced in the 1977 version of the OECD Model Convention because of a concern that Arts. 10-12 would otherwise apply to an agent or nominee who had a legal right to the income. The initial concern about the potential application of treaties in these cases was voiced by the UK, which had first suggested adopting a subject-to-tax test. The notion that treaty benefits should depend on effective taxation in the residence state was rejected, however, as being "contrary to the spirit and the general arrangement of the Draft Convention." Instead, the working party focused on identifying the true recipient of the income and the beneficial ownership terminology was adopted. The subject-to-tax test and the beneficial ownership requirement were obviously regarded as alternative answers to the same concern about the

² "The application of the OECD Model Tax Convention to partnerships", adopted by the Committee on Fiscal Affairs on 20 January 1999, Para. 54.

³ See the "History of Tax Treaties" database, available at < <http://www.taxtreatieshistory.org/>>.

application of treaties to persons who were interposed between the source and the true recipient of the income and who had legal entitlement to the income.

The reason for the suggested subject-to-tax test may have been because UK domestic law did not tax a resident trustee who received foreign-source income for a non-resident beneficiary. Such a trustee would, however, be resident for treaty purposes because his domestic income would be liable to tax. The UK may have been concerned about its position as source state if the domestic law of a treaty partner was the same in this respect. In this situation the UK was not willing to grant treaty relief to the trustee, but feared that it may be obliged to do so under the wording of the OECD Model as it stood then. The beneficial ownership concept deals with this problem in another way. Here again, in other words, the concern was that a person with legal entitlement to the income, who was interposed between the source of the income and the true recipient, would be able to claim treaty benefits.

In short, the original point of the beneficial ownership requirement was simply to remove custodians with legal entitlement to the income from the ambit of treaty protection. The introduction of the concept was limited to Arts. 10-12 because those were the situations in which the receipt of income by a custodian was common.⁴

Uncertainty in the application of beneficial owner test will not be reduced by the new draft

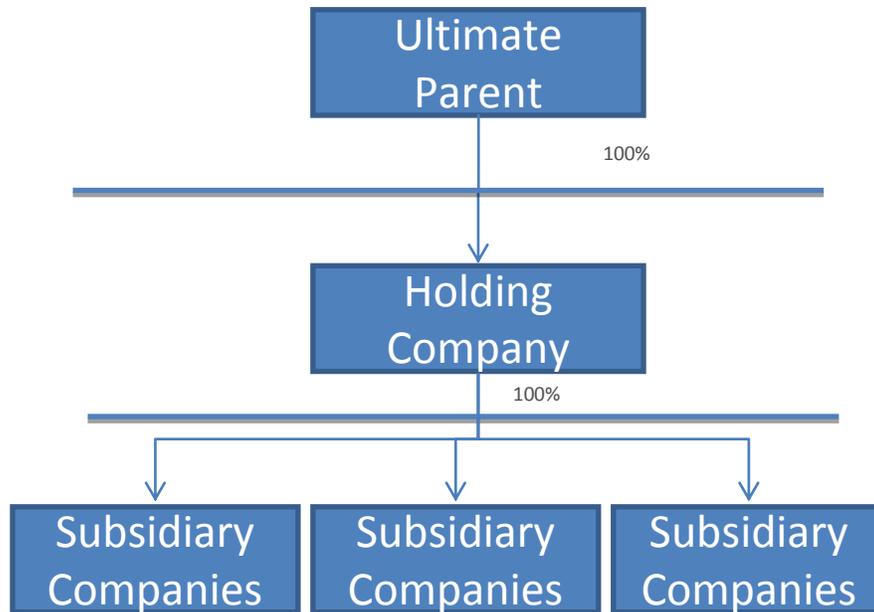
The additions to the Commentaries on the beneficial owner concept in 1992 and 2003 are already causing considerable uncertainty for taxpayers around the world and leading to extreme claims by tax authorities in the form of denying treaty benefits to holding companies. The very broad drafting in the new proposals, especially the text in proposed Para. 12.4 of the Commentary on Art. 10 (and the corresponding text in respect of Arts. 11 and 12), is likely to make this problem worse. For example, consider the following scenario:

Ultimate Parent is resident in OECD Country 1, and is the ultimate holding company for a large listed multinational group.

Ultimate Parent has a 100% subsidiary (Holding Company) located in OECD Country 2.

Holding Company holds multiple investments in Subsidiary Companies. Subsidiary Companies are located in multiple jurisdictions around the world. Subsidiary Companies undertake a wide range of business activities. The Ultimate Parent acquired the Holding Company and its subsidiaries as an acquisition of a large business unit from another large multinational company located in OECD Country 3. As the acquired business has expanded subsequently to other countries, further subsidiaries have been added below Holding Company. One of the subsidiaries of Holding Company is located in OECD Country 4. Holding Company's assets are in excess of USD \$400m.

