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Concept of Beneficial Ownership

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

Summary

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

This report addresses issues related to the beneficial ownership concept that would require thorough evaluation and consensus before extensive Comment

CONCEPT OF BENEFICIAL OWNERSHIP: DISCUSSION OF KEY ISSUES

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

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

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

Some Country Practices in the Area of Beneficial Ownership

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

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

Proposals for UN Model Update

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

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

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

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

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

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

~~"Under paragraph 2, the limitation of tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State … States which wish to make this more explicit are free to do so during bilateral negotiations…" [para 12]~~

"The requirement of beneficial ownership was introduced in paragraph 2 of Article 10 to clarify the meaning of the words "paid … to a resident" as they are used in paragraph 1 of the Article. It makes plain that the State of source is not obliged to give up taxing rights over dividend income merely because that income was immediately received by a resident of a State with which the State of source had concluded a convention. The term "beneficial owner" is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance." [para 12]

"Where an item of income is received by a resident of a Contracting State acting in the capacity of agent or nominee, it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State. The immediate recipient of the income in this situation qualifies as a resident, but no potential double taxation arises as a consequence of that status, since the recipient is not treated as the owner of the income for tax purposes [in the

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

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

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

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

~~"Under paragraph 2, the limitation of tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State … States which wish to make this more explicit are free to do so during bilateral negotiations." [para 8]~~

"The requirement of beneficial ownership was introduced in paragraph 2 of Article 11 to clarify the meaning of the words "paid … to a resident" as they are used in paragraph 1 of the Article. It makes plain that the State of source is not obliged to give up taxing rights over interest income merely because that income was immediately received by a resident of a State with which the State of source had concluded a convention. The term "beneficial owner" is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance." [para 9]

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

nominee relationship, simply acts as a conduit for another person who in fact received the benefits of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies"[4] concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties]." [para 10]

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

Note that: if it is decided to adopt these changes to paragraph 19 with respect to beneficial ownership, the Committee will have to also decide how to address the rest of existing paragraph 19, which cites paragraphs of the OECD Model Commentaries that no longer exist. Gi

Where an item of income is received by a resident of a Contracting

ANNEX 1

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

ANNEX 2

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

Introduction

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

“The Chinese State Administration of Taxation (SAT) issued a circular (Circular 601) on 27 October 2009 that provides guidance for determining whether a resident of a contracting state is the "beneficial owner"

2) The applicant has no or minimal business activities;

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

4) The applicant has no or minimal