dhruva advisors llp

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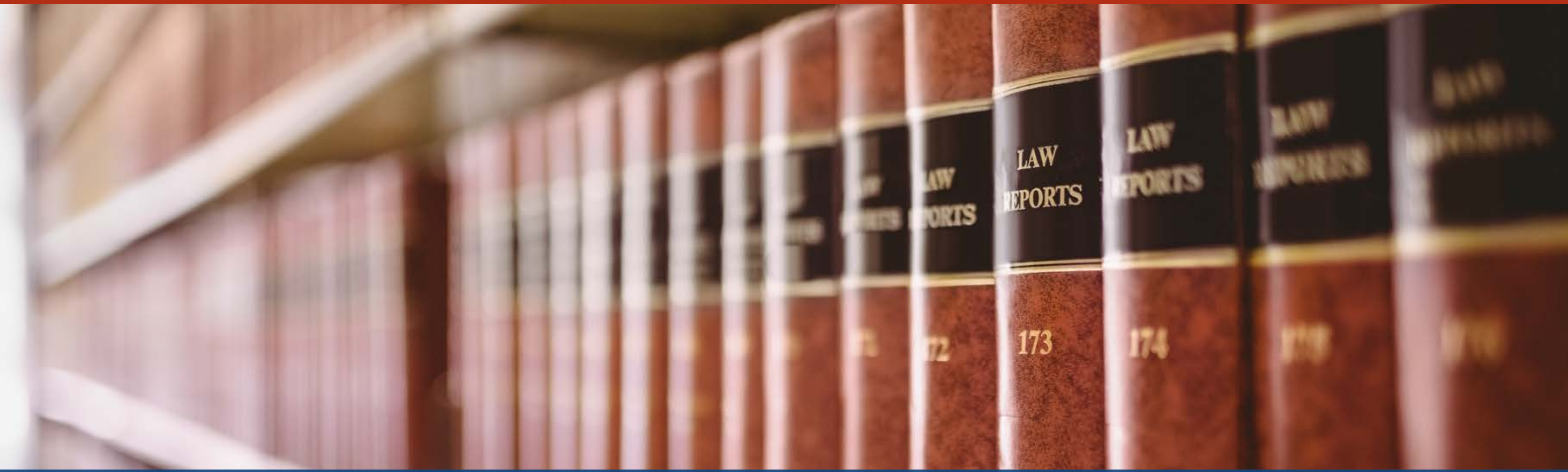

Beneficial ownership – a brewing controversy

'Beneficial ownership' has become the latest buzz word resulting in a controversy between the Non-resident Tax payers and the Indian tax Authorities. In a spate of recent orders that were issued last calendar year, tax authorities have concluded that the non-resident taxpayers lack beneficial ownership of income and have denied applicability of beneficial provisions of DTAA[1] to such non-resident tax payers.

What is beneficial ownership and is it different from Substance

The term "beneficial owner" is a DTAA concept and it is not defined under popular DTAAs such as the DTAA with Mauritius, Cyprus, Singapore, etc. Under the provisions of the Tax Act[2] it is used in various sections qua determination of ownership. A circular[3] issued by the nodal tax administrative body the Central Board of Direct Taxes in context of the India-Mauritius DTAA linked beneficial ownership to tax residency and clarified that a Tax Residency Certificate (TRC) was sufficient evidence for accepting the status of residence as well as beneficial ownership. This was subsequently confirmed by the supreme court[4] and later followed by High Court[5]. These cases were based on domestic law and the said circular.

Thus, apparently for the tax authorities, beneficial ownership is linked to residency / substance in a particular jurisdiction. Albeit, the question is whether this interpretation reconcile with

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[1] Double Taxation Avoidance Agreements ("DTAA") is an agreement entered by two countries to prevent incidence of double taxation to residents of the respective countries

[2] Income-tax Act, 1961 ("Act"); The term beneficial owner has been used for instance in Section 2(18), Section 2(22)(e), Section 79, etc.

[3] Circular No. 789 dated 13 April 2000

[4] The validity of the above Circular has been confirmed by the Supreme Court of India (SC) in its decision in the case of *Union of India v Azadi Bachao [2003] 263 ITR 706*.

[5] Director of Income Tax (International Taxation) VS Universal International Music B.V. [TS-56-HC-2013(BOM)-O], (2013) 214 TAXMAN 0019

general commercial understanding, authoritative international tax commentaries and international judicial precedents or even the position which the tax authorities are taking while concluding the assessment proceedings.