⁴ They were also the principal articles where the expression *paid to* is used.



Holding Company does not have employees in its own right, although the multinational group has a very large office (over 500 staff) in OECD Country 2, and some of these employees manage the affairs of Holding Company. The employees are employed by a single company which is a separate subsidiary of Ultimate Parent and services the many subsidiaries of Ultimate Parent located in OECD Country 2. The employment company is also resident in OECD Country 2.

The tax authorities in OECD Country 4, where one of the Subsidiary Companies is resident and operates, are denying treaty benefits on dividends paid by Subsidiary Company to Holding Company on the basis that Holding Company is “not the beneficial owner”.

Reasons given by the tax authorities include:

- Holding Company does not have an operating business;
- Holding Company does not have employees in its own right;
- Holding Company is 100% owned by Ultimate Parent.

Holding Company is not under any obligation to and does not redistribute the dividends received from the Subsidiary Companies; the funds are redeployed in the business of Holding Company. When Ultimate Parent requires, Holding Company will pay dividends to Ultimate Parent but there is no pattern to such distributions and they do not absorb all the dividends received over time by Holding Company.

The tax authorities in OECD Country 4 in effect are treating any interposed holding company as a conduit company within the terms of the current OECD Commentary, even though it is part of a substantial business operation of a multinational in the country where the holding company is resident and where there is no automatic redistribution of dividends received to the ultimate parent company. In our view the extremely broad language of the new proposed test will not

prevent the continued use of the beneficial owner concept to deny treaty benefits in this kind of case because the language is so open-ended and non-specific.

Recommendations

The discussion paper has not made a case for changing the meaning of the beneficial ownership concept from the meaning that it was originally intended to have, and there seem to be no good reasons for doing so. There are, on the other hand, very good reasons for sticking to the original purpose of the term, as its meaning could then be defined with a large measure of clarity and certainty. The sole purpose of the concept should, accordingly, be the exclusion of custodians and persons in a similar situation from treaty protection in their own right. As the proposed text of the new Commentaries points out, other anti-avoidance principles are available to deal with other treaty shopping situations. Extending the beneficial ownership concept beyond custodian and similar situations simply invites confusion and disputation.

The OECD could, however, usefully provide some guidance as to the limits of the custodian concept and similar situations. Domestic law is often not a good guide in this respect, as the policy aim of domestic law (to prevent persons from avoiding taxation by transferring their income to another person) is different from the policy aim of treaties (to prevent treaty shopping by paying income through a treaty-entitled person). It might be useful if this difference were stated explicitly in the Commentaries.

In terms of principle, it is recommended that the Commentaries distinguish two cases in relation to beneficial ownership. First, if the country of residence of the person to whom the income is paid does not attribute it to that person, that person will not be the beneficial owner of the income. Secondly, if the country of residence does attribute the income to that person, that person will not be treated as the beneficial owner of the income in only a very limited number of situations.

The crucial point should be that a person is not the beneficial owner of income to which the person is legally entitled and to whom the income is attributed for tax purposes if the person has no control over its application due to a legally enforceable obligation to pass the income on to another person. Only obligations attaching to specific items of income should prevent the person subject to the obligation from being the beneficial owner of the income received; obligations affecting a basket of various items of income should not have this effect if the person subject to the obligation is able to decide which incoming item of income will be used to satisfy which obligation. Further, it should be made clear that if a person is entitled to retain the income for use as the person decides, that person is the beneficial owner even though at some future time that income is likely to be paid over to a third person (which will be the case for virtually all income received by a legal entity).

Accordingly, if trust income is attributed directly to a beneficiary, the beneficiary would be the beneficial owner; this is the case in Australia, for example, if the beneficiary is entitled to the income as it arises or if the trustees of a discretionary trust grant the beneficiary a current entitlement to the income. In a system such as that of the UK, in which trust income is often

initially attributed to the trustee, the trustee would not be the beneficial owner of trust income if there is a beneficiary who is entitled to that specific item of income as it arises. In other cases, however, the trustee would be the beneficial owner of trust income even though the income is, for example, distributed immediately to a discretionary beneficiary. This principle accords with Para 12.1 footnote 1 of the proposed Commentary on Art. 10 (and the corresponding footnote in respect of Arts. 11 and 12).

The obligation that negates the beneficial ownership of the person in a custodian or similar situation could arise from the law of property, as in the case of trustees in common-law countries, or from the law of obligations, as in the case of a person who is subject to a contractual obligation to collect income on behalf of another person. But the obligation should be a legally enforceable one, rather than a moral obligation or one that is inferred from a factual pattern of behavior. Countries which are concerned about fact patterns that suggest a streaming of income through a treaty claimant should combat these situations using their general anti-avoidance principles or treaty provisions specifically directed at the problem; the denial of treaty benefits in these situations should be based on a specific appreciation of the facts which should be explicitly carried out in an anti-avoidance context.

