Offshore Derivative Instruments:
An Investigation into Tax Related Aspects

February 2013
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1. Introduction

In 1689, John Locke propounded a theory of unilateral appropriation to decipher ownership rights over a property. However, the realm of conduit structures that resemble nominee arrangements and over-the-counter structured derivative products throws up a world in which John Locke’s utterance on one of the most fundamental tenets of property seems rather unsophisticated. Ownership of property now involves a bundle of rights which include the legal title to the asset, the right to income stream from an asset, the right to control the asset and direct how it is used. There are several other structural combinations possible, due to which the concept of an “ownership right to property” becomes severely diluted. From a legal perspective, the most acute of problems that such structural forms have raised is in the matters of taxation, as it is difficult to ascertain the actual owner of the underlying assets. A conduit structure may allow for a lower rate of taxation and deferral of taxes in the country of residence, but may also lead to obtaining treaty benefits where such benefits did not exist. To resolve this quandary, tax authorities and scholars alike go back to a Lockean-like approach to determine ownership. They attempt to discern the “beneficial owner” who actually possesses the real entitlements to enjoy the advantages of, and controls the benefits accruing from such ownership, despite not holding legal title to the same. The objective of the tax authorities is clearly to prevent the avoidance of treaty abuse by “beneficial owners” through use of conduit structures.

From an analysis perspective, beneficial ownership can be understood as a substance-over-form approach to determine the relationship between a taxpayer and the taxable object based on underlying economic reality.1 It is not merely an investigation to identify where lays the ultimate economic ownership.

In swap transactions, it becomes difficult to determine who is the actual beneficial owner – whether it is the issuer long party (that has hedged its position by holding the referenced underlying asset or financial instrument situated in the source country) or the recipient counterparty of the derivative instrument. The investigation into beneficial ownership thus becomes particularly relevant for the source country.

Recently, tax authorities in India expressed intent to tax the income derived from derivative contracts in the form of swaps more specifically as understood in an Indian context as offshore derivative instruments.5 Such instruments are issued by banks and prime brokers (registered as foreign institutional investors - FIIs)6 to certain

1. John Locke, Two Treatises of Government, Cambridge University Press, 1960. John Locke’s idea of Private Property was pro-
pounded in a period riddled with conflicts between the King and Parliament. The objective of the same was to advocate that “sovereign authority” could not under any circumstances acquire private property from an individual without his consent. His theory of unilateral appropriation was used to safeguard genuine owners who did not have proper documentary records indicating their title over the land, from the sovereign authority.

2. The word “treaty” has been generically used in this article to refer to income tax treaties entered into between countries for the purposes of avoiding double taxation of international income flows.

3. Judgment of the Swiss Federal Administrative Tribunal, A-6537/ 2010 of 7 Mar. 2012, ITLR 618. This ruling is separately sum-
marized in this article.

times.indiatimes.com/2012-03-26/news/31240226_1_p-notes-foreign-investors-tax-norms. Participatory notes (P-notes) are a type of offshore derivative instruments more commonly issued in the Indian market context which are in the form of swaps and derive their value from the underlying Indian securities.

5. Offshore derivative instruments have been defined under Regulation 15A of the Securities Exchange Board of India (Foreign In-
stitutional Investors) Regulations, 1995 (FII Regulations) as, “any instrument, by whatever name called, which is issued overseas by a foreign institutional investor against securities held by it that are listed or proposed to be listed on any recognized stock exchange in India, as its underlying”.

6. A “foreign institutional investor” is defined under the FII Regulations as “an institution established or incorporated outside India which proposes to make investment in India in securities”.

