

Report on
Beneficial ownership under the OECD Model Convention and Commentaries
by Prof. dr. Kees van Raad

Pursuant to a request by Lacertus (Netherlands) B.V. I will in this report render my opinion regarding the issue under which conditions a resident of one country who receives royalties from a payor who is a resident of another country that has concluded a tax treaty with the former country, is to be considered the beneficial owner of the royalties received. As the OECD approach in this area equally applies to dividend, interest and royalty payments, references made below to the OECD Commentary will sometimes be to the Commentary on Art. 10 which provides occasionally for a more detailed explanation.

1. Introduction

The paragraphs on beneficial ownership in the current OECD Commentary on the Articles 10-12 were introduced in 1977. The text was subsequently expanded in 2003 and recently clarified in a Discussion Draft that the OECD released in April 2011. The proposed clarification of the Commentary text has not yet been finalized by the OECD, but as it reflects the current view within the OECD Committee of Fiscal Affairs it is taken into account in the analysis below of the meaning of the notion of beneficial owner and the use to be made of it in the interpretation and application of tax treaties.

2. Overview

In this brief report the following aspects of beneficial ownership will be analyzed:

- relevance of domestic law meanings of the term 'beneficial owner';
- meanings of beneficial ownership in other types and areas of law;
- the elements of the notion 'beneficial ownership';
- the beneficial ownership concept not being a general weapon against tax treaty shopping.

3. Domestic law

Surprisingly, when the term beneficial ownership was introduced in the OECD Model in 1977 the term did not have a specific meaning in the domestic tax any of the OECD Member States. In the course of the years various countries introduced in their domestic tax law a definition of beneficial ownership. It always has been questionable whether such definitions would have any meaning for the interpretation and application of tax treaties. According to Article 3.2 of the OECD Model any term that is not defined in the treaty itself should be given the meaning the term has under the law of the country applying the treaty, unless the treaty context otherwise requires. Without going into a detailed enquiry of the scope of the 'context' of a treaty, it is widely recognized that the OECD Commentary is part of a tax treaty's context. It is further acknowledged that changes and additions to the Commentary that do not introduce a novel approach, should be taken into account in the interpretation and application of tax treaties that were concluded prior to such clarifications of the Commentary.

When the OECD outlined in its original 1977 Commentary and expanded in its 2003 update the meaning of the notion 'beneficial ownership', it provided a contextual meaning of that term. Under proper construction and application of the general interpretation rule of Article 3.2, the definitions that individual countries have developed and laid down in their domestic tax law may be applied for purposes of the tax treaties concluded by these countries only to the extent that these definitions do not differ in substance from the concept of beneficial ownership laid down in the OECD Commentary. This is confirmed by text in the proposed paragraph 12.1 of the Commentary on Article 10 where it says that the term 'was intended ... not to refer to any technical meaning that it could have had under the domestic law of a specific country'. To stress the point, it is further stipulated in that paragraph of the Commentary that any domestic law meaning given to the term 'beneficial ownership' has relevance only 'to the extent it is consistent with the general guidelines included in the Commentary'.

4. Meanings of beneficial ownership in other areas of law

As noted earlier, the term 'beneficial owner' was not used in the domestic tax law of any of the OECD Member States when the term was introduced in the OECD Model in 1977. In common law countries, however, the concept was widely used in the area of trust law. Currently, the term is also employed in anti-money laundering rules (the proposed Commentary refers in footnote 1 to paragraph 4.5 of the Commentary on Article 12 to a 2001 OECD Report on Corporate Governance: Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes). In proposed paragraph 12.1 of the Commentary on Article 10 it is observed that for tax treaty purposes the term is 'not used in a narrow technical sense (such as the meaning that it has under the trust law of many common law countries)'. And in the earlier mentioned paragraph 4.5 of the Commentary on Article 12 it is stated that 'the meaning given to this term [in the OECD Commentary] ... 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 ... that exercise ultimate control over entities and assets'.

5. The elements of beneficial ownership

When the beneficial ownership requirement was introduced in the OECD Model in 1977, the Commentary did not provide any definition of the term and merely referred to agents and nominees as examples of persons that normally are not to be considered beneficial owner of income they receive in such capacity. In the 2003 update of the Commentary conduit companies acting as a fiduciary or administrator were added as a further example. No effort was made to include a (positive) definition of the notion 'beneficial owner'. In the April 2011 Discussion Draft for the first time it is attempted to provide such a definition. In the second sentence of proposed paragraph 12.4 of the Commentary on Article 10 (and in the similar paragraphs 10.2 and 4.3 of the Commentary on Articles 11 and 12, respectively) the following two elements of the notion 'beneficial owner' are laid down:

- the recipient of the income item received must have the full right to use and enjoy that income item, and
- this 'full' right means that it is unconstrained by a contractual or legal obligation to pass the payment to another person.

