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THE BENEFICIAL OWNER CONCEPT IN THE CONTEXT OF BEPS: PROBLEMS AND PROSPECTS*

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Abstract

The article analyzes the evolution of the beneficial owner concept in the context of the implementation of the Action Plan on Base Erosion and Profit Shifting. The main problem is the lack of an officially fixed definition of the term beneficial owner in international legal documents. The lack of unification in the definition of the concept of beneficial ownership, the ongoing discussions on its application, the growth of tax disputes, as well as the incompleteness of the reform in terms of the regulation of the concept in the OECD MC and its Commentary lend urgency and relevance to scientific research of the latter both in domestic and in world science of tax law. Although the terms beneficial owner, beneficial ownership, and so forth in the BEPS Plan may not be used directly, they are nevertheless of great practical value, especially in the light of the implementation of Actions 6 and 15 of the Plan. The article concludes that the concept is potentially compatible with other anti-abuse strategies (the limitation on benefits rule and the principal purpose test, in particular). The main issue that is explored in disputes about the norms of international agreements application is the assessment of the business purpose and proper qualification

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of the substance of the transactions (deals) made. In general, the beneficial owner concept not only has not lost its role in the fight against treaty shopping, but has taken up an official position among the instruments to combat BEPS.

Key words: Tax law, OECD, beneficial owner, conduit company, treaty shopping, tax benefits, passive income, dividend, interest, royalty.

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1. Introduction

The overwhelming majority of international treaties (agreements) for the avoidance of double taxation (hereinafter termed as tax treaties) contain requirements for a beneficial owner as a binding provision to avail benefits and privileges under the treaty in the case of cross-border payment of passive income (dividends, interest and royalties). Therefore, the beneficial owner concept is of fundamental importance for all participants in international tax interactions: for fiscal bodies – in part of administrating foreign economic transactions, for taxpayers – in part of arranging international tax planning.

Today, international taxation, without exaggeration, is experiencing the era of implementation of the BEPS Plan, developed by the OECD in 2013 and successfully agreed by the countries of the world community[1].

In this context, the issue of the place of anti-avoidance strategies in the BEPS deployment is topical.

In particular, what is the role of the beneficial owner concept in the system of other measures to counter gaining improper tax benefits? The question is practically meaningful, as the fiscal authorities consider the beneficial owner concept as one of the instruments to counteract BEPS.

2. The problem of the beneficial owner concept uncertainty

The right to tax benefits under tax treaties should be grounded, and the bilateral nature of tax treaties objectively limits the circle of persons who are entitled to them. The appearance of the beneficial owner concept is stipulated by the reaction of the international legal communication participants (primarily the OECD) to the abuse of benefits and privileges provided by tax treaties (so-called treaty shopping).

This concept has acquired special significance as an anti-abuse instrument in connection with the massive development of international holding structures, increased mobility of

[1] The total list of countries that have joined the implementation of the BEPS Plan now covers 116 states [Members of the Inclusive Framework 2019].

investments, capital and intellectual property objects, as well as a radical increase in the share and importance of passive income in the world economy.

Treaty shopping in this context is expressed in the following: interdependent persons create an artificial scheme having introduced into the chain of treaty interactions a *transit* (intermediate, conduit) company, which is purposefully established as a resident of the country participating in the tax treaty, and which, receiving income from the resident of another contracting state (the state of source), fully or partially transfers it to a third person that is a resident of a state that does not participate in the treaty. Thus, the effect of *circumvention of the law* is achieved: tax benefits and tax treaty benefits intended for residents of participating states are received by a third person established in another tax jurisdiction, which is contrary to the object and purposes of the treaty.

Such abuses are usually associated with gaining passive income (dividends, interest, royalties) having a special regime of international taxation. Obviously, not an intermediary company, but namely such a *third person* acts de facto as the beneficial owner of such gains.

It is also evidently, that such schemes do not correspond to the intentions of the countries participating in tax treaties to limit granting tax treaty benefits exclusively by their own residents. Such an assessment of the situation fits perfectly into the doctrine of *substance over form*, presuming the priority of economic content over specific legal forms.

The doctrine of *beneficial owner* is a limiting provision under the treaty to receive tax benefits and privileges. A foreign company acting as a recipient of income from the resident of the country of source, in order to apply tax benefits under the treaty, should confirm having a *beneficial owner* status.