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eligible entities.\footnote{It is a condition imposed on the FII to ensure that it issues ODIs only to those entities that are ‘regulated’ by an appropriate foreign regulatory authority. In this respect, SEBI has explained that by ‘regulated’, they refer to entities that either are (1) ‘themselves’ regulated or supervised and in this respect are licensed or registered by a foreign central bank. Alternatively, are ‘themselves’ registered and regulated by a securities or futures regulator or (2) are set up as a broad based fund or portfolio or a proprietary fund of an institutional investor or as university fund, endowment, foundation, charitable trust or society and ‘are managed by’ any of the entities covered under 1 (i.e. managed by anyone who are themselves ‘regulated’).}

This article seeks to analyze beneficial ownership from the perspective of tax treaties, as well as under Indian tax law. It also seeks to examine how the concept is being applied to investment structures and swap transactions like offshore derivative instruments, and under what circumstances treaty benefits may be denied on the basis of beneficial ownership.
Reasons why offshore derivative instruments (ODIs) have emerged as a preferred mode of seeking exposure to Indian equities, indices and other possible underlying securities are not hard to find. Synthetic exposure through such instruments allows for efficient tracking of underlying assets at transaction costs (lower than compared to direct participation) and minimal tax costs or leakages, without direct registration with Indian regulators and with an added layer of liquidity, as there are very limited restrictions on the transfer of contract notes.

Offshore derivative instruments have been defined under Indian securities laws in a manner such that the concerned offshore contract (typically in a form of total return swaps) would need to refer to an underlying Indian security and also be hedged onshore to whatever extent by the issuer FII. Participatory notes (P-notes) are, by definition a form of ODI including but not limited to swaps, contracts for difference, options, forwards, participatory notes, equity linked notes, warrants, or any other such instruments by whatever name they are called.

Below is a diagram that illustrates the structure of an Offshore Derivative Instrument.

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8. Participatory-Notes account for 15 to 20 percent of total FII holdings in India. As on November 2012 the notional value of P-Note investments in Indian markets (equity, debt and derivatives) stood at USD 34 billion. Participatory Note investments reach 8-month high of $32 billion, Please also see: http://articles.economictimes.indiatimes.com/2012-12-17/news/35869011_1_p-notes-fii-investments-p-note-investments.

9. See supra n. 4.

10. A swap consists of the exchange of two securities, interest rates, or currencies for the mutual benefit of the exchangers. In the most common swap arrangement one party agrees to pay fixed interest payments on designated dates to a counterparty who, in turn, agrees to make return interest payments that float with some reference rate.

11. An arrangement made in a futures contract whereby differences in settlement are made through cash payments, rather than the delivery of physical goods or securities. At the end of the contract, the parties exchange the difference between the opening and closing prices of a specified financial instrument.

12. An option is a financial derivative that represents a contract sold by one party to another party. It offers the buyer the right, but not the obligation, to call or put a security or other financial asset at an agreed-upon price during a certain period of time or on a specific date.

13. A forward contract is a binding agreement under which a commodity or financial instrument is bought or sold at the market price on the date of making the contract, but is delivered on a decided future date. It is a completed contract – as opposed to an options contract where the owner has the choice of completing or not completing.

14. See supra notes 4 and 5.

15. An Equity-linked Note is a debt instrument whose return is determined by the performance of a single equity security, a basket of equity securities, or an equity index providing investors fixed income like principal protection together with equity market upside exposure.

16. A Warrant is a derivative security that gives a holder the right to purchase securities from an issuer at a specific price within a certain time frame.
The position of the holder of an offshore derivative instrument is usually that of an unsecured counterparty to the FII, and under the offshore derivative instrument (the contractual arrangement with the issuing FII), the holder of a P-note is entitled only to the returns on the underlying security with no other rights in relation to the securities in respect of which the offshore derivative instrument has been issued. There are certain features of such offshore derivative instruments that prevent the holder of such notes from being perceived as the beneficial owner of the securities under exposure from such instruments. These features include the following aspects: (i) whether it is mandatory for the FII to actually hedge its underlying position (i.e. actually “hold” the position in Indian securities), (ii) whether the offshore derivative instrument holder could direct the voting on the shares held by the FII as its hedge, (iii) whether the offshore derivative instrument holder could be in a position to instruct the FII to sell the underlying securities and (iv) whether the offshore derivative instrument holder could, at the time of seeking redemption of that instrument, seek the FII to settle that instrument by actual delivery of the underlying securities. From an Indian market perspective, such options are absent considering that the ownership of the underlying securities and other attributes of ownership vest with the FII. Internationally, however, there has been a precedence of such structures, leading to a perception of the offshore derivative instrument holder as a beneficial owner – albeit only from a reporting perspective under securities laws.  

