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The concept of beneficial ownership in the OECD model tax convention 2014: A critical analysis – Part I

Introduction[1]

Tax avoidance and tax evasion schemes undermine the foundations of wealth of developed and developing countries. According to the Tax Justice Network in 2006 '… the total tax evasion worldwide amounts to more than USD 3.1 trn … or about 5.1% of the world GDP …'[2] Various aspects of harmful tax practices, aggressive tax planning and tax competition between countries are on the global agenda of international organisations. It is realised that combatting tax avoidance schemes is impossible without addressing the economic, social and ethical aspects of the problem. Legal instruments, even in the form of perfectly drafted double taxation treaties, are not enough. It is also crucial to apply specific approaches when dealing with developed and developing countries and recognise their national interests in a global context.

Unfortunately, an advanced idea of supporting international trade and foreign investments with the help of double taxation treaties is often negatively affected by improper use by some taxpayers who endeavour to obtain tax benefits in the form of full or partial tax relief, without arguably, being entitled to them. Therefore, besides preventing double taxation, contracting states have to set a goal of combating 'double non-taxation' and develop new instruments and methods to prevent tax avoidance. One such technique is the beneficial ownership concept, which is currently a part of the Organisation of Economic Co-operation and Development (OECD) methodology.

Beneficial ownership is an important concept which has several functions. It qualifies a person to tax treaty benefits and allocates taxing rights between contracting states in respect of passive income (dividends, royalties and interest).[3] It is also considered to be an instrument within specific anti-avoidance rules. However there has been a broad debate about the role of beneficial ownership as a tax anti-avoidance technique. As du Tuit has underlined:

> '… the notion of beneficial ownership was incorporated into the OECD Model in 1977 without defining it explicitly and with only limited reference in the Commentaries on the articles of the OECD Model … as to its meaning.'[4]

Collier has concluded: 'Unfortunately, almost the only thing on which there is widespread agreement is that the concept is not particularly well defined and could benefit from greater clarity'.[5]

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The current situation with regard to the beneficial ownership concept may be characterised as almost unique. The concept is found in hundreds of tax treaties but there is no mutual understanding as to what this term means, whether it has economic or only legal essence, should it have an international or domestic meaning and, moreover, whether it is an anti-treaty shopping instrument or just a means of income attribution. Moreover, a point of view exists that the concept may become obsolete or even useless[6] and that the fundamental problem is in the OECD methodology of allocating taxing rights which focuses on a 'person' (a resident of a contracting state) and that person's ownership or any other nexus with the income rather than on this person's tax liability with respect to a particular item of income.[7] The United Nations Model Tax Convention (UN MTC) also faces similar challenges, although the scope of this article is limited, principally, to the currently applied beneficial ownership concept within the OECD approach with a view to contributing to the development of the concept of 'beneficial ownership' as an economic and legal instrument.

Addressing this topic is particularly relevant in light of the current OECD initiatives aimed at combating harmful tax practices in the form of improper use of tax treaties. For example, in 2013, the Base Erosion and Profit Shifting Action Plan (BEPS Action Plan) was published within which it was stated that anti-avoidance techniques used by multinational taxpayers are getting more aggressive and may cause negative economic and social consequences in many countries.

This article contains three parts. The first is devoted to the economic and social objectives of tax treaties. Such treaties are introduced as instruments of states' policy which are intended to contribute to wealth creation and social stability. Thereafter, the social, economic and ethical significance of anti-avoidance measures both for developing and developed countries is examined.

Secondly, the beneficial ownership concept is introduced in its legal and economic context and its place within the range of general and specific anti-avoidance measures is considered.

Finally, case law from some OECD member states in which the practical application of the term 'beneficial owner' has been evident are examined.

Economic and social objectives of double taxation treaties

This section addresses the socio-economic objectives of the OECD Model Tax Convention on Income and on Capital (OECD MTC) as well as the nature and effect of anti-avoidance measures under that Model and provides a base for considering the concept of 'beneficial ownership' later in the article.