As is known, the term *beneficial owner* per se is borrowed by OECD from the Common law of Great Britain, where it was originally applied exclusively within the framework of trust law. Its actuality is due to the relative novelty of the institution in question for domestic law and order, as well as the fragmentation and incompleteness of its normative regulations, the lack of unification in interpretation and application, which generates numerous *zones of uncertainty* in cross-border tax relations (especially involving large holding structures, TNCs). This is evidenced by the growth of tax disputes related to the beneficial owner concept, as well as the significant activity of OECD and domestic legislators in resolving the gaps and contradictions that arise.

The main problem is the lack of an officially fixed definition of the term *beneficial owner* in international legal documents. Neither the OECD Model Convention on Income and Capital Taxes (hereinafter referred to as the OECD MC) using the term in the articles on dividends, interest and royalties since 1977, nor its Commentary contain the relevant

definition. The method of negative exclusion is used, that is, categories of subjects that are not recognized as beneficial owners (agents, nominees, conduit companies in the form of fiduciaries and income managers) are listed, and that accordingly, are not entitled to apply for benefits granted to residents of participating in tax treaties states.

The lack of a clear and uniform definition of the term *beneficial owner* in the OECD MC and the Commentary makes this concept rather vague, hindering practical identification of stakeholders as legitimate applicants for benefits under the treaty in taxing passive income. Attempts to solve the problem by including applicable definitions in individual tax treaties and into domestic legislation fail to compensate for the absence of a legitimate international legal concept *beneficial owner* and a uniform interpretation of its meaning.

Thus, the lack of unification in the definition of the beneficial ownership concept, the ongoing discussions on its application, the growth of tax disputes, as well as the incompleteness of the reform in terms of the regulation of the concept in the OECD MC and its Commentaries, lend significance and relevance to scientific research of the latter both in domestic and in the world science of tax law.

3. The BEPS Plan does not mention the beneficial owner concept. What does this mean?

By the beginning of the implementation of actions mapped out by the OECD in the BEPS Plan – the beneficial owner concept appeared to be in a state of definitive uncertainty. At the same time, among the main directions of this Plan there is action 6 *Prevent treaty abuse* – a set of anti-abuse strategies directed against the DTA abuse. Therefore, the question of the place of the beneficial owner concept in the system of other anti-abuse instruments used in the BEPS framework remains rather topical both from the theoretical and from the practical point of view.

The first question is related to the absence of any direct references to the «beneficial owner» in the BEPS materials that permits individual authors to modify or even cancel the concept in the BEPS context [Kotlyarov 2015: 44, 46-47].

However, most experts recognize the advisability of developing the doctrine in question in the light of OECD initiatives to combat treaty shopping. Despite the absence of direct references, the application of the beneficial owner concept derives inter alia from the provisions on hybrid cross-border schemes (Action 2), on the prevention of tax treaties abuse (Action 6) and the multilateral instrument development (Action 15).

Marcos Alvarez, Fernando Garcia and Natalia Marziali emphasize that the OECD Report on Action 6 of the BEPS Plan addresses the problem of conduit companies, which are a typical case of treaty shopping, effectively neutralized by the beneficial owner provision.

Moreover, this provision is topical not only because the current tax treaties include this very instrument to limit the treaty benefits, but also because in the vast majority of cases international tax treaties do not provide for a different type of limitations, contrary to the possibility provided by the OECD MC Commentary on Article 1 [Alvarez: 2018].

Most of the approaches developed both at the OECD level in general and among individual scientists and practicing lawyers support the need to keep the beneficial owner provision among anti-avoidance strategies even taking into account that the OECD highlights the two instruments application, namely: the principal purpose test (PPT) and the *limitation on benefits* (LOB) rule. The latest reform of OECD MC 2017 confirms this position – the changes introduced into the Commentary on OECD MC Articles 10-12, deals with the clarifications about the place of beneficial ownership among anti-avoidance rules already taking into account the BEPS Plan, having kept the concept as a whole unchanged.

Thus, the terms *beneficial owner, beneficial ownership* and so forth in the BEPS Plan may not be used directly, but nevertheless they have great practical value, especially in the light of the implementation of Actions 6 and 15 of the Plan.

