

Tax Policy Bulletin



OECD releases revised discussion draft on beneficial ownership

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On 19 October the OECD released its revised proposals on the topic of beneficial ownership. This contains some modifications from its earlier Discussion Draft (released in April 2011) which proposed various changes to the Commentary to the OECD Model Tax Treaty (OECD Model) in order to clarify the beneficial owner test.

Background

There has been a significant rise in controversy around the world in recent years centred on the topic of the beneficial owner test which appears in the dividends, interest and royalties articles of most double tax treaties. In response to the situation, the tax treaty working party of the OECD committee on Fiscal Affairs has since 2008 been carrying out work aimed at clarifying the concept. The intention is that this will be achieved through amendments to the Commentary to the OECD Model.

The main issue has been the lack of any clear – let alone common – understanding of what constitutes beneficial ownership. There is also a distinct lack of clarity about whether, and to what extent, the concept can be used by tax authorities as a general anti-avoidance tool. Another important point has been whether it is right to apply a state's domestic law in interpreting the term, or whether it should be given a more general treaty-based meaning. Both interpretations have been followed in recent case law.

The OECD Discussion Draft of April 2011

Last year, a ten-page Discussion Draft on the meaning of the term 'beneficial owner' was released by the OECD on 29 April 2011. It proposed new text for insertion into the Commentaries on Articles 10, 11 and 12 with the aim of giving further guidance on interpretation and to address the difficulties experienced to date.

The most important of the OECD's proposed changes was the attempt in that new text to clarify why agents, nominees and companies acting in a similar capacity are not beneficial owners. The text stated that the recipient in such cases does not have the "full right to use and enjoy the dividend" (i.e., the powers of the recipient are constrained, as the recipient is obliged to pass the payment on to another person). The text went on to state that the beneficial owner, on the other hand, has the "full right to use and enjoy" the income unconstrained by any contractual or legal obligation to 'pass on the payment' to another person. It also states that it is normally possible to tell if there is any obligation to pass on payment from the relevant legal documentation. However, facts and circumstances may also be relevant in showing that, in substance, the recipient clearly does not have the full right to use and enjoy the income.

These proposals were heavily criticised in the large number of responses to the OECD's Discussion Draft.

The thrust of many of the responses was to doubt whether the proposed wording would bring the intended clarity to the meaning of the term or remove, or materially reduce, disputes in this area.

In particular, the test of having "the full right to use and enjoy the income unconstrained by a contractual or legal obligation to pass the payment received to another person" was thought likely to prove difficult to interpret in practice – especially given the wording proposed in the draft OECD text that states that this may be determined based on the substance of the relevant facts and circumstances.

It was also noted that in many common situations the proposed OECD wording to describe the beneficial owner test would prove particularly problematic. For example, in the case of financing vehicles, where interest on a loan is received and is used wholly or partly to defray the financing costs of the vehicle concerned, does the recipient financing the vehicle forfeit its beneficial ownership of the interest received because some or all of the interest collected is on-paid in meeting obligations under a separate financing arrangement? Similarly, the problem of income equivalents is not dealt with at all in the text, and this will cause particular issues in the financial sector (where the beneficial ownership test is already complicated). For example, if an asset is hedged so that income arising on securities wholly or partly funds amounts paid away under a derivative, does this mean the beneficial ownership of the income on the asset is forfeit by this test?

In addition to the above attempt by the OECD to explain the requirements of the beneficial owner test, the Discussion Draft of April 2011 contained a number of other proposed clarifications. These included the statement that the term 'beneficial owner' is intended to address potential difficulties arising from the use of the words in the relevant Article, "paid to... a resident", and should be understood in that context. This clearly suggests the need for a treaty-based approach, although it was recognised in the draft that domestic law may be applicable if consistent with the general guidance in the Commentary. (This relegates the domestic law interpretation of the term substantially.) The text also clarified that being the beneficial owner of the income concerned does not guarantee a reduced treaty rate given the existence of other ways in the treaty of addressing treaty shopping. It is noted that the 'beneficial ownership' test addresses one type of situation – i.e. where a recipient is interposed and obliged to pass on the income collected to someone else – but it does not deal with other types of treaty abuse.

The OECD's Revised Proposals of October 2012

The main changes in this document are as follows:

- On the main issue of what it is to be a beneficial owner, the approach – and wording – has been amended but not changed fundamentally.