17. The term “holder” means the holder of, or the counterparty to, the offshore derivative instruments to the extent that such instrument qualifies as a P-note. There are certain regulatory obligations on the issuer FII, and it is required that (i) the holder not be a person resident in India (as such term is defined in the Foreign Exchange Management Act, 1999 as may be amended or supplemented from time to time) or (ii) a “non-resident Indian” (as such term is defined in the Foreign Exchange Management Deposit Regulations, 2000) or a person whose controller is an above-mentioned person. In addition to the above, the holder is a “person regulated by an appropriate foreign authority”, as such term and/or requirements relating thereto are defined or otherwise interpreted for purposes of Regulation 15A of the FII Regulations.

18. CSX Corporation v. Children’s Investment Fund Management (UK) LLP. The case examined the total return swap structure from a securities law perspective, which requires a disclosure of a beneficial owner from a reporting perspective.
3. Judicial Scrutiny of Swap Transactions from a Beneficial Ownership Perspective

A ruling of the Swiss Federal Administrative Tribunal that determines the beneficial owner of a total return swap is particularly relevant. The case is unique as it is the first and possibly the only ruling thus far that looks at aspects of beneficial ownership from the perspective of entitlement to treaty benefits in the context of a swap transaction.

The case dealt with a Danish bank that had entered into total return swaps agreements with parties in the United Kingdom, Germany, France and the United States on equity baskets involving Swiss securities. In order to hedge the swap positions, the bank also acquired the underlying amount of Swiss securities. Over the life of the swaps, the bank received dividend distributions on the acquired Swiss equities subject to taxes as withheld.

Following is a graphical representation of the structure under consideration—

![Graphical representation of the structure under consideration](image)

When the bank sought a refund on the basis of the Denmark-Switzerland Income and Capital Tax Treaty (1973), this was eventually denied by the Swiss tax authorities on the basis that the Danish bank was contractually obligated to pay to the swap counterparties the dividends and other returns, and thus it lacked beneficial ownership (leading to the question of whether the Danish bank was entitled to benefits under the Denmark-Switzerland Income and Capital Tax Treaty (1973)).

The Swiss Tribunal observed that entering into the concerned swap transactions did not oblige the Danish bank to acquire the underlying securities. Furthermore, the Danish bank would have had the obligation to distribute the dividend distributions to the swap counterparties even if its position were not hedged and it had not collected Swiss dividends. Thus, the Danish bank hedged the

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securities for its own benefit, and not the benefit of the counterparties. Other underlying factors that may have been considered were that (i) the Danish bank was to make the pay-outs to the swap counterparties only upon the expiry of the swap period (i.e. upon the swap’s maturity or earlier termination) and not as and when accrued and (ii) the swap counterparties did not directly hold any voting power or ability to direct the Danish bank as regards when to dispose of the concerned underlying Swiss securities.

The Tribunal held that the Danish bank was in fact the beneficial owner of the Swiss dividend received and that it was entitled to a refund of Swiss taxes withheld.
Income tax in India is governed by the provisions of the Income Tax Act, 1961, which contains detailed provisions in respect of chargeability to tax, determination of residency, computation of income, etc. The position of tax laws in respect of holders of an offshore derivative instrument is analyzed below.

I. Basis of Taxation

Under sections 4 and 5 of the Income Tax Act, non-residents may be taxed only on income that accrues in India or which arises from sources in India. The source rules for specific types of income are contained in section 9, which specifies certain circumstances where such income is deemed to accrue or arise in India.

Under section 9(1)(i), income earned by a non-resident from the transfer of a capital asset situated in India would be deemed to have been accrued in India (i.e. be sourced in India). Therefore, a non-resident may be liable to tax in India if it earns income from the transfer of a capital asset situated in India.

With respect to capital assets such as shares, the Supreme Court in Vodafone International Holdings B.V. v. Union of India22 reiterated the well-established principle that a share is legally situated at the place of incorporation of the company or the place where it can be effectively dealt with. Therefore, shares of a foreign company should ordinarily be viewed as capital assets situated outside India and thus, the sale of such shares should not be treated as income from Indian sources.