4. The OECD Article 29 and its Commentaries

Commentaries on passive incomes updated in 2017 introduced a reference to new Article 29 (*Limitation on benefits*) which is a kind of *constructor* to formulate relevant DTA provisions. The footnote and the Commentaries on this Article indicate that it reflects the intentions of the states included in the preamble of the OECD MC to eliminate double taxation without creating opportunities for tax exemption or tax reduction by tax evasion, including through treaty shopping schemes.

The enumerated intentions and wording of OECD MC 2017 Article 29 are consistent with the minimum standard agreed by the OECD and G20 under the BEPS Plan and described in paragraph 22 of the OECD Final Report on Action 6 of the BEPS Plan.

According to the latter, the elaboration of the article of a specific tax treaty depends on the contracting states' choice of a particular application of the agreed minimum standard. Depending on the circumstances, the states: (1) can only accept a general anti-avoidance rule (paragraph 9 of the Article), or (2) instead they can adopt a detailed version of specific anti-avoidance rules (paragraphs 1-7 of the Article) with their complementation, the mechanism relating to situations with conduit companies that are not affected by other provisions of the OECD MC, or (3) may prefer to include in the tax treaty a general anti-avoidance rule in accordance with paragraph 9 of the Article together with any set of specific rules of paragraphs 1-7 of Article 29.

Commentaries on Article 29 favor the latter version, as it combines the flexibility of GAAR to prevent a large number of tax abuses, with confidence in easy, *automatic* nature of the application of the *simplified version* of rules of paragraphs 1-7 (for example, under the criterion of a foreign owner). In this case, even if the specific anti-avoidance rules of paragraphs 1-7 are not applicable to the transaction or arrangement, the latter do not fall outside the scope of paragraph 9.

Along with this, the state can refuse from the general anti-avoidance rule of paragraph 9, relying on the specific rules of paragraphs 1-7 in combination with special measures to counteract schemes involving conduit companies. This is possible, if the *tough* anti-avoidance rules, sufficient to combat other forms of tax treaty are available in domestic legislation.

States that have chosen such an approach need to ensure the reliability of the version of Article 29 paragraphs 1-7 rules, being included in the DTA sufficient to prevent most forms of treaty shopping. Thus, the current version of the OECD MC expects the states not willing to include the general anti-avoidance rule of paragraph 9 in the tax treaty to adopt not *simplified* but detailed versions of the special anti-avoidance rules of paragraphs 1-7.

The OECD MC Article 29 also contains provisions aimed at opposing treaty shopping when persons not residents of Contracting States establish an organization – a resident of one Contracting State to reduce or fully exempt from taxation in the other Contracting State by receiving a benefit under the DTA between the two States.

According to the OECD MC Commentary on Article 29 receiving tax benefits through treaty shopping by a person who does not have direct access to the benefits under the treaty is able to prevent the bilateral and reciprocal nature of the tax treaty.

Knowing that citizens have the opportunity to indirectly gain access to benefits under a tax treaty concluded by another state, this or that state may lose interest in granting mutual benefits to residents of another state through concluding a tax treaty with it. The benefits derived indirectly can be unacceptable also for the tax system of the state, if, for example, the latter does not levy income tax on a certain type of income.

The OECD MC Article 29 paragraphs 1-7 provisions are aimed at refusing to grant treaty benefits to the structures normally used to indirectly obtaining tax benefits by persons who are not directly entitled to these benefits. However, Article 29 allows the competent authorities to grant benefits if they consider that the structure did not deem receiving benefits under the tax treaty to be one of its main objectives.

It should be noted that Article 29 restricts the application of other provisions of the OECD MC. So, by virtue of Article 29 a resident of one Contracting State is not entitled to a tax

treaty benefit if he is not a *qualified* person in accordance with paragraph 2 or if benefits are granted under the provisions of paragraphs 3-6.

On the other hand, a person is enabled to apply for benefits even if he is not a *qualified person* in the case when the income received is related to an actively operating business in the state of his tax domicile. In some cases, persons belonging to third-country residents are eligible for benefits, provided that they would be entitled to equivalent benefits if they invested directly.

And similarly, up to a provision that allows the competent authority of a Contracting State to grant contractual benefits at its own discretion even when other provisions of Article 29 deny this possibility.