A critical analysis of the socio-economic objectives underlying the OECD Model Tax Convention 2014

The system of taxation, as part of public finance, is one of the key contributors to national wealth. It involves many institutional and individual stakeholders and involves an intersection of legal, economic, social and ethical interests. As regards the latter, Boatright has stressed:

> 'Public finance … is concerned largely with raising and distributing funds for government purposes. These tasks raise ethical dilemmas of personal conduct, as well as broad questions of public policy, when corporate and public financial decisions affect society.'[8]

From an economic point of view taxation can be presented as a mechanism for allocation of resources and distribution of wealth.[9] Therefore, the system of taxation should be both fair (legal and ethical issues) and efficient (the economic dimension). The situation becomes much more complicated when these principles – equity and efficiency – are followed at an international level. Co-operation between the states is required and the OECD provides a firm basis for such co-operation. For more than 50 years, it has been working on improving standards for more effective double taxation treaties between contracting states.

> 'It has long been recognized … that it is desirable to clarify, standardize, and confirm the fiscal situation of taxpayers who are engaged in commercial, industrial, financial, or any other activities in other countries through the application by all countries of common solutions to identical cases of double taxation …'[10]

Similarly, the other Model, which is widely applied by countries, namely the UN MTC, has been dealing with double taxation issues since 1921. Comparative analysis of the provisions of the UN and OECD models[11] is beyond the scope of this article. Both the UN and OECD Models endeavour to facilitate international trade and investment by eliminating double taxation. However, it is widely accepted that the Models differ in the balancing of taxing rights between source and residence countries. In this respect, Lennard has stressed:

> '… the main differences between the two models are as to the extent of this relinquishment of taxation rights by the source country. Traditionally it has been said that the OECD is more of a 'residence country' model (… reducing source country taxing rights and being generally preferable to capital-exporting countries) and the UN Model is a more 'source country' oriented model, generally preferable to host countries of investments …'[12]

He has also argued that an element of 'inter-nation equity' implies that source countries (generally developing countries) may create an attractive investment climate, but have the right to tax profits in order to develop their social infrastructure. Here, the UN MTC provides greater fiscal manoeuvrability for source countries in such areas as the taxation of passive income, permanent establishments and attribution of profits (eg the application of a 'force of attraction rule'), pensions and social security payments, and mutual agreement procedures.

The 31 Articles of the OECD MTC cover a wide range of issues especially with respect to possible double taxation. Commentary on the Articles of the MTC (the Commentaries) has become a useful methodological and practical instrument recognised by contracting states. However, the non-binding nature of the Commentaries has become a topic of broad discussion. Blocker has emphasised that OECD member states may follow the Commentaries and their interpretations, but they are not obliged to do so. Ward has agreed with this view and has added that there is no intention to make the Commentaries legally binding arguing that the Commentaries should be treated as part of the legal context of a double taxation treaty based on the OECD Model and, thereby, inform as to the intentions of the contracting states.[13] Nevertheless, Pijl whilst exploring the rationale behind non-binding instruments has emphasised that the Commentaries have a '… certain degree of political bindingness'.[14]

The quality of the Commentaries will improve if focus is placed on the main purpose of a tax treaty – the ability of contracting states to achieve economic and social objectives through minimising double taxation and effective anti-avoidance measures. As regards the latter, tax avoidance and tax evasion, especially by multinational enterprises (MNEs), is a threat to the wealth of many states. The work of the OECD Fiscal Committee reinforces this argument and the 'anti-avoidance line' can be traced clearly in its recent reports and documents (especially in the BEPS Action Plan). However, the OECD approach is still fragmentary. Both the OECD MTC and the Commentaries lack a holistic approach to the crucial problem – states' tax revenues losses and the social consequences of successful avoidance schemes.