Though general anti-avoidance rules are proposed to be implemented only from 1 April 2015, assuming that such rules would be applied in respect of offshore derivative instrument structures, the manner of such application could raise issues. For example, will general anti-avoidance rules be applied to look through the FII structure and therefore seek to tax the holder of such instrument directly, or will such rules look at the FII structure to deny treaty benefits to the FII (that had issued the offshore derivative instrument). Under the look-through scenario, the tax authority can perceive the holder of an offshore derivative instrument as the actual owner of the hedged underlying securities and seek to tax on that basis.

II. Taxation of Indirect Transfers

In Vodafone International Holdings B.V. v. Union of India, the Indian Supreme Court stated that the Indian tax authorities are to only “look at” a particular document or transaction when determining the taxability thereof, thus indicating a form-over-substance approach with respect to taxation. Thus, in light of the above-mentioned determination, an indirect transfer of capital assets situated in India, between two non-residents, executed outside India was held to be not taxable under the Income Tax Act.

In response to the decision of the Supreme Court, a retroactive clarification was inserted in the 1961 Tax Act by the Finance Act, 2012 to state (purportedly, “clarifying”) that such foreign shares or interest may be treated as a capital asset situated in India if it “derives, directly or indirectly, its value substantially from assets located in India”. The newly introduced Explanation 5 to section 9(1)(i) expands the source rule to cover shares or interest in a foreign company, the value of which

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is substantially derived from assets situated in India. However, while the foreign shares/interest may be deemed to be situated in India, the charge of capital gains tax may not extend to that portion of its value relating to assets located outside India. Assets located outside India do not have any nexus with the territory of India to justify taxation under the Income Tax Act. It is therefore necessary to “read down” the amended section 9(1)(i) based on the nexus principle.

In case of an ODI holder, while the value of the ODI can be linked to the value of an asset located in India (equity, index or other forms of underlying securities from which the swap derives its value), it is a contractual arrangement that does not typically obligate the FII to acquire or dispose the referenced security. Accordingly, contractually it is not mandatory for the FII to fully hedge its position to the swap exposure vis-à-vis the counterparties. Furthermore, even when the ODI holder redeems the ODI, the obligation (in case of a ‘net’ swap on a portfolio of equities) is only to pay the counterparty a net sum equal to economic return on the holding of the underlying securities over the swap period made up of any movement on the market price plus any dividends received. Therefore, there is no requirement that the FII should sell the underlying securities. Thus the agreement between the issuer FII and the ODI holder, being only in the nature of a contractual arrangement without any control on the underlying securities, should not be perceived as a ‘share’ or ‘interest’ under the newly introduced Explanation 5 to section 9(1)(i) of the ITA.


Another basis on which a holder of an offshore derivative instrument may have tax costs linked to its offshore derivative instruments could be when the issuer FII passes on the tax risk to the holder of such instrument. An FII would be subject to tax in India if it is not able to claim benefits under the India-Mauritius Income Tax Treaty (1982) (India-Mauritius treaty).

The capital gains arising from the transfer of Indian securities would be taxable in India even if the Indian shares were held by a non-resident company, as the source of income is the shares/securities in the Indian (issuer) company. This would be taxable under the Income Tax Act in the case of Indian resident taxpayers. A non-resident taxpayer has the option to be taxed under an applicable treaty or under the Income Tax Act, whichever is more beneficial to the taxpayer. It is in this context that reliance on a treaty becomes critical for the alienator of Indian shares.

In order for the entity to be eligible to claim benefits under the India-Mauritius treaty, the FII must be a “person”, and such “person” must qualify as a “resident” of Mauritius, as defined under that treaty.

In determining the FII’s status considering the above, reference is made to Circular 789 of 13 April 2000 (Circular 789) issued by the Central Board of Direct Taxes. Circular 789 states:

It is hereby clarified that wherever a Certificate of Residence is issued by the Mauritian Authorities, such Certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the [double taxation avoidance convention] accordingly.

Thus the FII would be eligible for benefits under the India-Mauritius treaty if it is incorporated in Mauritius and has been issued a tax residency certificate by the Mauritian income tax authorities.