Thus, the new OECD MC Article 29 together with its Commentary is a summary of the implementation of the OECD Final Report proposals on Action 6 of the BEPS Plan. The specific scope and effect of restrictions on granting tax benefits to be included in tax treaties was determined by each country when signing on June 17, 2017, Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI), prepared under Action 15 of the BEPS Plan [Eckert 2017].

5. Correlation of the beneficial owner concept, the «limitation on benefits» rule and the principal purpose test

The final OECD Report on Action 6 of the BEPS Plan recommends that the tax agreements should include PPT and LOB rules either (1) simultaneously, or (2) only PPT or (3) LOB, supplemented by special rules for countering schemes with conduit companies.

Therefore, the answer to the question of the compatibility of the beneficial ownership concept with the BEPS Plan depends, first of all, on its compatibility with the LOB and / or PPT rules.

As is known, the *limitation on benefits* (LOB) rule is a provision of tax treaties to refuse to grant tax benefits when abusing the treaty provisions on the part of the taxpayer[2].

It can be formulated either in the form of a general permission to the competent authorities to refuse to grant benefits in case of revealing such abuse, or to be present in the text of the treaty as a specific test, in accordance with which the taxpayer is entitled to claim benefits and privileges under the tax treaty. In particular, it is possible to single out:

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[2] The LOB rule was originally stipulated by the US Model Tax Convention in force since 1981 and is present in virtually all DTAs concluded by the US [United States Model Income Tax Convention: Art. 22].

- a test for ownership or *the look-through approach* (benefits are granted depending on the presence of direct or indirect participation of the income recipient in the income payer capital);

- the *subject-to-tax approach* (benefits are granted only when the income is taxed in the state of residence of the income recipient);

- a base erosion test (*the channel approach*) (if a resident from a third state controls the income recipient, and a certain share of the latter's income is used in the interests of such a resident, then the income recepient is not provided with benefits under the treaty);

- the *general bona fide provision* (the income recipient can apply for benefits under the treaty if his behavior, transactions and the composition of property that yield income correspond to reasonable commercial rules);

- the *activity provision* (benefits under the treaty are provided if the income recipient carries out active entrepreneurial activity in the state of his residence and the income gained is related to such activities);

- *the amount of tax provision* (benefits are granted in amounts not exceeding the amount of taxes actually paid by the recipient of income in the state of his residence);

- *the stock exchange provision* (the recipient of income enjoys benefits under the treaty if (1) a certain category of his shares is quoted on the stock exchange in the state of his residence, or (2) the recipient is directly or indirectly controlled by the company a certain shares category of which is quoted on the stock exchange in the state of its residence);

- the *competent authority provision* (benefits are granted if the competent authority of the state of source, within the granted discretion, permits such benefits application).

In turn, the principal purpose test (PPT) makes gaining tax benefits provided for in the treaty, depending on the purpose pursued by the taxpayer. The latter is deprived of the right to benefits if the competent body, after examining the actual circumstances, concludes that receiving benefits under the treaty is the principal purpose of the transaction.

The PPT rule is known to the OECD MC Commentaries excluding the granting of benefits if the principal purpose of transactions or concluded arrangements was to provide a more favorable taxation provision and in specific circumstances this is contrary to the object and purposes of the treaty provisions (paragraph 61 of the Commentary on OECD MC 2017 Article 1, paragraph 9.5 in the previous versions, respectively).

Concerning the compatibility of the concept of beneficial ownership with LOB and PPT rules, different sometimes mutually exclusive positions have been formed in the tax literature.

So, for instance, Koichiro Yoshimura, exploring the possibility of sharing the provisions of the beneficial owner and LOB, comes to the conclusion about the advisability of such a combination. In his opinion, the LOB rule sets clear standards when the probability and / or degree of tax abuses are high; on the contrary, the beneficial owner provision covers cases of tax evasion, when the probability or degree of tax abuses are not obvious (therefore they are not *captured* by the LOB). In this sense, it is advisable to apply namely the concept of a beneficial owner, since it takes into account the very nature of conduit companies.

