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Tax Treaties, International Transactions and Beneficial Ownership (Part I)

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As tax planning becomes increasingly international, M&A practitioners must pay attention to the confusing matrix of international tax treaties. This involves teasing through the nuances of sometimes strange language. And often, one must pay particular attention to the concept of beneficial ownership.

The concept is relatively simple, as tax law goes. Tax treaty benefits are only allowed if a recipient of income located in one state actually beneficially owns the income it receives. If the payee is merely passing the income on to another entity and *for* another entity, it cannot take advantage of reduced treaty rates. So far, so good.

But determining whether a payee is a beneficial owner of income can be difficult in practice. The Organisation for Economic Co-operation and Development (OECD) has provided multiple rounds of commentary. Even so, identifying the beneficial owner can be tough.

The OECD is legitimately concerned about treaty shopping and the use of conduit companies to obtain treaty benefits. Still, there must be a balance between anti-abuse provisions and clear rules that assure certainty to businesses. It's a delicate balance to strike, and the OECD may have missed the mark.

By trying to use beneficial ownership as a more general anti-abuse provision, the OECD may have detracted from the utility of the concept. What's worse, it appears to have created confusion in international tax planning.

Thankfully, a revised draft commentary by the OECD published last year suggests it is at least moving in the right direction. However, even if the revised commentary is adopted, companies will have to grapple with the uncertainty of operating in hundreds of different jurisdictions with unpredictable taxing authorities. Tax treaties should offer safe harbors from this uncertain world, not add to the

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chaos. By examining the OECD Commentary and judicial decisions in this area, one can discern at least *some* practical guidance.

Original Beneficial Ownership Requirement

Tax treaties can provide reduced rates of taxation for payments of interest, dividends or royalties. Treaties generally require that the payment be made by a qualified resident of one contracting state to a qualified resident of the other contracting state. In order to qualify for benefits, many OECD-based treaties tack on another requirement. These treaties expressly require the payee to be the "beneficial owner" of a payment.

What does it mean to be a "beneficial owner"? This gets tricky. Originally, the OECD Commentary simply stated that tax treaty benefits are not available when an "intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer." [*See OECD Model Tax Convention on Income and on Capital: Commentary on Article 10*, at ¶12 (1977).]

This language was not excessively clear, but it was plain enough. By referencing agents and nominees, it suggested that the proper focus of the beneficial ownership question was one of *control*. In other words, if an intermediary entity has no right to control the income it receives, and is *required* to pass it on to another subsidiary, it is not entitled to treaty benefits.

The reference to agency or nominee status gave some focus to international M&A planning. As usual with tax law, the OECD's attempt at guidance was just the beginning of a developing saga.

2003 Commentary— Substance-over-Form Vagueness

In 2003, the OECD added additional commentary that injected further confusion into the beneficial ownership concept. The revised commentary included substance-over-form language to the definition of beneficial owner. The OECD Commentary notes that the "term 'beneficial owner' is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance." [*OECD Model Tax Convention on Income and on Capital: Commentary on Article 10*, at ¶12.1 (2003).]

This change was obviously troubling for practitioners seeking clarity. When you want to be sure that your tax plans turn out as intended, narrow technical definitions can be exactly what you need. With the revised language, there was now uncertainty as to whether a payee would be entitled to treaty benefits as long as it had the full legal right to control its own income.

If a payee in one country chose to pass on or to on-lend income to an entity in a third country, treaty benefits could be at risk. The threat that a tax collector in Mozambique or a court in Uzbekistan might apply substance-over-form principles to deny treaty benefits

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to cross-border payments added uncertainty to international tax planning in M&A deals. Courts in various countries have since struggled with the concept.

Indofood—Back-to-Back Loans and the Bankruptcy Test

In 2006, a U.K. Court of Appeals did provide a little clarity when it analyzed beneficial ownership in *Indofood International Finance Ltd. v. JPMorgan Chase Bank, N.A., London Branch*. [2006 EWCA Civ 158 (Mar. 2, 2006), TaxAnalysts Doc 2006-11532, 17.] This was the first instance in which a court, rather than the OECD itself, addressed the meaning of the term "beneficial ownership" under an OECD-based tax treaty. It should be noted that *Indofood* was not a tax case. Its discussion regarding beneficial ownership related to analyzing tax gross-up provisions in a private contract.

In *Indofood,* an Indonesian company had previously set up a Mauritian SPV to issue loan notes in order to take advantage of interest withholding rates under the Indonesia-Mauritius tax treaty. The Mauritian SPV issued notes and, on the same day, on-lent the funds it had raised to the Indonesian company on substantially the same terms as the notes. Unfortunately, the Indonesia-Mauritius treaty had been terminated.