The Supreme Court of India upheld the validity

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23. The India-Mauritius tax treaty, one of the more relied upon tax treaties when making inbound investments into India, provides for an exemption from tax in India on capital gains earned on the sale of shares of Indian companies by a resident of Mauritius. For purposes of this section, it is assumed that the FII issuing the offshore derivative instrument is based in Mauritius and accordingly, the relevant treaty being analyzed is the India-Mauritius treaty.
of Circular 789 in the case of Union of India v. Azadi Bachao Andolan,26 holding that companies incorporated in Mauritius and having been granted a certificate of residence by the Mauritian tax authorities were liable to tax in Mauritius and would be eligible for benefits under the India-Mauritius treaty. Subsequently, in the case of ETrade Mauritius Limited v. ADIT & Ors,27 where the Indian tax authorities sought to deny treaty benefits to a Mauritian company on the basis that the shares of its Indian subsidiary were actually held by the US parent of the Mauritian company, the Authority for Advance Rulings (AAR) rejected such contention and held that a Mauritian company with a tax residency certificate is entitled to treaty benefits and may also be considered the beneficial owner of the dividend or capital gains accruing in relation to shares of the Indian subsidiary. Accordingly, where the FII is a resident of Mauritius, having been incorporated in Mauritius, and holds a tax residency certificate issued by the Mauritian tax authorities, then based on the Circular 789 and the above judicial precedents, the FII should be entitled to the benefits under the India-Mauritius treaty at the time of receiving distributions from the underlying securities that it holds to hedge its position against the offshore derivative instruments as issued.

IV. Beneficial Ownership in an Indian Context

The term “beneficial owner” has not been defined under Indian law, leading to a myriad of interpretations and controversies with respect to the precise meaning of the term. In common parlance, a beneficial owner is recognized as an owner of something because the actual use and title belong to that person, even though legal title may belong to someone else.27

In India a “look at” approach is adopted while assessing a transaction and hence the question of beneficial ownership is not generally inquired into. This view was reflected by AAR in Moody’s Analytics Inc.28

However, Indian tax authorities are investing the commercial understandings, the manner in which they are documented and the conduct of the concerned parties to contend that the beneficial owner is a different entity and thus, from a treaty perspective, the country of residence is not Mauritius. However, Indian law and the recent rulings still conform to the view that legal ownership prevails over beneficial ownership.29

In the Swiss swaps case, the Swiss Tribunal observed that the concept of “beneficial ownership” is implicit in all income tax treaties. It also opined that income tax treaties must be interpreted in good faith to prevent abuse of law by parties that do not carry on any genuine economic activity. Although the decision was ultimately in favour of the Danish bank that issued the total return swaps, an analysis of the issues from an Indian context would be useful.

In the recent case of In re: KSPG Netherlands Holding B.V.,30 the Authority for Advance Rulings (AAR) held that in the absence of any factual and legal basis to hold that a German company was the real “beneficial owner” of shares of the Indian subsidiary, the capital gains arising from the transfer of shares of that wholly owned Indian subsidiary by a Netherlands-based company held by that German company would not be subject

26. However, there could be other grounds for the Indian income tax authorities to tax the income of the FII on the underlying securities that it holds to hedge its position. These could include (i) the underlying securities held by the FII are in the nature of business income and the concerned FII has a permanent establishment in India and (ii) on the basis of general anti-avoidance rules (currently proposed to be introduced from 1 April 2015).
30. 2010-TIOL-09-ARA-IT.
to tax in India under the provisions of the India-Netherlands tax treaty. Further, the AAR went on to state that as the Dutch company was a distinct legal entity having its own board of directors and management systems, in the absence of any evidence to show that it was a mere conduit, device or sham entity, it would be the Dutch company that would be regarded as the beneficial owner of the shares of the Indian company. The other factors that the AAR took into consideration in determining that the Dutch company was the beneficial owner of the shares were that (i) the gains will accrue in the profit and loss account of the Dutch company, (ii) it could not be assumed that the Dutch company would be acting contrary to its corporate status and (iii) no transfer has occurred by unlawful means.