In addition, ideal enforcement is hardly achievable here, and costs for the practical implementation of the concept can be high. Then it is necessary to resort to the LOB rule, which is implemented by means of simpler and more accessible criteria. At the same time, it is important to separate the functions of the indicated anti-avoidance instruments, since the results (legal consequences) of their application are different. A taxpayer who does not meet the LOB is unable to use benefits under DTA in principle, while a taxpayer who fails to qualify as a beneficial owner cannot use the treaty privileges only to the extent that he is not recognized as actually being entitled to a particular income. This difference is justified, since the LOB rule *catches* cases with a high probability of tax anti evasion [Yoshimura, 2013: 779-780].

Thus, as part of the implementation of the BEPS Plan, the beneficial owner concept and the LOB rule are capable of not excluding, but mutually complement each other.

Professor Robert J. Danone and his disciple Benjamin Malek advocate a different perspective on the compatibility of the anti-avoidance strategies under consideration. They believe that the interaction of the principal purpose test with the concept of beneficial ownership depends on the interpretation of the latter.

In their view, the OECD MC 2014 has narrowed the concept of beneficial ownership to such a degree that it probably no longer covers conduit companies. Subsequently, the Report on Action 6 of the BEPS Plan and the OECD MC 2017 does not at all mention the concept with regard to countering schemes involving conduit companies.

In this context, the OECD recommends the use of either a principal purpose test (PPT) or a specific anti-avoidance rule (SAAR). Even if the tax jurisdiction continues to use a broad interpretation of the term *beneficial owner*, this concept may contradict the PPT.

Under a broad interpretation, the latter is applicable to most schemes involving conduit companies. In such a case, in relation to them, it is a specific anti-avoidance rule – SAAR,

while PPT is more general, ie, it is GAAR and, following the maxim lex specialis derogat legi generali, the concept of beneficial ownership must have priority over PPT.

But according to Danone and Malek the application of the concept does not always have the same consequences as the PPT. Broadly interpreted, the concept of beneficial ownership, aimed at objective factors, will lead to the abandonment of benefits under DTA where the application of PPT, taking into account the purpose and business rationale for transactions, on the contrary, would dictate their provision [Danon 2018: 54-55, Malek 2018:66-69].

6. The positions of the courts on the application of the anti-abuse instruments to resolve tax disputes

The main conclusion, possible to obtain from the court practice analysis, witnesses the opportunity of simultaneous application of the doctrine of a business purpose and the concept of beneficial ownership while resolving disputes on granting tax benefits under tax treaties. It is hardly possible to imagine a situation where the application of the concept under consideration will lead to the abandonment to grant benefits in the framework of the tax treaty, but at the same time will leave room to provide for the treaty benefits in accordance with the business purpose doctrine.

The recent years court practice demonstrates the increasing role of the principal purpose test in tax disputes on the application of tax treaties, covering (1) disputes about the legitimacy of tax benefits application (reduced rates, exemptions from taxation) by Russian companies paying passive income abroad and (2) disputes on schemes of deduction from taxation of income from activities in the territory of the Russian Federation via transfer to offshore or low-tax jurisdictions.

According to the position of the fiscal authorities of most countries, the main issue being explored in disputes over the application of norms of international treaties is the assessment of the business purpose and proper qualification of the essence of the transactions (deals) made.

At the same time, the burden of proof is redistributed not in favor of taxpayers who, according to tax authorities, should ground necessity to conduct transactions (deals) in a certain form and involvement of foreign companies in the business structure and transactions (deals), as well as afford proof of the reasonableness of the choice and relevance of entrepreneurial risk.

7. The beneficial owner concept is an effective instrument to counter treaty shopping

What are the implications of implementing the BEPS Plan for the *beneficial owner* concept at the present situation? First of all, it should be noted that the latest OECD MC reform, resulted in the wording of 2017, retained the concept in essence unchanged regarding the the OECD MC 2014 version. This indicates that there is no conflict in the system of anti-abuse tools included in the OECD MC for various reasons.

However, it cannot be ruled out that the subsequent practice will reveal new contradictions, which will probably be eliminated by the *price* of another OECD MC reform, related to clarifying the meaning of the concept of beneficial ownership in the light of new realities and challenges. For example, analyzing the potential impact of the BEPS Plan on the derivative and financial instruments market in 2014, Richard Collier assumed that the stipulated by the Plan approach to limiting treaty benefits should entail changing the characteristics used by the OECD MC to qualify a recipient as a beneficial owner [Collier 2014: 247-248].

