

OECD

Consultation regarding the meaning of 'beneficial ownership'

In April 2011, the OECD Committee on Fiscal Affairs released for public comment a discussion draft on the clarification of the meaning of 'beneficial owner in the OECD Model Tax Convention.

The OECD has now published the comments received on this discussion draft. Working Party 1 of the Committee on Fiscal Affairs will examine these comments at its September 2011 meeting.

As promised in the previous MTN, we now summarise the draft and the responses. As we shall see, the responses are generally consistent in their criticism of the draft which, rather than "clarify", would appear to create scope for further uncertainty and risk for taxpayers.

Discussion Draft

The particularly contentious parts of the new wording are re-produced below. The wording reproduced below relates to dividends (although the corresponding wording on interest and royalties is substantially the same):

*"In these various examples (agent, nominee, conduit company acting as a fiduciary or administrator), the recipient of the dividend is not the "beneficial owner" because that recipient does not have the full right to use and enjoy the dividend that it receives and this dividend is not its own; the powers of that recipient over that dividend are indeed constrained in that the recipient is obliged (because of a contractual, fiduciary or other duty) to pass the payment received to another person. **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 use and enjoyment, of the shares on which the dividend is paid.**"*

The above paragraph (and specifically the emboldened wording) has been highly controversial. In particular, it could be read as to accept as beneficial owner only a person that has the full right to use and enjoy a dividend, interest or royalty without any obligation (whether a legal obligation or something falling short of a legal obligation) to pay on all or part of the dividend, interest or royalty.

Impact on Financial Service Industry

Financial service businesses have been particularly vocal about the potential impact on their business. As the Loan Market Association ("LMA") puts it:

“Taken to its logical conclusion, this seems to mean that potentially all financial institutions might cease to be “beneficial owners” of their interest receipts... Most financial institutions are, in essence, intermediaries. In the vast majority of cases they raise funds...which incur either funding costs or obligations to account for profits. Those funds are used to make loans to borrowers and the resulting interest receipts are used to pay those funding costs or to distribute to investors as profit.”

The LMA concludes that the proposed changes are “unworkable” and recommends that the commentary be left in its current form.

Both HSBC and Standard Chartered Bank have commented on the proposed wording. The HSBC response focuses on derivatives and requests clarification that equivalent payments under derivatives should not mean that the payer does not have full use and enjoyment of income earned on any underlying hedges. Standard Chartered point out that:

“...in the context of financial entities, a conclusion that the intermediary should be taken to be the beneficial owner of the income should not be disturbed by the fact that the entity may hedge/trade its exposure in a transaction with a third party, albeit some elements of the latter transaction may reference payment flows from an underlying asset or exposure.”

Rightly or wrongly, there is an element of “scare-mongering” in the response from the financial services industry. The LMA consider that the “inevitable effect of the proposed changes will be to discourage cross-border lending at a time when liquidity in the global financial markets is at a premium.” HSBC caution that the uncertainty will affect market volumes and liquidity.

Impact on Other Industries

Ernst and Young’s response looks beyond the financial services industry and points to other examples to illustrate the potential difficulties caused by the proposed wording:

- Holding Company – for example, a holding company receives (on average) €5m dividends per year from an investment. This investment is financed with equity and debt and the interest payments on the debt equal €4m per year. Based on the proposed wording there is a risk that tax authorities could argue that the holding company is not the beneficial owner of the dividends.
- Software Company – for example, a software company receives €5m of royalty income from software licenses to clients, but is contractually liable to pay €4m for the use of two other software programs embedded in the software programs it licenses out. Based on the proposed wording there is a risk that tax authorities could hold that the software company is not the beneficial owner of the royalties it receives.

Concluding Comments

Working Party 1 of the Committee on Fiscal Affairs will have its work cut out in trying to determine which way to go when it examines these comments at its September 2011 meeting.

Part of the difficulty is that although the responses to the proposed changes were almost entirely negative, there is no clear consensus on how to fix the problem. The range of proposed approaches can be summarised as follows:

- Beneficial ownership is an undefined treaty term and, in accordance with Article 3(2) of the OECD Model Treaty, should take its meaning from the domestic law of a state that has a clearly understood concept of beneficial ownership. If contracting states do not have the concept of beneficial ownership under their domestic law, then they should be encouraged to negotiate a specific definition of beneficial ownership into their treaties. (Chartered Institute of Taxation)
- Beneficial ownership is an undefined treaty term, but in accordance with Article 3(2) of the OECD Model, the context requires that an “international tax meaning” (rather than domestic law) should be adopted. (*Indofood*)
- The proposed Commentary amendments are “unworkable” and the Commentary should be left as it is (LMA).
- The proposed Commentary amendments may be made to work subject to amendments. However, the amendments proposed by respondents are not consistent.

In our view, it is unsatisfactory to use amendments to the OECD Commentary to “re-shape” the meaning of beneficial ownership in all existing treaties since this undermines the fundamental nature of a tax treaty as a bilateral agreement between two contracting states. If a contracting state were to introduce a domestic law definition of “beneficial ownership” for treaty purposes then it would be difficult to argue that the context requires an “international tax meaning” to prevail, at least in respect of subsequently concluded treaties. That said, in respect of treaties where the context requires an “international tax meaning” then it is right that the OECD should help to shape consensus as to what this should be. However, we feel that the range of views in the responses shows that it is clear that there is no consensus as to how the “international tax meaning” of beneficial ownership should be defined.

In terms of the proposed amendments, we think it dangerous to suggest that the beneficial owner must have ***“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...”*** This language, if adopted, could lead to increased uncertainty and litigation, since it would be open to an aggressive tax authority to argue that almost any recipient of income is not the beneficial owner if it has payment obligations of its own.

It seems that a precise definition of beneficial ownership remains elusive and attempts to define it in words only serve to create uncertainty and controversy. Unless and until consensus emerges, it may be more helpful if the OECD merely states the general principle, and provides specific examples, both negative (agents and nominees) as well as introducing more positive examples (for example income arising on a financial asset acquired by a financial institution to hedge a derivatives position).