To understand the meaning of the term beneficial ownership it is important to understand the rationale behind the introduction of the concept. The concept of beneficial ownership was introduced by the OECD[6] in 1977 as a safeguard to prevent abuse of DTAAs by undertaking treaty shopping and **primarily applies to passive incomes like dividend, interest & royalties.**

In DTAA parlance treaty shopping refers to interposition of entities in jurisdictions that has a more advantageous DTAA as compared to the home jurisdiction. This is achieved by setting up entities in low / favourable tax jurisdiction and shifting the assets that confer the right to collect these dividends, interest and / or royalties[7] to such jurisdictions.

Accordingly, the concept of beneficial ownership was introduced in the DTAA articles dealing with the aforesaid sources of passive income to clarify the meaning of the word "paid to a resident". The objective was to clarify that the source state was not obliged to give up taxing rights over passive income merely because the recipient was a resident of a DTAA jurisdiction unless he was also the beneficial owner of such income. The term 'beneficial ownership' is applied to distinguish legal ownership from economic ownership in circumstances where the legal owner is not the economic owner of an asset (owing to contractual or legal obligations or by conduct). In strict legal / technical sense with respect to any asset of a company / body corporate all rights in the asset, by operation of law, typically belongs to in absolute terms to the legal owner being such company / body corporate.

For instance, the shareholder of the company under corporate laws would never be the beneficial owner of the assets of the company. However, the term used in the context of the DTAAs, while construed strictly, must be given a meaning in context of the rationale behind its introduction which is to determine the real owner of an income where the legal ownership could be disregarded. Based on international commentaries and judicial precedents, a beneficial owner is someone who besides being a legal owner has "dominion and control" over the property i.e. an owner of property who holds it for his own benefit and not as an agent, trustee, or nominee for some other person, one who has right to deal with the property as his own.

The revised draft of the OECD Commentary[8] states that the recipient of a passive income is not the "beneficial owner", when the recipient's right to use and enjoy the passive income is constrained by a contractual or legal obligation to pass on the payment received to another

[6] The Organisation for Economic Co-operation and Development

[7] For instance, say company A (based in Country A) earns income from Company B (based in Country B). Country A and B have signed a DTAA which is in favour of Country B as compared to a DTAA signed between Country A and C. If Company A were to resort to treaty shopping, it would incorporate a subsidiary company (Company C) in Country C and route the transaction with Company B through this subsidiary

[8] Model Tax Convention (Full Version), 2015 – for instance refer paragraph 10.2 on page C(11)-8 in the context of Interest Article.

person. Further, the Model Commentaries to the tax treaties and leading international tax lawyers have commented that the term must be given a purposive interpretation (viz. prevention of tax avoidance) and persons not entitled to treaty protection are to be prevented from obtaining benefits thereunder by interposing entities between the ultimate beneficiary and the payer. What is thus important is to establish 'direct and proximate' relationship to such income / payment in order to invoke the provisions of 'beneficial ownership' to deny treaty benefits.

Thus, beneficial ownership is not linked to substance or lack thereof in a particular jurisdiction rather it is the determination of dominion and control over the source of income.

As mentioned earlier, the tax authorities in India have been examining this issue closely in recent months. We have however, seen the approach to beneficial owner being a test of substance rather than on dominion and control. As an illustration we see the various tax authorities focussing on issues such as:

- Office address, total floor area of the office, go-downs and seeking details of any other premise owned;
- Whether there are multiples companies with common address;
- Employee register with the details of all the employees;
- Whether the directors of the company hold multiple directorships, etc.;
- Bank statements for relevant periods;
- Explanations as to the source of funds out of which investments have been made; and
- Filings with authorities of the home jurisdiction such as financials, tax returns, etc. for relevant periods; etc.

This approach may not be quite ideal in the context of different passive incomes. For instance, one does not particularly require an office space or employees to earn passive incomes like interest or royalties and there could be many such examples in context of different sources of income.

Even an examination of the bank statements and seeking source of funds may not necessarily throw light on beneficial ownership. Even a one hundred per cent interest in a subsidiary does not preclude the latter's "beneficial ownership" in the assets held by it[9]. Similarly, even a back-to-back loan in which the interposed taxpayer make profit of its own via an interest margin in the manner of a bank, will have to be recognised for tax purposes, unless it is established that the decision-making ability of the subsidiary / taxpayer is compromised in any manner.

Thus, the focus should be in determining whether the taxpayer has "dominion and control" over the income which would need to be examined based on facts of each case. In international jurisprudence there are a plethora of cases such as Indofood[10], Prévost Car[11],

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[9] As mentioned in Professor Klaus Vogel's commentary on interest income in the context of "beneficial owner"

[10] Indofood International Finance Ltd v JP Morgan Chase Bank NA, London Branch [2006] EWCA Civ 158

[11] Prévost Car Inc v Her Majesty the Queen (2008) TCC 231 and Her Majesty the Queen v Prévost Car Inc 2009 FCA 57

Aiken Industries[12], Real Madrid[13], etc. where tax officers have successfully questioned beneficial ownership and judgements have emphasised on dominion and control, business rationale, etc. in the context of passive income.

