The City of London Law Society

4 College Hill
London EC4R 2RB

Tel +44 (0)20 7329 2173
Fax +44 (0)20 7329 2190
DX 98936 – Cheapside 2

mail@citysolicitors.org.uk

www.citysolicitors.org.uk

Jeffrey Owens
Director, CTPA
OECD
2, rue André Pascal
75775 Paris
FRANCE

By e-mail: jeffrey.owens@oecd.org

12th July 2011

Dear Sir

CLLS Revenue Law Committee response to clarification of the meaning of "beneficial owner" in the OECD Model Tax Convention (*comments on OECD Discussion Draft of 29 April 2011)*

The City of London Law Society ("CLLS") represents approximately 14,000 City lawyers based in London through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response has been prepared by the CLLS Revenue Law Committee.

Our comments on the OECD Discussion Draft of 29 April 2011

Executive Summary

- Our overall concern is that by seeking to clarify the meaning of "beneficial owner" the OECD's proposed revised commentary may actually create uncertainty and possibly result in the denial of treaty benefits where there is no abuse.

- Our main observation is that treaty shopping should not be dealt with through the meaning of "beneficial owner". Clarification of that term should be for contracting

states to define in treaty negotiations with the commentary providing background and suggested approaches. Treaty shopping should be addressed using specific Treaty anti-abuse rules rather than a nebulous interpretation of "beneficial owner".

- In any event, there is no international consensus that the "full right" definition used in the draft commentary is the correct test. Also the "substance" approach is not accepted by all jurisdictions and further that approach will lead to uncertainty.

- Many commercial arrangements which do not involve Treaty shopping will be adversely affected and in some cases there will be a risk of double taxation.

Detailed comments

It is acknowledged that the interpretation of "beneficial owner" in treaties is a complex matter with leading commentators taking different views. Although case law in different jurisdictions has considered the correct interpretation, the results have not been entirely consistent and there is no one accepted interpretation. Broadly, there appears to be three approaches, each of which can be justified based on the terms of the OECD model and case law: (1) apply the domestic meaning of "beneficial owner" in the state granting relief, relying on Article 3(2) of the model; (2) apply a narrow international fiscal meaning based on form; and (3) apply a wider international fiscal meaning which looks at the substance of the arrangement as a practical matter including whether there is abuse.

The proposed revised draft commentary appears to choose approach (3) as the preferred interpretation. We would make the following observations on this.

1. The revised commentary does not give sufficient weight to the possibility that the domestic meaning should be used where the context requires. We disagree with the revised commentary where it states that the domestic meaning is only relevant where it is consistent with the OECD commentary. This approach gives insufficient weight to Article 3(2) of the OECD model. Although we acknowledge that the case of *Indofood International Finance Limited v JP Morgan Chase Bank* was decided on the basis of an "international fiscal meaning", in that case there was no domestic law meaning which could have applied. The situation may have been different if the treaty in question was between two common law states which had a similar domestic definition. As the use of beneficial owner has its origins in common law jurisdictions it is arguable that the commentary should refer to common law tests as the starting point.

2. The revised commentary uses the phase "full right to use and enjoy" as being synonymous with beneficial ownership. However, there is no direct authority that this is the test to apply. The *Indofood* case referred to the "full privilege" and the case of *Prevost Car Inc v The Queen* refers to "use and enjoyment" and the beneficial owner being the person "who enjoys and assumes all the attributes of ownership".

   To the extent the OECD draft commentary derives from *Indofood* we note the differing views of experts on the interpretation of that case. In particular, the view that the court took was influenced by the likely interpretation of an Indonesian Court which may be prepared to take a "substance over form" approach. The case is also of limited authority in that it was a civil not a tax case and the Court did not cite any authority or give reasons for its conclusion that the international fiscal meaning meant the "full privilege".

In particular, we believe that part of the proposed revised draft commentary which refers to the "substance" of the arrangement places too much reliance on *Indofood.* In *Prevost*, for example, the Court did not go down a substance over form route.

3. Further, we see a fundamental problem with the phrase "*full* right to use and enjoy" (our emphasis added) as often, in practice, a person may have some but not all of the attributes of ownership in a purely commercial arrangement with no treaty abuse motive. In many commercial arrangements, one party may charge its assets or contract to pass its receivables to its creditors but this is not normally understood to mean that that person is not the beneficial owner of its assets and more so, one would not regard the creditor as the beneficial owner. Examples would include SPVs used in securitisations. In a typical securitisation, an originator of assets sells those assets to an SPV. The SPV issues notes to investors and the proceeds of this note issuance are used to pay the purchase price of the assets to the originator. The payment flows on the underlying assets are then paid to the SPV and the SPV then uses those receipts to make payments on the notes. Where the SPV is resident in a jurisdiction different to that of the underlying obligors, a double tax treaty may be relied upon to enable the obligors to make payments to the SPV without withholding tax. These structures are well known in the market and many jurisdictions have specific tax codes dealing with the taxation of the SPVs.

   Accordingly, the bar may be set too high in referring to the "full right to use and enjoy". The tests in common law jurisdictions may be a better starting point where a company can still be the beneficial owner even if it has some but not all of the attributes of ownership. Greater certainty would be achieved if the commentary were left unchanged and only conduits as currently identified were denied Treaty benefits.