A final word is in order in respect of the assignment of income, which should not be confused with the beneficial ownership discussion. In certain cases in which a person purports to assign income to another person, the domestic law of many countries continues to attribute the income for the purposes of tax law to the original owner who makes the assignment. The issue here, however, is whether the assignment is recognized for tax purposes, rather than any question related to a person's receipt of income on behalf of someone else. This question is, in other words, not relevant to the beneficial ownership discussion for treaty purposes.

We hope that these comments are useful and we look forward to seeing the further work of the OECD on this matter.

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Extracts from OECD Working Documents of 1968 to 1971 in respect of Beneficial Ownership

Note: The extracts reproduced here relate mainly to Working Party 27, which dealt with interest and royalties. Dividends were dealt with by Working Party 23, which was primarily concerned with the application of treaties to various systems of corporate/shareholder taxation. There is no indication in the working documents, however, that the considerations recorded in respect of interest and royalties were thought not to be applicable to dividends.

Working Party No. 27 of the Fiscal Committee

Preliminary Report on Suggested Amendments to Articles 11 and 12 of the Draft Convention, Relating to interest and Royalties Respectively

FC/WP27(68)1, 30 December 1968

25. The United Kingdom Delegation considers that the drafting of the Articles on dividends, interest, and royalties “is defective if a ‘subject to tax test’ is not included in them”. In its view the relief provided for under these Articles ought to apply only if the beneficial owner of the income in question is resident in the other contracting State.

If it is the desire of the United Kingdom Delegation to make relief in the country of source dependent on effective liability to tax in the recipient’s country of residence, then the suggestion would be contrary to the spirit and the general arrangement of the Draft Convention.

On the other hand, it is evident that relief in the country of source applies only if the recipient is actually resident in the other contracting State.

This is stated clearly in the text of paragraph 1. Moreover, determining who is the true recipient and his State of residence is a matter of administration and inspection.

Moreover, there is nothing in the Draft Convention to prevent Contracting States from agreeing upon a procedure whereby the State of source first levies tax according to its law and subsequently refunds the excess tax on production of a certificate by the competent administration that the recipient is resident in the other contracting State.

The Committee will be asked to give its opinion on the comment made by the United Kingdom Delegation.

Note on the Discussion of the First report of Working Party No. 27 of the Fiscal Committee on interest and Royalties During the 31st Session of the Fiscal Committee held from 10th to 13th June, 1969

DAF/FC/69.10, 4 July 1969

Paragraph 25

The Delegate for the United Kingdom considered that as they stood Articles 10, 11 and 12 were defective in that they would apply to dividends, interest and royalties paid to an agent or a nominee with a legal right to the income. He thought that there were two possible ways of remedying the situation: either a “subject to tax clause” could be introduced (as in the Luxembourg-United Kingdom Conventions) under which the source country would give up its taxing rights only if the resident country taxed the interest, or the Articles could be made to apply only to interest, etc., paid to the “beneficial owner” (as in the Netherlands-United Kingdom Convention). The Delegates for Switzerland and the United States both preferred the “beneficial owner” solution. The Delegate for the United Kingdom thought that it should be inserted in the Convention itself, not necessarily in Articles 10, 11 and 12, but possibly as a general provision in a separate Article. The Delegate for Germany found no trouble with the existing text and would prefer to make it clear in the commentaries that the recipient must be the beneficial owner. The Rapporteur agreed to take up this problem in his new report.

Conclusion

The Chairman thanked the Working Party, and in particular the Rapporteur, for the considerable amount of work they had already done. The Committee agreed that the Working Party’s Draft Addition to the Commentary [FC/WP27(69)1 of 30th May, 1969] would be discussed together with the new report which the Working Party would prepare.

Notes on Discussion of Dividends and Abuse of Tax Conventions During the 32nd Session of the Fiscal Committee held from 16th to 19th September, 1969

DAF/FC/69.13, 20 October 1969

(d) Apparent Beneficiaries and Provisions in Bilateral Conventions

The Delegate for France mentioned that Article 14 of the France-Switzerland Convention provided that apparent beneficiaries (i.e. those representing the interest of non-residents) could not benefit from the Convention. Moreover to benefit from the Convention, an individual had to be assessed on his income and not through a “système forfaitaire”, and companies having a special status were denied the benefit of the Articles on interest and royalties.

The Rapporteur drew attention to the difficulty of identifying the beneficial owner in certain cases (e.g. bearer shares).

