

Research on the Identification of "Beneficial Owner" in Tax Treaties: Based on Case Analysis

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Abstract: Nowadays, with the development of cross-border trade and the increase of tax agreements signed between countries, money laundering and tax treaty abuse crime is more and more rampant. The beneficial ownership rule first introduced in the last century by the OECD is an effective way to curb it. Based on introducing the origin and development of beneficial ownership rules, this paper analyzes the differences in international identification standards, then adopts the case analysis method to discuss the differences in the identification standards of beneficial ownership in tax treaties, and finally puts forward suggestions for the construction of a rational identification standard for beneficial ownership.

Keywords: tax treaty, beneficial owner, treaty-shopping, substantive business activities, anti-tax avoidance

1. Introduction

With the advancement of economic globalization, tax agreements have become an important way to balance tax interests between countries. The contracting countries usually levy withholding tax at a preferential rate on the dividends, interest and royalties of the resident enterprises of the other Contracting State from their territory. Generally, resident enterprises of non-Contracting States cannot claim the preferential treatment provided by tax treaties. However, some multinational enterprises have tried every means to obtain such preferential treatment that they should not enjoy by setting up agent and conduit companies in the Contracting States [1]. This treaty abuse (Treaty-shopping) behavior, on the one hand, infringes the taxation sovereignty of the Contracting States, and on the other hand, causes a competition imbalance among enterprises [2].

To identify and limit treaty abuse, the Organization for Economic Co-operation and Development (OECD) introduced the beneficial ownership rule in its model tax treaty issued in 1977. That is, if an enterprise of a Contracting State that receives dividends, interest and royalties does not meet the conditions for beneficial ownership identification, then the enterprise cannot become the beneficial owner of the payments, and thus cannot enjoy the preferential tax rate between the Contracting States. However, the 1977 OECD model did not define beneficial owner, but simply adopted the exclusion method to exclude agent and conduit companies from the beneficial owners, which has led to many difficulties in the application of the beneficial ownership rule in international tax practice.

According to OECD statistics, multinational corporations' treaty-shopping behavior has resulted in an annual loss of more than US\$240 billion in global corporate income tax [3]. Passive investment recipients' tax avoidance is one of the main causes of global corporate income tax losses. Often,

passive investment recipients have cleverly devised organizational structures to disguise themselves as beneficial owners and thus improperly obtain tax treaty benefits they should not be entitled to. Whether passive investment recipients have the status of beneficial owners becomes the key to answering whether they can enjoy tax treaty treatment. Therefore, clarifying the criteria for the identification of beneficial owner and further improving the beneficial ownership rule is of great importance in international tax law to prevent parties from making unfair use of tax treaties.

Therefore, an in-depth study of the beneficial ownership rule, exploring the identification standards of the beneficial ownership rule, and clarifying the connection between the beneficial ownership rule and other anti-tax avoidance rules are conducive to creating a fair competition environment in the international community and to protect the taxation interest of sovereign states.

2. Origin and Development of the Beneficial Ownership Rule

The beneficial ownership rule was first introduced in the 1945 bilateral tax treaty between the United Kingdom and the United States on inheritance tax. In this tax treaty, the United Kingdom and the United States grant each other preferential rates of withholding tax for the inheritance obtained by a resident of one Contracting State from a resident of the other Contracting State [4]. In this treaty, the provisions on the beneficial ownership rule consist of two main points: firstly, only when the recipient of the inheritance meets the conditions for the identification of the beneficial owner, can he be eligible for preferential treatment in the tax treaty; secondly, the recipient of the inheritance bears the burden of proof to provide the authority with materials that meet the beneficial owner identification standard. Since then, similar provisions have been made in tax treaties signed by many other countries to regulate cross-border dividends, interest and royalties payment, which has also promoted the development of the beneficial ownership rule in the international taxation practice [5].

In 1977, the beneficial ownership rule was introduced into the Model Tax Convention (MTC) by the OECD. Specific provisions are provided in Articles 10, 11 and 12 of the OECD Model on passive investment income such as dividends, interest and royalties.

In 2015, the OECD released its final report on Action 6 of the Base Erosion and Profit Shifting Project—Preventing the Granting of Treaty Benefits in Inappropriate Circumstances. In this report, PPT (Principal purposes test) rule and LOB(Limitation-on-benefits) rule are introduced to deal with tax evasion and tax avoidance [6].

With the increase in tax evasion and tax avoidance by multinational corporations using tax treaties, the OECD recognizes that regulating tax treaty abuse has become an equally important task as avoiding double taxation. In 2017, the OECD's main focus on tax treaties was to prevent base erosion and profit shifting. In the same year, the OECD issued the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (hereinafter referred to as the Convention).

