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

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Part I of this article provided a history and overview of the "beneficial ownership" requirement in OECD treaties, and discussed how different countries, including China, have interpreted the requirement. In general, if a recipient of income does not beneficially own such income and rather receives it as an agent, nominee, or conduit for a third party, its treaty benefits may be at risk. This Part II discusses the Israeli Taxing Authority's position on beneficial ownership and examines how total return equity swaps might be viewed by the ITA and other taxing authorities.

Israel—Economic Risk Analysis

Another example of a country with its own approach to beneficial ownership in OECD treaties is Israel, which has a detailed Circular on the topic. [*See* ITA Circular 22/2004.] The Israeli Tax Authority's (ITA) Circular is significant in several respects. First, it confirms that treaty benefits might be denied to a party that is not a "beneficial owner," even if the treaty in question does not include a beneficial ownership requirement. This is important to remember. Practitioners must pay attention to beneficial ownership even if a particular treaty does not address it.

The ITA Circular focuses on traditional conduit situations such as back-to-back lending. The Circular broadly understands the "beneficial owner" requirement as looking beyond the legal formalities of ownership to determine whether there is a treaty abuse. The ITA's approach is noteworthy in that it addresses both economic substance (*i.e.*, which party bears the economic benefits and risks associated with the property) and control (*i.e.*, which party has the ability to control the use of and rights associated with the property).

But the ITA does not address how these concepts might be reconciled if they were to conflict. And that, in some sense, is the million-dollar question. Many modern financial transactions are designed to divvy up control and economic exposure. Oftentimes, a party will want economic exposure to an underlying reference obligation, but not the legal risks and obligations that go along with actual ownership.

Imagine an investor that wants economic exposure to Bitcoins but is located in a jurisdiction where the legality of such investments is uncertain. The investor could enter into a total return swap with an institution in a Bitcoin-friendly jurisdiction (such as Singapore or Hong Kong) that holds the underlying deposits. Since Bitcoins do not pay dividends, the question of tax withholding on dividend equivalents may not be a concern.

But beneficial ownership principles may still affect whether the long party is considered the true owner of the underlying investments. Recharacterization of the swap may have implications that go well beyond tax withholding, and involve regulatory or criminal penalties in the investor's jurisdiction. Thoughtful planning is obviously important.

Even trickier is when a party actually *does* want to own and control the underlying, but also wants the appearance of noncontrol, in which case the transaction is superficially designed to place control with a custodian or third party. Careful advisors sometimes have to function like detectives to make sure they fully understand their client's motivations and how the execution of the transaction may differ from the way it is described in the operating documents.

Dividend Equivalents in a Total Return Swap

For example, consider a plain-vanilla cross-border total return swap on an underlying equity (such as a publicly traded stock). The party with synthetic exposure to the underlying stock (but not legal ownership thereof), certainly possesses many of the economic benefits and risks associated with owning the stock. Its counterparty, generally a bank, often controls the voting rights, ownership, and ultimate disposition of the stock (assuming it is not economically compelled to hedge by actually owning the stock).

How would the ITA view such an economic arrangement? Which party would it consider to beneficially own the dividends with respect to the stock? An analysis focusing on legal control might conclude that the bank owns the stock as well as the dividends, and is the beneficial owner. But it is theoretically possible that the ITA might conclude that the bank is not the true beneficial owner because many of the economic aspects of ownership are being passed on to its counterparty.

In other words, an economic analysis of beneficial ownership might be in conflict with an analysis that focuses on legal control over income. Often, a recipient of income can have full legal control over that income if the transaction is designed with the beneficial ownership requirement in mind. But if it is seen as passing on the income to a third party and, more importantly, being economically compelled to do so, its treaty benefits might be at risk. This could happen in Israel, China or a number of other jurisdictions.

Careful planning for economic analysis of beneficial ownership is prudent. In the case of the total return swap, this would involve ensuring that the bank was not economically compelled to own the underlying stock. For example, a total return swap on a highly liquid stock is safer because with an illiquid stock, the bank's hedging might affect the price or liquidity of the underlying equity. This is not news to taxpayers in the United States, where the Treasury Department's preamble to proposed regulations specifically warned about swaps that reference illiquid obligations. [2012-1 CB 487.]

If the bank is not able to easily dispose of the underlying stock and passes all of the economic benefits of ownership on to its counterparty, it is likely that its beneficial ownership will be questioned. Even if the bank chooses to hedge by owning the underlying, if it has other realistic options, it should be considered the beneficial owner. This is because it has no legal or economic compulsion to own the actual stock *for* the other party. If it wanted to, it could perform its duties under the swap without owning the underlying.

Other factors matter as well. If a bank "crosses in" by purchasing the stock from the counterparty and then "crosses out" by selling it back at the end of the swap, its beneficial ownership might also reasonably be questioned. Obviously, if the duration of the swap is short and straddles a dividend date, this could look suspicious as well. Even excessive collateral posted by the counterparty could make the beneficial ownership analysis more difficult.