The importance of a holistic approach to this problem is well developed in the research papers and official reports of the International Monetary Fund and the World Bank, which demonstrate a macroeconomic approach which treats an economy as a whole, rather than as a collection of individualised markets. Further, authors of such papers and reports also raise issues of 'fair' treaties that take into account the interests of developing countries which '… inevitably lose if being involved in tax competition, the so called "races to the bottom"'.[15]

The focus of the OECD MTC and the Commentaries needs to be modified. *First,* avoidance of double taxation is a means of encouraging international investment and increasing the wealth of contracting states. Therefore, prevention of double taxation *per se* is not an ultimate objective; its prevention simply leads to an accumulation of a state's wealth. *Secondly,* there is a need to emphasise and strengthen the anti-avoidance stem of the OECD MTC and the Commentaries bearing in mind its economic impact. Ideally, the approach '*to states' wealth accumulation through corporations' value creation*' may be developed as a key economic approach in OECD materials devoted to taxation.

Tax-avoidance measures and their socio-economic effect

The economic nature of tax planning is well summarised by Vernimmen and others, who have emphasised the scope for tax planning to create value for investors by reducing taxes and generating savings.[16] Any consequent impact on corporation dividend policy (eg taxation of dividends) changes the company's value and, as a result, influences the wealth of shareholders and, more generally, stakeholders.

However, the stakeholders' desire to achieve higher values may lead to higher risks and raises a combination of economic and ethical issues – namely, the increased risk of insolvency which may be faced by a corporation's voluntary and involuntary creditors. As Boatright has pointed out, in case of default the limited liability of shareholders enables them to 'sell' the company to the creditors and '… walk away from a firm and leave its problem in the hands of others'.[17] However, Brealy and others have also argued that the goal of increasing shareholders' wealth should not encourage unethical behaviour.[18]

When the issue of tax avoidance is addressed, it is crucial to realise that reduction of tax revenue for the state may lead, on the other hand, to an increase in a corporation's value and bring benefits to society. This reinforces the need to look at the combination of economic, social and ethical aspects when formulating a state's or international tax policy, especially when classifying particular behaviour as tax avoidance.

This is important because the scale of worldwide tax avoidance is staggering. Cavelti has indicated:

> '… European governments lose more than USD 1.5 trn, and with a loss of USD 337bn the United States is the country with the highest loss through tax evasion followed by Brazil (approx. USD 280bn), Italy (approx. USD 238bn), Russia (USD 221bn) and Germany (USD 214bn). Moreover, about 18.1% of the earnings worldwide escape taxation. In Europe this ratio is even higher at 20.5%...'[19]

Regrettably, national and international authorities and organisations are not always ready to confront such loss of revenue either technically or methodologically. One of the reasons for this is that they usually have to react to the refined tax planning strategies of taxpayers. More importantly, however, tax authorities' methodological basis is not always compelling. There is often no clear difference drawn between such terms as tax 'avoidance', 'evasion', 'mitigation' and 'optimisation'. Baker has addressed this problem from several angles, stressing the point that tax is a cost and it is normal for 'homo economicus' to reduce costs. He suggested a line where at one extreme is a tax-disinterested taxpayer (takes no steps to mitigate tax liability) and at the other extreme – a taxpayer with criminal intentions (tax fraud). Baker placed tax avoidance on this spectrum between mitigation and fraud and suggested that tax avoidance might be identified 'by demarcating the boundaries of tax fraud and mitigation'.[20] He also identified sub-categories of avoidance (countered, abusive and ill-advised tax avoidance) instead of using a *purpose-test* (examining the intention of a taxpayer in entering into a transaction in order to obtain tax benefits and avoid tax). Further, Baker suggested that instances other than those falling within these three sub-categories would be tax mitigation and, therefore, should not be treated by tax authorities as tax avoidance.[21]