Since the introduction of beneficial ownership into the OECD model, OECD has published discussion papers and research reports on this concept at regular intervals. To sum up, the main views of the OECD on the beneficial owner are as follows:

First, there is no specific concept or definition of beneficial ownership, and it should be understood in conjunction with the purpose and context of the tax treaty;

Second, agents and nominees are not beneficial owners; conduit companies are treated differently based on their role in the transmission of benefits from passive investment, and conduit companies that act as agents and nominees are not beneficial owners;

Third, the beneficial ownership rule is a special anti-tax avoidance rule, not a general anti-tax avoidance rule.

3. Current Situation and Problems of Abusing Tax Treaties

As more and more tax treaties are signed among countries, many multinational companies have found that they can make use of the tax treaties between different countries to reduce their taxes by setting up conduit companies in these countries. This is the most common way of tax treaty abuse.

Figure 1 shows a typical business structure designed for treaty shopping. A multinational company C is located in country K and wants to invest in a subsidiary in country N. The withholding tax rate between country K and country N is 15%, and the rate between country M and country K is 5%. At the same time, a bilateral tax treaty has been signed between M and N, in which the preferential withholding tax rate applicable to cross-border dividends, interest and royalties between country M and N is 5%. Company C first establishes an intermediary company B in country M but does not carry out any substantive business activity. In the second step, company C invests in company A through company B. In this case, the dividends distributed by company A will first be distributed to company B at the preferential withholding tax rate of 5%. Company B then distributes the dividend to Company C at the preferential tax rate between countries M and K. Through this structure, the company in country K reduces the tax burden on dividends, but the tax benefits of country N are eroded. Such abuse of tax treaties not only harms the tax interests of relevant countries but also weakens the willingness of countries to conclude tax treaties, which is harmful to the development of international tax cooperation.

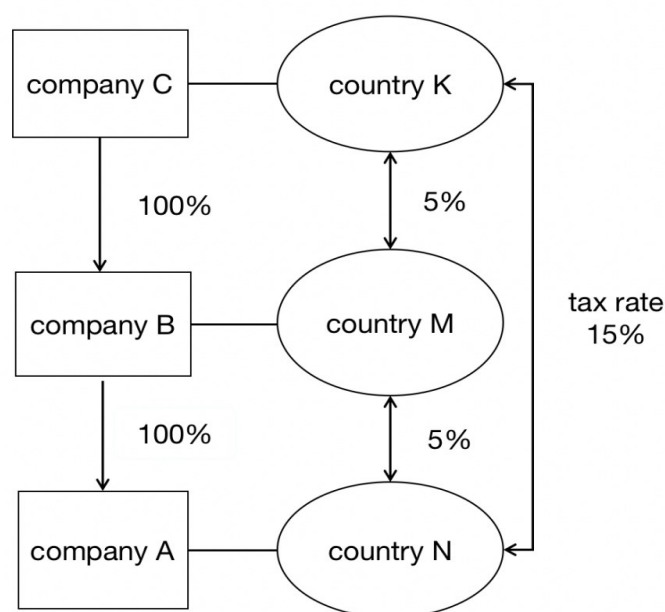


Figure 1: A typical business structure designed for tax treaty abuse.

In this case, the application of the beneficial ownership rule can effectively identify whether the beneficial owner of the cross-border investment is a resident of the contracting party, excluding agents, nominees, and conduit companies from beneficial owners, preventing the inappropriate grant of treaty benefits. Therefore, the beneficial ownership rule plays a crucial role in combating tax avoidance.

4. Analysis on the Standard of Identifying Beneficial Owner of Tax Treaties Based on Typical Cases

The concept of a beneficial owner originated from equity and trust. After centuries of development, this concept has gradually expanded from trust law and inheritance law to the entire field of tax law. Although there is no consensus on what a beneficial owner is in international tax law, three standards have been formed on how to identify a beneficial owner, namely, the standard of legal nature, the standard of economic substance, and the mixed standard. The standard of legal nature and economic substance are the general standards for identifying beneficial owners, but some countries use mixed standards to identify beneficial owners.

Since the concept of the beneficial owner was introduced into the tax law, domestic courts have dealt with international tax-related disputes by interpreting the beneficial ownership rule. When the courts of major developed countries solve the disputes concerning the international tax of passive investment income, there are three main rules for the interpretation and application of beneficial ownership.