In due course, the parties commenced litigation over tax gross-up obligations. The question before the court was whether there was an alternative to the tax gross-up. Specifically, they asked whether a Dutch entity could be interposed and assigned the benefit of the loan agreement between the Indonesian company and the Mauritian SPV in order to take advantage of the Netherlands-Indonesia tax treaty.

As a business matter, this seemed quite sensible. The theory was that this creative fix might preserve the tax benefit that had existed under the original arrangement. And that would obviate the nasty dispute.

The *Indofood* court held that, based on the existing obligations under the notes, the new Dutch entity would be a mere "administrator of the income" and not the beneficial owner. The court held that establishing the Dutch entity would not solve the problem, and the gross-up required by the parties' contract would still be triggered. The implication of the court's decision is that the prior arrangement also ran afoul of the beneficial ownership requirement in the Indonesia-Mauritius treaty.

Yet despite holding that the Dutch entity would not beneficially own the income, the *Indofood* court was not necessarily guilty of applying a vague substance-over-form approach. Indeed, the court cited a sensible and clear test for beneficial ownership that focused on the potential bankruptcy of the intermediary. The court cited this "bankruptcy test" as articulated by Professor Philip Baker QC, who asks, "What would happen if the recipient went bankrupt before paying over the income to the intended, ultimate recipient?"

The bankruptcy test suggests that if the ultimate recipient could claim the funds after such a bankruptcy, then the intermediary is not the beneficial owner. However, if the ultimate recipient could not claim the funds, then the intermediary is properly considered the beneficial owner. The bankruptcy test was apparently not satisfied in *Indofood* because the Indonesian company had jointly and severally guaranteed the notes issued by the Mauritanian SPV.

Such an approach to beneficial ownership makes sense. It also contributes much-needed clarity to the OECD's reference to agents and nominees. After all, credit risk certainly matters in international finance; just look at the collapse of Lehman Brothers and the painful consequences for its unsecured creditors.

In international M&A, passing the bankruptcy test is a good first step to making sure that an intermediate entity can receive treaty benefits as a beneficial owner of income. Nevertheless, *Indofood* did not suggest that the bankruptcy test is the end of the analysis. Given the substance-over-form language in the OECD Commentary, this is unlikely.

All aspects of a transaction must be considered when analyzing beneficial ownership. Given the OECD Commentary's substance-over-form language, it is still possible that an entity with full legal control over income might not be considered the beneficial owner. If a recipient of income appears to be merely passing the income on to another entity in order to take advantage of treaty benefits, it might lose its entitlement to those treaty benefits.

Prévost Car—Formalism but with a Domestic Trap

Prévost Car Inc. v. The Queen, a decision of the Canadian Tax Court, is the second instance in which a court considered the meaning of the term "beneficial owner" under an OECD tax treaty. [2008 DTC 3080.]

The facts of the case involve a Swedish company and a British company that established a holding company in the Netherlands. The Swedish company held 51 percent of its shares and the British company held 49 percent. The holding company held shares of Prévost Car, a Canadian taxpayer.

Pursuant to a shareholders agreement, 80 percent of the profits of the holding company and its subsidiaries were to be distributed each year in the form of dividends, returns of capital or repayment of loans. Accordingly, Prévost Car paid dividends to the holding company, which then passed the dividend on to its shareholders. The distribution of profits was subject to there being sufficient financial resources to meet capital requirements.

The Canadian tax authority argued that the Netherlands holding company was not the beneficial owner of dividends received from Prévost Car. However, the court disagreed, reasoning that the holding company had complete control over the dividends. In contrast, an agent, nominee or conduit company "*never* has any attribute of ownership of the dividend."

The court relied on Canada's domestic law definition of "beneficial owner" as the person who "receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend received." The court was persuaded that prior to distribution of the dividends to the shareholders, the holding company held the monies represented by the dividend as an asset. As in *Indofood*, the bankruptcy test was relevant to the question of beneficial ownership.

In addition, the court found there was no evidence that dividends from Prévost Car were *ab initio* destined for the shareholders. The court found it significant that the holding company was not party to the shareholders agreement. *Prévost Car's* willingness to clearly define the terms and boundaries of beneficial ownership is a welcome respite for M&A practitioners seeking clarity and certainty.

Mixed Message?

But the decision is troubling in some respects. Given *Prévost Car's* reliance on Canadian domestic law for the definition of beneficial ownership, it is difficult to say whether the case offers general support for a more formalistic approach to beneficial ownership in OECD-based treaties. After all, other jurisdictions may have broader definitions of beneficial ownership in their local law than Canadian law reflects.