The Delegate for Germany drew attention to the fact that the laws of different countries varied concerning powers of investigation into the affairs of enterprises, and that his country preferred to look at the status of a company rather than who was behind it. He cited provisions in the German-Luxembourg Convention which denied the benefits of the Convention to companies not subject to tax.

The Delegate for Belgium indicated that Conventions signed by his country also contained provisions aimed against abuse of Conventions, in particular in the Article on Royalties. He suggested that it might help the Rapporteur in drawing up his revised report if Delegations would send to him details of such provisions in bilateral conventions.

Working Party No. 27 of the Fiscal Committee

Report on suggested amendments to Articles 11 and 12 of the Draft Convention, relating to interest and royalties respectively

FC/WP27(70)1, 16 February 1970

25. The United Kingdom Delegation considers that as they stand Articles 10, 11 and 12 are defective in that they would apply to dividends, interests and royalties paid to an agent or a nominee with a legal right to the income. To remedy this situation, it proposes either that a “subject to tax clause” be introduced, under which the country of source would give up its right to tax only if the country of residence taxed the income, or else that these Articles be made to apply only to income paid to the “beneficial owner”.

The Working Party recommends the second solution which seems more likely to meet with the general agreement of the Fiscal Committee. The first solution, which is aimed at making relief in the country of source dependent on effective taxation in the country of residence, would be contrary to the spirit and general economy of the Draft Convention and would moreover give rise to difficulties in the appreciation of the concept of “effective taxation”.

The second solution consists in taking into consideration the State of residence of the beneficial owner, the dividends, interest or royalties and in disregarding the State of residence of the person having the receipt of such income, whether so doing in the name and on behalf of the beneficial owner, or in his own name but on behalf of the beneficial owner.

There is no reason to think that the case of the person acting manifestly as an agent in the name and on behalf of the beneficial owner gives rise to any difficulties.

It may be otherwise with the trustee acting legally in his own name out on behalf of the beneficial owner.

It is probable that certain States have no difficulty from the legal standpoint in attributing to the beneficial owner income received through a trustee.

Such States would, however, be in no way harmed by the insertion into the Model Convention of a text to ensure legal safety in other States for whom the interposition of a trustee could cause complications.

The Working Party therefore recommends that there be written into the Model Convention a provision whereby the “beneficial owner text” would be applied.

The tenor of such a provision might be modelled on that formulated for the same purpose in the convention between the Netherlands and the United Kingdom.

Another question of form arises, namely whether it is advisable to repeat the provision in each of the Articles 10, 11 and 12, or to make it a separate Article applying to the three classes of income to which those Articles apply.

The Working Party suggests that the latter method should be used, but recognises that the Drafting Group would be best qualified to settle the question.

Working Party No. 27 of the Fiscal Committee

Proposals for the Amendment of Articles 11 and 12 of the Draft Convention, Relating to Interest and Royalties Respectively, and of the Commentaries Thereon

FC/WP27(70)2, 4 November 1970

Article 11 relating to Interest

Paragraph 1. This paragraph is formulated as follows:

“Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State if such resident is the beneficial owner thereof.” (Paragraph 25)

Two sub-paragraphs are added under paragraph 18 of the Commentary on Article 11, as follows:

“The purpose of the condition added at the end of paragraph 1 of the Article to ensure that the relevant residential qualification shall be residence in the other State by the person beneficially entitled to the interest and not residence there by any trustee or other intermediary standing between him and having the legal right to such income.” (Paragraph 25)

“The term ‘paid’ is capable of very wide construction, since the concept of ‘payment’ means ‘the fulfilment of the obligation to put funds at the disposal of the creditor in the manner required by contract or by custom’.” (Paragraph 3)

Article 12 Relating to Royalties

Paragraph 1 — This paragraph is formulated as follows:

“Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State, if such resident is the beneficial owner thereof.” (Paragraph 25)

Two subparagraphs are added under paragraph 10 of the Commentary on Article 12 as follows:

“The purpose of the condition added at the end of paragraph 1 of the Article is to ensure that the relevant residential qualification shall be residence in the other State by the person beneficially entitled to the royalties and not residence there by any trustee or other intermediary standing between him and having the legal right to such income.” (Paragraph 25)

“The term ‘paid’ is capable of very wide construction, since the concept of ‘payment’ means ‘the fulfilment of the obligation to put funds at the disposal of the creditor in the manner required by contract or by custom’.” (Paragraph 17)

Fiscal Committee Taxation of Interest and Royalties

Revised Articles 11 and 12 of the OECD, Draft Convention and Commentaries thereon

FC(71)1, 14 January 1971

This is a Note by the Secretary of the Committee which essentially adopted the suggested language of FC/WP27(70)2.