Some tax scientists perceive OECD MC 2014 version of paragraph 12.5 of the Commentary on Article 10, paragraph 10.3 of the Commentary on Article 11 and paragraph 4.4 of the Commentary on Article 12 as acknowledgement of the concept inefficiency in the fight against tax evasion that will decline its role and significance [Vallada 2015: 47-49].

There are calls not to exaggerate the meaning of the concept, which is referred to simply as *a slightly obscure compromise product*, as expanding the scope of its application can reduce its certainty and confront situations to which it is poorly adapted [Hagmann 2017: 47-48].

It is argued that the concept is too narrow, being limited to abuses by direct recipients of passive income that are not recognized by their beneficial owners, and more complex schemes are not covered by it [Hagmann 2017].

This point of view encounters active objections in tax literature, where, contrary to the opinion that the beneficial owner concept is gradually losing its protective value, the prevailing position is that its application, among other things, is due to the prevention of tax avoidance and taxation evasion [Brook 2014: 43-57].

It seems obvious that the beneficial owner concept is an effective instrument to counteract treaty shopping through conduit companies; it guarantees that a resident claiming a benefit does indeed own income, and his purpose is not to transfer income to a resident of a state not participating in the applicable treaty [Pérez 2017: 25-26].

In my opinion, the beneficial owner concept not only has not lost its role in the fight against treaty shopping, but has got an official place among the instruments to combat BEPS.

The version in effect since 2017 of paragraph 12.5 of the Commentary on Article 10 (and similarly, paragraph 10.3 of the Commentary on Article 11 and paragraph 4.4 of the Commentary on Article 12) states that “The provisions of Article 29 and the principles set forth in the “Misuse of the Convention” section of the Commentary on Article 1 will apply to prevent abuses, including the terms of concluded contracts, when the recipient is the beneficial owner of the dividends. The term “beneficial owner” refers to some forms of tax evasion (with the participation of an intermediary who must then transfer the dividends to someone else) and is not related to other cases, such as certain forms of abuse of the terms of the treaties that are dealt with by these provisions and principles, therefore it should not be considered as a constraint to apply other approaches to the resolution of such situations”.

As for the practice of courts and fiscal bodies, they directly focus on the application of the concept of a beneficial owner as a universal instrument aimed at counteracting the erosion of the tax base and the deduction of income from taxation.

8. Conclusion

Due to the *young* age of the novelties regulating the beneficial owner concept in the domestic legal order, many aspects of the latter are of little explored, controversial nature and are just waiting to be tested in practice. At the same time, the area of cross-border operations traditionally produces high risks for the budgetary system in terms of income underfunding due to aggressive tax planning, and sometimes – direct fraud of the persons concerned.

The wide spread of international holdings and unfair economy on taxes withheld from passive income substantially updates this issue. That is why various aspects of aggressive tax planning are included in the global agenda for the world community.

Obviously, the work on the concept of beneficial ownership of income should continue both at the level of domestic law and order, and in the international legal context. The approach according to which the concept in question should be considered within the broader context, as a manifestation of the general requirement to prevent abuses of the terms of international tax treaties is strengthening. On the agenda is the development of a unified international legal definition of the *beneficial owner* and its official legitimation through direct inclusion in the text of the OECD MC or its Commentary.

Such a universal definition should receive unconditional priority over any meaning of the term that is contained in domestic legal systems. The appearance of an official definition will facilitate simplification and strengthening of uniformity in the interpretation and application of tax treaties. Ultimately, this will help reduce uncertainty and fragmentation

in cross-border tax relations, which is the most important task of any tax reforms in the modern world.

Beneficial ownership of income does not remain a dogmatically fixed doctrine, but continues to actively evolve, acting as a resonant issue for debates and discussions. The development and implementation of the BEPS plan gives this evolution a new impetus, making for a new look at seemingly well-known truths. And numerous and sometimes heterogeneous interpretations of the concept by courts and tax authorities continue to produce risks in terms of both double taxation and the total absence of taxability of cross-border income. In these conditions, the global challenges that modern reality poses to the tax authorities, taxpayers and tax lawyers of all countries of the world community require adequate responses.

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