These suggestions illustrate the need to establish mutual international understanding of the term 'tax avoidance'. As will be seen, tax administrations and courts have faced this problem particularly in cases dealing with the meaning of 'beneficial owner' within the context of treaty shopping. Moreover, the attitude of countries towards treaty shopping varies. For the present, an interesting evaluation of treaty shopping and its possible significance for wealth accretion is evident in the following extract from the judgment of the Supreme Court of India in the *Azadi Bachao case*:

> 'Many developed countries tolerate or encourage treaty shopping, even if it is unintended, improper or unjustified, for other non-tax reasons, unless it leads to a significant loss of tax revenues. … Overall, *countries need to take … a holistic view. The developing countries allow treaty shopping to encourage capital and technology inflows*, which developed countries are keen to provide to them.'[22] (*emphasis added*)

The next part of this article considers the concept of 'beneficial ownership' against the backdrop of the OECD MTC and its significance in relation to the abuse of double taxation treaties, notably through treaty shopping.

The concept of beneficial ownership in the OECD MTC

Although first reflected in the OECD MTC about 40 years ago, the 'beneficial ownership' concept still remains a controversial issue. It is suggested that the situation will not be clarified by introducing one more definition of this term. A key to the 'mystery' of 'beneficial ownership' may be the application of a holistic legal and economic approach. The fact of legal ownership (whether of the underlying asset or of the flows of income) or of a 'bundle of rights that defines what an owner can and cannot do with a thing'[23] may not reflect the fact of actual utilisation of the asset or income. Actual use may be hard to ascertain. The fact that a person bears risks from possession of an asset means that this person may require compensation for taking the risk. This, in turn, leads to the conclusion that this person derives benefits from this asset. Utility, benefits and risks are economic criteria.

Within the context of the concept of beneficial ownership in the OECD MTC and related documents, three main issues arise:

- the beneficial ownership concept as an anti-avoidance technique or an instrument of income attribution;
- the interaction of international and domestic meanings of the term 'beneficial owner'; and
- the legal and economic nature of beneficial ownership.

Examining the beneficial ownership concept

Since the concept of beneficial ownership was introduced in 1977[24] there has not been any generally agreed definition of it. As Collier has pointed out:

> '… almost the only thing on which there is widespread agreement is that the concept is not particularly well defined and could benefit from greater clarity.'[25]

Further, Li has stated:

> 'The term has been adopted in most bilateral tax treaties, but defined in none. Its meaning is thus left to be interpreted under art 3(2) of the OECD Model … Because the term has no specific meaning in the domestic tax law of most countries, the way in which domestic courts should interpret this treaty-originated concept has been the subject of much scholarly debate.'[26]

Article 3(2) of the OECD MTC provides that treaty terms which are not defined in the treaty are to be given a domestic meaning unless this conflicts with the context of a treaty.[27] However as seen above, Li has indicated that the 'beneficial ownership' concept is used in the majority of double taxation treaties based on the OECD MTC, but at the same time it is not defined in domestic law of the majority of the OECD member states.[28]

The main articles where the term is used are arts 10 'Dividends', 11 'Interest' and 12 'Royalties' of the OECD MTC.[29] The economic rationale behind these provisions is a clear signal that the use of conduit companies in chains of financial relationships with the sole purpose of gaining benefits from double taxation treaties (avoiding withholding tax and achieving lower or zero tax rate on dividends, interest or royalties) should not have been allowed.

The Commentary to para 2 of art 10, explains that the term should not be used in a technical narrow sense, but in light of the purposes of the OECD MTC, ie avoiding double taxation and combating tax avoidance.[30] Further, it is stated in paras 10.2–10.3 of the Commentary to arts 11 and 12 that relief or exemption from taxation should not be granted where income is received by an agent, conduit or a nominee, through being a resident of the contracting state.[31] The Commentaries also identify the following attributes of a conduit company, namely formal ownership, narrow powers to dispose of the income and acting as a mere administrator or fiduciary with regard to the income.