The core feature therefore is that the person receiving the payment (i.e., the dividend, interest or royalty) may not be under an obligation - contractually or legally - to pass that payment to another person.

In ordinary cases, a person (individual or company) that *receives* income payments, typically will also have obligations to *make* income payments. E.g., an individual receiving a salary payment may have a contractual obligation to pay rent for the house where he is living. And a bank receiving interest on a loan it has issued may have a contractual obligation to pay interest on a customer's deposit. Clearly, it is beyond doubt in these examples that the individual and the bank are the beneficial owners of the salary and interest payments received as these payments are entirely unrelated to the payments that are made. This would be different if the income payments they received would have been earmarked by an obligation based on the law or a contract, to be forwarded to another person.

In the third sentence of proposed paragraph 12.4 it is further explained that the existence of an obligation to pass the payment received to another person will normally be derived from a legal document (e.g., a contract). In the absence of a contract it is also possible that through facts and circumstances the existence of such an obligation is established. At this point a misunderstanding should be avoided: under the OECD text it is *not* possible to prove that a person generally should not be considered beneficial owner of a particular income payment on the basis of facts and circumstances; the facts and circumstances test can be applied only to establish in the absence of legal documents *the existence of a legal obligation* that the recipient of an income item must pass the payment received to another person.

If the test laid down in proposed paragraph 12.4 is applied to the facts of the *Indofood* case (*Indofood International Finance Ltd. v JP Morgan Chase Bank N.A.* London, UK Court of Appeal, March 2, 2006, No.: [2006] EWCA/Civ/2006), the Netherlands company would indeed not qualify as the beneficial owner of the interest payment received from the Indonesian company, as the Court in that case also decided. On the other hand, in the *Prévost* case (Federal Court of Appeal of Canada, February 26, 2009, *The Queen v. Prévost Car Inc.*, 2009 FCA 59) the Netherlands company to which Prévost Car Inc. made a dividend distribution would indeed be the beneficial owner of that dividend (as the Court also decided in that case) as it was under no obligation – contractual or otherwise – to pass the dividend received to its shareholders.

A final point to be made in this context concerns the connection between the treaty notion of beneficial ownership and the tax treatment of the recipient of the payment in his country of residence. In the last sentence of the current paragraph 12.1 of the Commentary on Article 10 (renumbered 12.2 in the Discussion Draft) it is observed that a recipient of an income payment who is not the beneficial owner of the payment received and therefore is not entitled to a reduction or exemption of source state taxation, is not subject to double taxation as he is not treated as the owner of the income for tax purposes in the state of residence, i.e., the income item is not taxed to him in his residence state. In other words, an indication of a recipient's status as possible beneficial owner of an income item received can be derived from the finding whether the income is attributed and taxed to him in his residence country. This is also confirmed by the tax treaty practice of various countries; see, e.g., Article 9 of the 1989 Germany-Italy Protocol: 'The recipient of the dividends, interest and royalties is the beneficial owner within the meaning of Articles 10, 11 and 12 if he is entitled to the right upon which the payments are based and the income derived therefrom is attributable to him under the tax laws of both States'.

6. The beneficial ownership concept is not a general instrument against tax treaty shopping

In recent years, a number of non-Member States of the OECD has given a very broad interpretation to the notion of 'beneficial owner', including under this heading activity

tests, substance requirements or limitations on tax deductible payments made (e.g., Indonesia and China). As a matter of fact, such countries typically adopt a definition of beneficial owner that comes close to the limitation-on-benefits provision that is laid down in paragraph 20 of the OECD Commentary on Article 1. This, obviously, goes way beyond the intention of the OECD's Committee of Fiscal Affairs. Clearly to counter this approach, proposed paragraph 12.5 of the Commentary on Article 10 in the Discussion Draft provides the following clarification: 'As explained in the section on "Improper use of the Convention" in the Commentary on Article 1, there are many ways of addressing conduit company and, more generally, treaty shopping situations. These include specific treaty anti-abuse provisions, general anti-abuse rules and substance-over-form or economic substance approaches. 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 the dividend to someone else), it does not deal with other cases of treaty shopping'. Countries are therefore suggested in this paragraph to resort to such other approaches when they want to address those other forms of what they perceive as treaty abuse.

The Hague
27 September 2011

A handwritten signature in black ink, appearing to read 'Lees van Rand'. The signature is written in a cursive, flowing style.