4. Extending the "full right to use and enjoy" test to situations where "in substance" the recipient does not have the full right to use and enjoy is likely to lead to uncertainty and will target non-abusive situations. In applying a substance test, it is difficult to have certainty on where to draw the line. At one end of the spectrum, there may be a situation where an intermediate company is in substance as a mere fiduciary or administrator of the income as envisaged by the current OECD commentary and at the other end of the spectrum, one would argue that all subsidiaries in international groups ultimately do not use and enjoy their income as at some stage it will be remitted to the ultimate parent and then the parent's shareholders. Indeed, is it envisaged that the revised OECD commentary would treat the Dutch company in *Prevost* as not in substance being the beneficial owner when the Court in that case held that it was the beneficial owner?

   An uncertain substance test may result in entities like pension funds and investment funds (not falling within paragraph 6.14) not being treated as the beneficial owners of their income. Indeed it is a feature of banks, pension funds, insurance companies and most other financial institutions that they do not in any sense use or enjoy the loans they make. They are intermediaries (de facto if not de jure) and pass on most of their receipts under loans to their funders or investors, retaining only a small profit margin. There is, in the usual case, no question of tax avoidance or abuse - yet the test proposed in the draft commentary suggests that some or even all financial intermediaries should not be entitled to claim treaty relief. This would make many commercial transactions

unviable and there is the risk that commercial non-abusive transactions will result in double taxation.

Even though we disagree with a substance based approach, if the OECD were nevertheless to proceed on this basis it would be helpful to have concrete examples rather than just an abstract substance test.

5. Therefore, many normal commercial transactions may fail the "beneficial owner" requirement where there is no treaty shopping. This has been recognised by the UK tax authority in relation to the similar test in *Indofood*. In many normal commercial arrangements, including capital markets investments involving SPVs, the UK revenue authority will not apply the "international fiscal meaning" to payments to an SPV if the third party investors would themselves have been entitled to treaty benefits had they received the income directly. Only if the substance of the arrangement amounts to an improper use of the treaty will the *Indofood* international fiscal meaning be used.

For example, the UK revenue authority may argue that an SPV interposed as a conduit between a tax haven lender and a UK borrower does not have beneficial ownership and deny a treaty claim in such circumstances; but they would not seek to deny treaty relief for a typical securitisation SPV. Note that both entities are conduits in the economic sense, passing almost all of their interest receipts to third parties in an entirely pre-determined way. The legal arrangements may be very similar in both cases. But the UK revenue authority approach is to recognise that the two scenarios are different: one is characterised as abuse, contrary to the purposes for which treaties were agreed, and the other is a commercial transaction to which tax is incidental. Following *Indofood*, the UK revenue authority adopted this approach so as to not create uncertainty for investors and issuers in the capital markets, and lenders and corporate borrowers in the loan markets.

This approach by the UK revenue authority is stated to be in accordance with the object of treaties and their purpose. This type of approach is not reflected in the proposed draft commentary, although we acknowledge that OECD member countries can make their own observations and comments on the commentary.

In our view, creeping changes to the commentary on the meaning of beneficial ownership are seeking to use that term as an anti-treaty shopping provision. Whilst we support measures to tackle treaty shopping, we do not think this is the way it should be done. This approach leads to uncertainty and may affect non-abusive transactions. Instead, we believe that the commentary on beneficial ownership should be kept in simple form as it currently is and that treaty shopping should be addressed by (1) specific treaty anti-abuse rules (2) domestic guidance/interpretation (for example the approach in the UK and China).

6. Further, we believe that the commentary should not be used to define "beneficial ownership". It should be for contracting states to decide whether they wish to put in a definition in their treaty and the OECD commentary could give examples of suggested definitions and approaches in a similar way to the suggested approaches to specific anti-abuse rules referred to in the commentary in Article 1. The commentary should be an aid to interpreting the OECD model not the place where treaty terms are defined.

7. An additional complication is that subsequent revisions to the commentary are not treated as binding in some jurisdictions but in other countries they are binding

or persuasive. Cases like *Indofood* where the UK Courts accepted that the Indonesian Courts would take into account subsequent revisions to the commentary may not be good law in other jurisdictions. This leads to further confusion and complications in interpreting treaties, especially where these cases are then encapsulated in the commentary.

If you would like to discuss any of our comments, please do not hesitate to contact me.

Yours faithfully,

Bradley Phillips
Chair
City of London Law Society Revenue Law Committee

THE CITY OF LONDON LAW SOCIETY
REVENUE LAW COMMITTEE

Individuals and firms represented on this committee are as follows.

B.S. Phillips (Herbert Smith LLP) (Chairman)

H. Barclay (Macfarlanes LLP)

C.N. Bates (Norton Rose LLP)

D. Friel (Latham & Watkins LLP)

P.D. Hale (Simmons & Simmons)

M.J. Hardwick (Linklaters LLP)

C. Hargreaves (Freshfields Bruckhaus Deringer)

C. Harrison (Allen & Overy LLP)

K. Hughes (Hogan Lovells LLP)

G. Miles (Slaughter and May)

J. Scobie (Kirkland & Ellis LLP)

V. Maguire (Clifford Chance LLP)

C.G. Vanderspar (Berwin Leighton Paisner)

S. Yates (Travers Smith LLP)