However, debates arose, recently, within the OECD when a Discussion Draft entitled 'Clarification of the meaning of "Beneficial owner" in the OECD Model Tax Convention'[32] was published in 2011. This document was prepared in response to numerous and various interpretations by tax authorities and courts of beneficial ownership.

The Discussion Draft is important on a number of counts. It accepted that the term 'beneficial owner' should not be used in a narrow technical sense, but should be understood in its context and in light of the objectives of the OECD MTC. It also considered three interesting issues. First, it recognised that domestic law meanings of 'beneficial owner' may be helpful. Although, arguably, this approach could bring difficulties with regard to different interpretations of the term (eg in common law and civil law systems). Subsequently, scholars and practitioners have criticised this suggestion and have maintained that an international treaty based interpretation should be sought.[33] For example, Booker has noted that '… opening the door to a domestic law characterization of beneficial ownership exacerbates the risk of diverging interpretations and double taxation that the OECD wants to avoid'.[34]

Secondly, para 12.4 in the Discussion Draft seeks to define the 'beneficial owner' as:

> 'The recipient of a dividend is the 'beneficial owner' of that dividend where he has the full right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass 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 full right to use and enjoy the dividend: also, *the use and enjoyment of a dividend must be distinguished from the legal ownership*, as well as the enjoyment, of the shares on which the dividend is paid.' (*emphasis added*)

Finally, the Discussion Draft proposed a new para 12.6 which would address the meaning of 'beneficial owner' for the purposes of the OECD MTC and in the context of other legal instruments (eg international anti-money laundering legislation), where the aim is to specify an individual who exercises ultimate control over a company.[35] In this respect, the Discussion Draft recognises that different meanings of 'beneficial owner' in other international instruments may not be appropriate in the context of arts 10, 11 and 12 of the OECD MTC, especially where other such meanings may contradict the domestic meaning of the term in a particular state.[36]

So, the concept of beneficial ownership in the OECD MTC has its advantages and drawbacks. The first merit of the OECD approach is the clear statement that the term 'beneficial ownership' should have an international meaning. The second is the OECD's approach with regard to agents, nominees and conduit companies where the mere fact of interposition of a company is insufficient, without more, to constitute that company as a beneficial owner.

Finally, the OECD acknowledges an economic approach to beneficial ownership. This is evident from the Discussion Draft which recognises the criterion of the 'full right to use and enjoy' the income as a characteristic of beneficial ownership and separation of the 'use and enjoyment' criterion from the formal legal ownership. Danon has opined that the question of ownership should be tested on the basis of a substance-over-form approach. He also submitted that this is not decisive as to whether the income recipient owns the underlying asset.[37] Therefore, beneficial ownership is about the level of economic control over the income and the '… factual ability of a person of a third country to compel an entity interposed in the residence state to transfer to the former the income received from the source state'.[38]

The key drawback of the current OECD approach is the lack of consistency in the determination of the meaning of 'beneficial ownership' and the extent to which this should be resolved within an international or domestic context.

An economic rationale for the beneficial ownership concept

One of the issues to be examined is the interaction of legal and economic nature of the beneficial ownership concept. Unfortunately, law and economics with respect to beneficial ownership are often presented as incompatible.[39] It should be admitted that there is no clear and mutual approach, both methodological and practical, to the economic meaning of beneficial ownership. However, it would not be right to deny the role of economic factors in defining beneficial owner. Moreover, legal and economic approaches contribute to one objective – identification of the beneficial owner by delivering a reasonable and motivated assessment.

The following approaches, concerning the economic meaning of the beneficial ownership concept, can be emphasised:

1. 'Substance-over-form' doctrine;
2. 'The responsibility centres' concept; and
3. 'Remaining economic risk' concept.