- The “full right to use and enjoy” income test is reduced to the “right to use and enjoy” (the term full being considered to introduce needless complexity) but comments on the beneficial owner test being failed where the owner is “constrained by a contractual or legal obligation to pass on the payment received to another person” are retained. Also retained are the comments that such an obligation may be found to exist on the basis of “facts and circumstances” which show “in substance” that the recipient does not have the right to use and enjoy the income. As noted above, these comments were at the heart of the negative taxpayer response to the first discussion draft because of the uncertainty they introduced in the interpretation of the beneficial owner test.
- The OECD now seeks to meet these objections in two ways. First, it is stated that an obligation to pass on the payment must be “related” to the payment received – so that if an obligation to make a payment is “unrelated” it will not be relevant to the beneficial ownership issue. Second, examples are given of payments which are not problematic in this context, being “unrelated obligations that the recipient may have as a debtor or as a party to financial transactions or typical distribution obligations of pension schemes and of collective investment vehicles entitled to treaty benefits”.
- In relation to the other changes initially put forward by the OECD in the 2011 Discussion Draft, the proposed comments expressly relegating the importance of domestic law interpretations of the beneficial owner test have now been removed; the comments on the need also to satisfy any relevant anti-treaty shopping measures have been retained; as are the proposed comments that the beneficial owner test in treaties is used purely in the context of the ownership of income (and is not to be confused with asset ownership tests in money laundering and similar rules).
- Some new comments effecting minor changes are also now proposed for the situation where an intermediary is interposed between the payer of income and the relevant beneficial owners. The Commentary already makes it plain that in this situation reduced withholding rates may apply but the position is strengthened and the text of the preamble of paragraph 2 of the Article itself is also changed so that the position is also clear if an intermediary or conduit is in a different state than the state of the beneficial owner.

Analysis

It is clear that the central issue relates to the OECD’s attempt to describe the circumstances in which the beneficial owner test is failed by virtue of the recipient’s obligation to “pass the payment on”. As noted by the OECD themselves (and in relation to responses on their initial approach), “the vast majority of commentators either objected to that paragraph or thought it was unclear”.

In the context, it seems odd that the initial approach is largely unchanged. It is certainly helpful that there are the additional comments now inserted on the fact that unrelated payments do not affect the beneficial owners position of income received (whether or not it is used to fund those payments) but this simply leads to the obvious question: what does it mean for a payment to be related or unrelated? It is clear that this is the key concept: the terms are used four times in the space of the proposed text. There is, however, no word of explanation on the meaning of this term. The OECD state that the new wording is intended to provide some comfort with respect to some of the situations identified in previous taxpayer comments made on the first Discussion Draft. This suggests that some criteria have been recognised – and are intended to be reflected – in the related/unrelated wording. What such criteria are, however, remains unclear.

Whether payments are related might be determined by a large number of possible criteria, such as: same counterparty to the transactions; same time of execution of transactions; same subject matter or same reference asset/currency; same or similar interest rates or rates of return; same duration of transactions; same amount or quantum of contracts; etc. The point, in short, is that use of the terms related/unrelated without any explanation relocates the discussion on the beneficial owner test but does not solve it.

Given that the overall objective of the current work of the OECD is to improve clarity on the meaning of the beneficial owner test, it is not clear that the current proposals advance the position on this central issue. Indeed, the greatest danger in this area is the potential for confusion between beneficial ownership and economic ownership. On the basis of the proposed revisions, there is a risk that the dividing line between these two concepts had become further blurred.

Of the remaining areas where changes have been proposed, the comments on the need to satisfy any relevant anti-treaty shopping provisions and on the income-specific context of the beneficial owner test are largely unchanged from the previous proposals. The strengthened position in relation to ultimate beneficial owners being entitled to access treaty rates, though not a change of principle, is to be welcomed. However, the removal of comments relegating the importance of domestic law on the interpretation of the beneficial ownership test seems to back off from the OECD’s earlier position of seeking to give a clear answer to the ongoing debate as to whether the test is to be addressed as, in effect, a treaty concept or interpreted by reference to domestic law.

OECD Consultation

Comments on this revised document are invited up to 15 December 2012. However, it should be noted that the OECD is, in releasing this revised draft, not seeking comments on the substance of its proposals but rather on drafting issues only. This is very likely to mean that any future changes as a result of the consultative process will be modest.

Contacts

If you would like further advice or information in relation to the issues outlined in this bulletin, please call your local PwC contact or any of the individuals listed below:

Richard Collier (PwC UK)
+44 (0) 20 7212 3395
richard.collier@uk.pwc.com

Stef van Weeghel (PwC Netherlands)
+31 (0) 88 792 6763
stef.van.weeghel@nl.pwc.com

Mike Gaffney (PwC US)
+1 (646) 471 7135
mike.gaffney@us.pwc.com

Nick Pantaleo (PwC Canada)
+1 (416) 365 2701
nick.pantaleo@ca.pwc.com

Jonathan Hare (PwC UK)
+44 (0) 20 7804 6772
jonathan.hare@uk.pwc.com

Peter Yu (PwC Hong Kong)
+852 2289 3122
peter.sh.yu@hk.pwc.com

Gautam Mehra (PwC India)
+91 22 2496 2122
gautam.mehra@in.pwc.com

Matthew Wong (PwC China)
+86 21 6386 3078
matthew.mf.wong@cn.pwc.com

Steve Nauheim (PwC US)
+1 (202) 414 1524
stephen.a.nauheim@us.pwc.com

Philip Greenfield (PwC UK)
+44 (0) 20 212 6047
philip.greenfield@uk.pwc.com

www.pwc.com/taxpolicy

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