For instance beneficial ownership test would not be met, where an entity is proposed to be interposed without a plausible business rationale (e.g. in the Indofood case, where a Dutch Subsidiary was proposed to be interposed on account of a change in the Indonesia-Mauritius DTAA and in Aiken case, where a Honduras entity was interposed) or where the actions of the taxpayer itself lead to the belief that the entity is a conduit (e.g. in Indofood case, where payments were directly made to the UK Holding entity instead of the Mauritius subsidiary).

Additionally, existence of back to back payments in isolation should not result in an entity being regarded to be a conduit, unless the actions of the parties lead to the conclusion that the back to back arrangement has the effect of removing dominion and control over the income (e.g. in Real Madrid case, where 99% of the income received was paid to the holding company and payments were made at times without invoices or the payments made did not correspond to the provisions of the contract in force).

In summary the beneficial owner of an income would exhibit the following features:

- the taxpayer is formed for business objectives and not to exploit tax benefits alone (e.g. *Prévost Car* case, where a Dutch SPV was selected as a neutral jurisdiction by UK and Swedish joint venture partners);
- makes independent decisions vis-à-vis investment, expenditure, etc.;
- enjoys unrestricted right to use and enjoy income earned by the taxpayer; and
- bears business risks (such as currency risk, investment risk, etc.) commensurate with its activities and income earned;

Where the above features are present, how such income is applied (whether for meeting their expenses or declaring dividends to shareholders, etc.) are immaterial, so long as such decisions are made by the taxpayer independently and not influenced by anyone else.

Given the significant developments in International Tax landscape such as the BEPS project, what is clear is that the focus of the tax authorities on application of the benefits of DTAAs is increasing by the day. To guard against a protracted litigation which might result from this controversy the Taxpayers and international investors may proactively consider re-looking at their current documentation to evaluate if it demonstrates independent decision and their intended business rationale.

[12] Aiken Industries Inc v Commissioner of Internal Revenue 56 TC 925 (1971).

[13] Judgment no. 1110/2003 *Real Madrid F.C. vs Oficina Nacional de Inspección*, Audiencia Nacional 18 July 2006

ADDRESS

Mumbai
1101, One IndiaBulls Centre,
11th Floor, Tower 2B,
841, Senapati Bapat Marg,
Elphinstone Road (West),
Mumbai 400 013
Tel: +91 22 6108 1000 / 1900

Ahmedabad
B3, 3rd Floor, Safal Profitaire,
Near Auda Garden,
Prahladnagar, Corporate Road,
Ahmedabad - 380 015
Tel: +91-79-6134 3434

Bengaluru
Prestige Terraces, 2nd Floor
Union Street, Infantry Road,
Bengaluru 560 001
Tel: +91-80-4660 2500

Delhi / NCR
101 & 102, 1st Floor, Tower 4B
DLF Corporate Park
M G Road, Gurgaon
Haryana - 122 002
Tel: +91-124-668 7000

Singapore
Dhruva Advisors (Singapore) Pte. Ltd.
20 Collyer Quay, #23 01
Singapore 049319
Tel: +65 9105 3645

Dubai
WTS Dhruva Consultants
U-Bora Tower 2,
11th Floor, Office 1101
Business Bay P.O. Box 127165
Dubai, UAE
Tel: + 971 56 900 5849

Bahrain
WTS Dhruva Consultants
Bahrain Financial Harbour, East Tower - Floor 23, Office
2301, Building 1398, Road 4626, Block 346. Manama,
Kingdom of Bahrain
Tel: 973 1663 1921

New York
Dhruva Advisors USA, Inc.
340 Madison Avenue, 19th Floor, New York,
New York 10173 USA
Tel: +1-212-220-9494

Silicon Valley, USA
Dhruva Advisors USA, Inc.
5201 Great America Parkway,
Santa Clara,
California 95054
Tel: +1 408 930 5063

KEY CONTACTS

Dinesh Kanabar (Mumbai)
Chief Executive Officer
dinesh.kanabar@dhruvaadvisors.com

Vishal Gada (Ahmedabad)
vishal.gada@dhruvaadvisors.com

Ajay Rotti (Bengaluru)
ajay.rotti@dhruvaadvisors.com

Krishan Malhotra (Delhi / NCR)
krishan.malhotra@dhruvaadvisors.com

Mahip Gupta (Singapore)
mahip.gupta@dhruvaadvisors.com

Pratik Shah (Dubai)
pratik.shah@dhruvaadvisors.com

Lawrence Zlatkin (USA)
lawrence.zlatkin@dhruvaadvisors.com

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