4.1. The Standard of Legal Nature

The standard of legal nature focuses on examining the rights and obligations of the parties involved in the transaction concerning the income, and judging which party has a contractual or legal right to the income. When a resident of one Contracting State pays dividends, interest and royalties to the other Contracting State, according to the relevant contract or law, which party shall enjoy the income, and the party who enjoys the income shall not undertake to transfer the income to other parties under contractual or legal obligation, then that party is the beneficial owner.

The Canadian case of *Prévost* is a classic case in which the beneficial owner was identified using the standard of legal nature. Figure 2 is a clear illustration of this case. In 2009, Canada-based company *Prévost* applied to the Federal Court of Appeal of Canada for an appeal in its case. The focus is whether the dividends paid by *Prévost* to its parent company in the Netherlands can be covered by the bilateral tax treaty between Canada and the Netherlands, that is, whether *Prévost* can be recognized as the beneficial owner.

In 2009, the Federal Court of Appeal of Canada ruled that the Dutch holding company was the beneficial owner of the dividend. The court held that, after careful review, the Dutch holding company had no legal obligation under the Canadian Corporations Act, contractual or otherwise, to pay dividends received from *Prévost* to its shareholders, even though the Dutch holding company was co-founded by the UK's *Henlys* and Sweden's *Volvo* and was set up to take full ownership and control of *Prévost*. The court considers that the beneficial owner of a dividend is a person who takes advantage of the dividend for the recipient's purposes, enjoys the benefit, and assumes the risks of the dividend received. Once an entity is identified as the beneficial owner of a dividend, the entity has all rights to and assumes all risks and obligations in, the dividend based on its ownership of the dividend. In short, the beneficial owner of the dividend is not obliged to anyone to dispose of the dividend, and he owns and uses the dividend solely for his benefit [7].

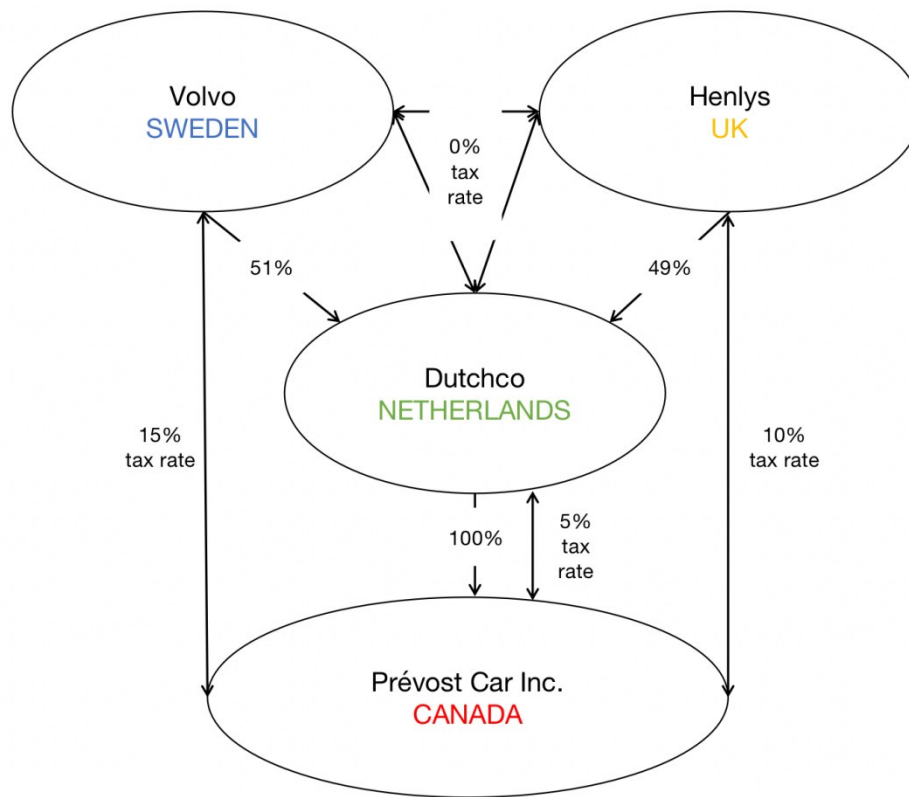


Figure 2: An illustration of *Canada v. Prévost Car Inc.*

In this case, two points are worth pondering. First, the Federal Court of Appeal of Canada has adopted the standard of legal nature as to whether a dividend recipient is a beneficial owner. A key point in the application of the standard of legal nature is that the court will generally consider whether the dividend recipient is obliged to transfer the received dividend to a third party (its controlling shareholder or another related party) as the key to determining whether it is a beneficial owner. Second, although after a court investigation, the Dutch company did not have the employees and office to match the dividends it received, and ostensibly had the characteristics of a conduit company, it had legal rights to the income it received, in line with the beneficial owner identity.