The Treasury Department's proposed regulations state that the underlying security should not represent more than 10 percent of the collateral posted by the short party. [Proposed Reg. §1.871-16(c)(3).] One concern is that this could make the swap look more like a stock lending arrangement where the bank is merely holding the stock for its counterparty's benefit. Another potential issue is the length of the swap. The proposed regulations provide that the contract should be actually outstanding for more than 90 days. [Proposed Reg. §1.871-16(c)(4).] Of course, the U.S. Treasury Department's proposed regulations do not address beneficial ownership in OECD treaties, and there is nothing to prevent a local taxing jurisdiction from taking an approach that differs from that of the United States.

Despite having all of the control and legal voting rights with respect to the underlying stock, a local taxing authority might deny treaty benefits if the deal seems abusive from an economic perspective. Of course, even if the arrangement is sound from a legal and economic perspective, it is always possible that a local authority might inappropriately deny treaty benefits anyway. This is why additional clarity from the OECD is needed.

2012 Discussion Draft—A Positive Step?

In 2012, the OECD proposed revised draft commentary on the term "beneficial owner." It was revising commentary from the previous year, which sparked a great deal of critical comments. The revised draft commentary is thankfully a step in the right direction.

If approved, the new language would provide that the recipient of a payment of dividend, interest or royalties is the beneficial owner if he "has the right to use and enjoy the payment unconstrained by a contractual or legal obligation to pass the payment received to another person." [*OECD Model Tax Convention: Revised Proposals Concerning the Meaning of Beneficial Owner in Articles 10, 11 and 12,* at 12.1 (Oct. 19, 2012 to Dec. 15, 2012).] The focus on legal control over the payment provides some straightforward guidance and is potentially helpful for tax planning.

Another positive aspect of the revised draft commentary is its exclusion of domestic law definitions of "beneficial ownership." The original draft commentary from 2011 stated that "domestic law meaning is applicable to the extent that it is consistent with the general guidance included in this Commentary." This confusing statement provoked an outpouring of negative comments, and the OECD wisely removed it from the revised draft language.

But there is still lingering ambiguity. The draft language provides that an obligation to pass on a payment may exist on the basis of "facts and circumstances" which show "in substance" that the payee does not enjoy the right to use the income. One cannot merely rely on legal documents and "bankruptcy tests" to tell who is a beneficial owner of income. Rather, due care must be given to the economic realities.

Of course, the fear is that a local court could choose to apply an aggressive interpretation of the beneficial ownership requirement in order to deny treaty benefits. The revised draft language is a clarifying development in this saga, as it does put the primary focus on the legal arrangements between the parties. But often times a beneficial owner in a legal sense may *look* an awful lot like an agent or nominee.

As discussed, this can happen when a bank makes a dividend equivalent payment to a counterparty under a total return swap. Often, the dividend equivalent payment mirrors precisely the dividend it received on the underlying stock. In such a case, even if the bank has full legal control over the dividend and is not economically compelled to own the underlying stock, it still appears as though the bank is simply passing on the dividend payment.

Planning for Beneficial Ownership

Despite the lack of clarity from the OECD and courts on the meaning of beneficial ownership, there are a number of steps international M&A practitioners can take to put their deals in a better position *vis-à-vis* local taxing authorities. The most basic step is to apply the "bankruptcy test" and ask: If the recipient of income goes bankrupt before passing on the income, will the income still be passed on or be subject to the claims of its creditors? If the income will still be passed on, the recipient is likely not the beneficial owner.

Beyond the "bankruptcy test," the next thing to examine is legal control over the income. Is the recipient legally compelled to pass on the income to another party? Even if it is obligated to make corresponding payments, such as under a total return swap, there should still be enough disconnect between the original receipt of income, and the obligation to pass an equivalent income payment on to a third party, as to protect beneficial ownership status. This is where careful drafting comes in handy.

But the OECD and local authorities are intent on making sure that careful drafting of legal agreements is not enough. And this is not an unreasonable goal. Even *Prévost Car Inc. v. The Queen*, which took a fairly formalistic approach to beneficial ownership, nevertheless suggests that if the parties do not actually follow what the contracts say, the courts will not either. [2008 DTC 3080.] However, the lack of clarity does offer practitioners a difficult task in planning for potential challenges by local taxing authorities.

What can help? China identified "substantial business operations" of the recipient as one important issue. If a recipient of income that claims treaty benefits has a substantial business operation aside from passing along income, this may help in the beneficial ownership analysis. It may not be necessary in all jurisdictions, but it often cannot hurt.

In addition, as noted by the Israeli Circular on beneficial ownership, it is important to question who bears the economic risk and benefit associated with the income. Even if the beneficial owner has legal control over the income, if they have economically shifted nearly all of the benefits and risks to a third party, their treaty benefits could be threatened. Careful planning on a number of levels is needed to deal with the uncertainty in this area.

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