In fact, *Prévost Car* made a potentially significant statement on the use of the OECD Commentary itself. It noted that the OECD Commentary is "somewhat suspect" in determining the intention of the drafters of a tax treaty that was signed prior to the Commentary in question. But, the court did note that such commentary "can provide some assistance" at clarifying the meaning of earlier terms. Practitioners should be aware of all the OECD Commentary on beneficial ownership, no matter how old the particular tax treaty may be.

Also, it is not clear whether the more formalistic approach adopted by the *Prévost Car* court was due to the generally favorable facts presented to the court. For example, the court notes that it would have been concerned about a "predetermined or automatic flow of funds." What about situations in which income is "*ab initio* destined for" another party, with the recipient acting "as a funnel" or "a conduit" in order to flow the income through to the other party?

The court implies that it might have ruled differently. There is also language in *Prévost Car* suggesting that a title owner of property may not be the beneficial owner if it is subject to another party's instructions as to the exercise of its ownership rights. The court states that the corporate veil should not be pierced unless a corporation is a conduit "*or has agreed to act on someone else's behalf pursuant to that person's instructions without any right to do other than what that person instructs it*, for example, a stockbroker who is the registered owner of the shares it holds for clients."

This last point is potentially crucial for M&A practitioners. If you want a party to be considered as the beneficial owner of income it receives, make certain that it is not subject to another party's instructions as to its ownership rights. What if the legal arrangements say one thing, but in reality one party routinely takes instruction from its counterparty regarding the exercise of its ownership or voting rights?

It is not overly cautious to suggest that treaty benefits might be in jeopardy. This concern is important to heed regardless of the particular deal being planned. The transaction may involve a conduit financing, a financial product such as a credit default swap or a total return swap, or some other cross-border transaction. Whatever the circumstance, before counting on the bounty of treaty benefits, consider the optics and the substance of who really has control over the income.

China—Substantial Business Operation Is Needed

The primary difficulty with the *Prévost Car* opinion for international M&A planning is that it suggests that domestic law controls the definition of beneficial ownership. In this limited sense, *Indofood* is a more helpful opinion, since it relied on an "international" meaning of the term.

Different jurisdictions can have different understandings of what it means to be a beneficial owner. Plainly, this can be a headache for tax planning. For example, China has issued a Circular that defines a beneficial owner as one who meets all the following four conditions:

1. A person who has the right to own or dispose of the income and rights or property in the income
2. A person who is usually engaged in a substantial business operation
3. A person who is not an agent
4. A person who is not a conduit company

[*See* Circular 601 (Oct. 27, 2009).] The first and third conditions make sense, and they focus on control and the person's legal rights with respect to the payment. However, the second requirement, that the person be "usually engaged in a substantial business operation," is arguably a step beyond what the OECD Model Treaty requires.

Indeed, it goes beyond what many international M&A deals contemplate. Prudent international tax planners may want to heed this requirement, even in jurisdictions that don't expressly enunciate it.

The fourth requirement, regarding conduit companies, is also one that international M&A practitioners must keep in mind. China might deny treaty benefits even to an entity that has full legal control over a payment and whose creditors may claim the payment in the event of bankruptcy. Mere control over the income and lack of agency or nominee status may not be enough to qualify as a beneficial owner in China. The same could be true in other jurisdictions that take a similar approach.

It is worth noting that the United States takes a similar approach. The U.S. Treasury Department has issued conduit financing regulations under Internal Revenue Code Section 881. These regulations apply to back-to-back financing transactions among related parties where one is a disregarded entity for U.S. tax purposes. If a transaction falls under these regulations, treaty benefits can be denied. So these issues can pop up all over the world.

Beneficial Ownership Requirement Might Be Implied

What if your treaty has no "beneficial ownership" requirement? As it turns out, you still need to be careful. For one, U.S. tax treaties often have "limitations on benefits" clauses that function in a similar manner to the beneficial ownership requirement in OECD treaties. But even if an OECD treaty has no express beneficial ownership requirement, such a requirement might still be implied.

OECD Commentary states that the "requirement of beneficial ownership was introduced ... to clarify the meaning of the words 'paid ... to a resident.'" So, even if a tax treaty doesn't say that beneficial ownership of a payment is required for treaty benefits, a local taxing authority in some far-off land might disagree. This makes older treaties—those that have not been updated since 1977—worth worrying about as well.

Tax Treaties, International Transactions and Beneficial Ownership (Part II) *will appear in a future issue of* THE M&A TAX REPORT.