Similar to the *Prévost* case, in *Canada v. VELCRO CANADA INC.*, the Canadian court also adopted the standard of legal nature in confirming the beneficial owner [8].

4.2. The Standard of Economic Substance

The economic substance standard focuses on the economic substance behind the relevant transaction, and it explores the real beneficiary of the dividends, interest and royalties received. It is often the case that a resident enterprise established in one Contracting State is controlled by another company (the parent company), but the former is not contractually or legally obligated to transfer the dividends, interest and royalties received from the other Contracting State to the latter (the parent company).

However, from the standard of economic substance, whether the subsidiary needs to transfer the cross-border income to its holding company is determined by the parent company. If the subsidiary company has transferred all or most of the cross-border income to its parent company, according to the standard of legal nature, the subsidiary is the beneficial owner of the income, because the standard of legal nature focuses on the apparent "beneficiality" of the transaction when determining whether the party involved in the transaction is beneficial owner; however, according to the standard of economic substance, it is difficult for the subsidiary to be identified as the beneficial owner of cross-

border income because the parent company is the real beneficiary of the cross-border income. The economic substance standard determines whether the party involved in the transaction has the status of the beneficial owner not only by the examination of the apparent owner of the cross-border income, but also by examining the transmission channel of passive investment income to find the ultimate beneficiary. This is fully reflected in *Real Madrid F.C. v. Oficina Nacional de Inspeccion*.

In this case, Real Madrid paid royalties to a Hungarian company, and at about the same time, the Hungarian company transferred some of the revenue to a Dutch company and a Cypriot company. After an investigation by the Spanish court, the court determined that the purpose of the business structure was to obtain treaty benefits because the preferential withholding tax rate for royalties stipulated in the Spain-Hungary bilateral tax treaty is 0%.

The Spanish tax authority argued that the Hungarian company was not the beneficial owner of the royalties under the provisions of the Spain-Hungary bilateral tax treaty. In this case, the court interprets the beneficial owner clause as an anti-treaty abuse clause, and the reasoning process is similar to the principle adopted in the annotations of the OECD Model, that is, from the perspective of economic substance standard, to explore who is the real beneficiary of the royalties [9].

4.3. The Mixed Standard

A typical case that uses the mixed standard to confirm the identity of the beneficial owner is *Indofood International Finance Ltd v. JP Morgan Chase Bank NA*. In 2002, an Indonesian company PT Indofood Sukses Makmur TBK wanted to raise capital by the issue of loan notes on the international market. If it did so by itself, the company would have been obliged under Indonesian law to deduct 20% of the interest payable to the note-holders and pay it to the Indonesian Revenue. This liability ("withholding tax") could be reduced to 10% if the issue of the loan notes was made by a wholly owned subsidiary incorporated in the Republic of Mauritius and the capital so raised was lent to the parent company on terms that complied with the conditions specified in the Indonesian/Mauritius Double Tax Agreement [10]. Therefore, the company opted for an alternative business structure: issuing bonds through a subsidiary in Mauritius, instead of through the Indonesia parent company.

Indonesia soon after suspended the bilateral tax treaty with Mauritius due to the above-mentioned problem of tax evasion. To avoid the loss of interest income, the Indonesian company established a subsidiary in the Netherlands to replace the Mauritius subsidiary, because the Dutch/Indonesia Double Tax Agreement stipulates that the withholding tax rate on interest is preferential at 10%. An issue arising in this structure is whether the Dutch subsidiary will be considered the beneficial owner of the interest under the Netherlands-Indonesia double tax treaty since the Dutch company will pay the interest to other parties upon receipt of it. After the court's investigation, under the terms of the loan contract, the Dutch subsidiary was obliged to transfer the interest earned from the parent company in Indonesia to the bondholders within 48 hours without any reservation. Accordingly, the court held that the Dutch subsidiary, acting as an intermediary company, was not the beneficial owner of the interest, because it had a legal obligation under the contract to pay the interest earned to the bondholders.

In the above case, the meaning of the term beneficial owner is not limited to legal understanding, but also needs to identify and analyze the identity of the beneficial owner in combination with economic substance. Analyzing the above transaction by its economic substance, the bond issuer (the newly established subsidiary in the Netherlands) is obliged to pay the bondholders the interest received from the parent company (the Indonesian company).