The 'Substance-over-form' doctrine and the 'economic approach' are often confused in the academic literature and practice. The 'Substance-over-form' approach implies that real economic relationships are taken into consideration in the process of identifying the beneficial owner. However, this does not mean that an economic approach is exhausted at this stage. The Substance-over-form approach is mostly a title of general technique based on substantial examination of the nature of relationships between an investor and financial resources' recipient. The Economic approach is a range, a variety of tools and techniques that aiming to contribute to the process of beneficial owner determination.

One of such techniques, named the concept of 'responsibility centres', is described in detail by Verdoner and others[40], who underline the importance of qualitative and quantitative aspects of the term 'beneficial ownership'. The concept of 'responsibility centres' reflects the contribution of each participant to an economic chain of value creation.

In order to determine the functional profile of all the persons or entities involved, the FAR-analysis (Functions, Assets, Risks) is applied. This approach is widely used in the OECD methodology (eg attribution of profits to permanent establishments and transfer-pricing analysis). By applying FAR-analysis functional roles can be identified (production, marketing, research, development etc.). Each of the identified units has its own role and responsibility (investment, profit, costs, revenue and expense centre).[41]

This method allows a match of economic and legal criteria and terms, eg 'cost centre – nominee', 'cost/revenue centre – broker/agent', 'profit centre – trader/distributor', 'investment centre – owner'. After identifying connections between economic and legal labels it is possible to determine how particular functions and responsibility should be compensated.[42] As a result, the application of an economic approach enables a distinction to be made between nominee, agent and investor.

Another economic technique which allows interpretation of the term 'beneficial owner' is based on the risk attribution approach and contains several tools or, more precisely, tests. One of them is based on the sharing of risk by a person deemed to be a beneficial owner. Verdoner and others, besides the test of legal ownership, have offered the criterion of identifying a person who bears the risk of changes of value in the underlying asset.[43]

The other modification of the risk-oriented test was introduced by van Bladel and looks to the financial institution's pattern. Van Bladel determined economic ownership as remaining with the legal owner's economic risk. Therefore, if no economic ownership of the asset remains, the legal owner of the asset should not be treated as the beneficial owner.[44]

Van Bladel also addresses the example of Bank of International Settlements (BIS) methodology. As he points out, it is not difficult to determine whether the owner of an asset bears any economic risk or not, because each type of asset requires a percentage of capital to cover potential losses from this asset possession and even in the case of 1.6% risk, beneficial ownership may be assumed. He concluded:

> 'To be Beneficial Owner, the owner of an asset needs at least be the legal owner of the asset. … 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.'[45] (emphasis added)

Thoughts

The objective of the beneficial ownership concept is to prevent improper use of double taxation treaties by granting benefits to a person who is not a beneficial owner of income (dividends, interest and royalty), but who is merely interposed (conduit company, nominee, fiduciary, administrator etc.) between the source of income and actual recipient of this income in order to obtain treaty benefits in the form of reduced rate of withholding tax. The test of legal rights is not always helpful. It may clarify the fact that a person has no contractual obligations to pass income or even may use and enjoy it, but it is only the first step in identifying the beneficial owner.

It follows from the OECD approach that a test of economic beneficial ownership may be applied. However, this approach is not developed and often involves the use of the substance-over-form approach – an approach which aims to identify the substantive nature of a transaction, but one which does not necessarily reflect the whole economic approach and should not be used interchangeably with it. Moreover, though it may be helpful to understand the economic nature of a transaction, this may not always indicate who the beneficial owner is. The opposite approach is introduced in this research. It is suggested that it may not be important to identify the person who receives the income ultimately, but the person who bears the risk of possessing the income or the underlying asset.

Risks imply compensation. Compensation means the derivation of economic benefits from the income or the asset even if this person is not a legal owner, or does not actually receive any compensation. Particular types of risks may be determined on the basis of the analysis of functions and responsibilities.

The key to clarification of the beneficial ownership concept is in developing a technique which combines instruments of legal and economic analysis.

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Endnotes

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