5. Development Trend of Standard of Identifying Beneficial Owner

5.1. Comparison of the Current Standards

The legal nature standard focuses on examining the legal and contractual relationship between the two parties to the transaction. Compared with that, the economic substance standard breaks through the legal relationship between the two parties and explores the real beneficiaries behind the transaction. The economic substance standard does not limit the scope of review to the payers and receivers of dividends, interest and royalties, but takes into account the controlling parties and beneficiaries behind the relevant transactions. With this penetrating method, it makes more difficult the identification of beneficial owner, which is conducive to regulating the abuse of tax treaties. However, because of the complex multinational enterprise structures, more tax intelligence is needed to explore the motives and beneficiaries behind the transactions.

In practice, using the standard of legal nature and the standard of economic substance is the most common way of confirming the status of the beneficial owner, each of which has its advantages and disadvantages. The standard of legal nature has a clearer judgment process, so it is more predictable. Tax authorities have less discretion in the enforcement and, therefore, fewer related tax disputes arise. However, due to its clearness, it is more likely that multinational enterprises can make use of it to be identified as beneficial owners by designing complex business structures after analysis of relevant tax treaty provisions.

Using the economic substance standard can pierce the veil of the transaction to explore the real beneficiary behind it. It can regulate effectively the behavior of multinational enterprises abusing the agreement to avoid tax, and safeguard the tax benefits of sovereign states. However, compared with the standard of legal nature, the economic substance standard requires more tax information, and the identification is more ambiguous. Therefore, the tax authority has greater discretionary power, resulting in more tax disputes.

5.2. Suggestions on Establishing Reasonable Standards

5.2.1. Specify the Rule for Identifying Beneficial Owner

When judging whether the applicant takes tax evasion and tax avoidance as the main purpose or one of the main purposes of the tax arrangement, the tax authority shall take into account whether the applicant has substantial business activities.

When examining whether an applicant meets the conditions of "engaging in substantive business activities", it is recommended to distinguish the nature of the entities to apply different judgment standards. (1) If the applicant belongs to an industrial entity: the focus of the review is whether it has performed the corresponding functions for its business activities, such as product manufacturing, product promotion, and publicity, and whether it pays wages to employees; (2) If the applicant is an investment holding company: the focus of the review is to judge whether its management activities constitute substantial business activities; (3) If the applicant belongs to an enterprise with both industrial operation and investment holding management activities: firstly, according to standard (2), whether its investment holding management activities constitute substantive business activities shall be reviewed and judged. If the examination result is affirmative, the applicant meets the conditions for the identification of the beneficial owner; if the examination result is negative, then examine whether the entity's business activities are significant, if the examination result is affirmative, it meets the identification standard of beneficial owner.

5.2.2. Strengthen the Exchange of Tax Information Between Countries

Compared with the standard of legal nature, using the substantial economic substance standard to determine the beneficial owner requires more tax information collected, and the tax authority needs to make a comprehensive analysis based on the situation of the specific case. In this case, the amount of tax information that the tax authority needs to collect is huge, but requiring the applicant to submit all tax information will increase the burden of proof on the applicant, and the applicant is very likely to provide false information. In 2016, developed countries such as the United Kingdom, France, and Germany announced that they would implement an automatic exchange mechanism for information on the ultimate beneficiaries of enterprises. Developing countries should strengthen the exchange of tax information with developed countries. In this way, on the one hand, the burden of proof of the applicant can be reduced; on the other hand, more information on the structure of multinational enterprises can be obtained, a list of potential beneficial owners can be established, and a special examination can be conducted on enterprises that may have abused tax treaties.

6. Conclusion

The vigorous development of international trade and investment activities has spawned many large multinational enterprises, which, through investment, deliver capital and advanced technology to host countries and obtain investment benefits in return. In this process, tax treaty abuse like tax evasion and avoidance has become more and more frequent, causing huge losses to the tax interests of all countries in the world. As a result, the problem of tax treaty abuse has received widespread attention from the international community. The beneficial ownership rule is gaining prominence as the main anti-avoidance measure to regulate investment income from dividends, interest and royalties. However, in the field of international taxation, scholars have been debating the issue of the beneficial owner. There are also differences between the OECD model and the standards adopted by courts in various countries when identifying beneficial owners. To sum up, there are three main identification standards: the standard of legal nature, the standard of economic substance, and the mixed standard. The year 2003 marked the change from the standard of legal nature to the standard of economic substance in the identification of the beneficial owner in the OECD Model. "substance-over-form" has also been recognized and adopted by more and more countries, and the economic substance factor is regarded as one of the important factors in identifying the beneficial owner [11]. Therefore, clearly defining the connotation and identification standards of the beneficial owner and regulating the abuse of tax treaties are not only conducive to creating a fair tax environment, and attracting foreign capital, but also maintaining tax interests.

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