Further, as also indicated in the more recent Vodafone case, the Supreme Court of India upheld the Azadi Bachao Andolan case, which enunciated the principle that a tax residency certificate issued by the Mauritian tax authorities would constitute sufficient evidence for the applicability of benefits under the India-Mauritius treaty. This virtually reaffirms that the “form-over-substance” approach is expected to be adopted to determine the tax liabilities for FIIs on their holdings in India.31

V. Recent Indian Tax Controversy Regarding P-notes

Certain proposals32 of the (Indian) Ministry of Finance and a retroactive clarification by the newly introduced Explanation 5 to section 9(1) (i) that expands the source rule to cover shares or interest in a foreign company, have led to a perception that income from offshore derivative instruments could be doubly taxed: first, in the hands of the holders of offshore derivative instruments on account of the indirect transfer (taxation of transfer of interests in the offshore derivative instruments having underlying Indian assets) and second, if anti-avoidance measures are invoked, denial of treaty benefits to the FII (that has issued the offshore derivative instrument) which would then pass on the liability to the holder of the offshore derivative instrument.

31. [In this regard, it is also pertinent to note the recent Indian ruling by the Bombay High Court in the case of Aditya Birla Nuvo Limited v. DDIT (Writ Petition 730 of 2009; 345 of 2010; 1837 of 2009; and 38 of 2010), TS-346-HC-2011 (Bom). In this case, the Court ruled on the transfer of shares of an Indian joint venture company and also the transfer of shares of a Mauritian company which held shares in the above-mentioned Indian joint venture. The Court dismissed the writ petitions filed by the taxpayer and expressed its prima facie view that such sale of shares is liable to capital gains tax in India. It was maintained that the Mauritian company held the shares only as a permitted transferee of its US parent, and the beneficial ownership of the shares was therefore vested with the parent. The Court seems to have considered whether the Mauritian entity was acting as an agent of the parent in determining whether it was the beneficial owner of the shares of the Indian company. The Court decided that the Union of India v. Azadi Bachao Andolan ruling would be inapplicable on the grounds that the transaction is a colourable transaction and thus in such cases, the tax authorities are permitted to determine the real owner of the shares. The question this case poses is whether – when it comes to the application of treaty benefits – the courts may look at the substance of the transaction and not merely rely on the tax residency certificate that was thought to be sufficient in light of the Azadi ruling.

32. FIIs Worried as P-Notes May Come under IT Scanner, supra n. 3. The concern from industry and investors is whether a holder of an offshore derivative instrument would be taxable in India considering that the value of such instrument is linked to the value of an asset located in India. While the offshore derivative instrument is not in the nature of a “share” or an “interest” in any foreign entity, as it is merely a contractual arrangement, the position is still not settled; while a holder of an offshore derivative instrument may not be taxed, there could be some burden imposed on the counterparty FII if it fails to demonstrate that it is eligible for benefits under the India-Mauritius treaty and that it is the “beneficial owner” of the economic distributions from the underlying securities.
5. Beneficial Ownership as Interpreted in International Case Law and International Tax Law Literature

This section further narrows the focus on those aspects that directly deal with the situs of the beneficial ownership, and who or what could be considered as possessing the attributes of beneficial ownership.

The concept of “beneficial owner” can be best defined as, “the person who can ultimately exercise rights of ownership in the property”, as held by J. Hart in Cowan v. Nova Scotia (Minister of Finance): 33

It seems to me that the plain ordinary meaning of the expression “beneficial owner” is the real or true owner of the property. The property may be registered in another name or held in trust for the real owner, but the “beneficial owner” is the one who can ultimately exercise the rights of ownership in the property. 35

This understanding was approved in the recent Canadian case of Prévost Car Inc. v. R. 36 The Tax Court of Canada held that the beneficial owner is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she has received. The Court further went on to explicitly state that it is the true owner of the property who is the beneficial owner of the property.

A similar view was also echoed by the UK Court of Appeals in the case of J. Sainsbury PLC v. O’Connor, 37 where the Court described the concept of beneficial ownership in the following manner:

The expression “beneficial ownership” is certainly one which has for several centuries had a very well recognized meaning amongst property lawyers. And there can be no doubt that Parliament must have intended to adopt that meaning. It means ownership for your own benefit as opposed to ownership as trustee for another. It exists either where there is no division of legal and beneficial ownership or where legal ownership is vested in one person and the beneficial ownership or, which is the same thing, the equitable interest in the property in another. 38

Similarly, as suggested by the OECD 39 and legal scholars, 40 only when a company acts in a capacity such as a mere agent or nominee of its parent company will it not be considered to be a beneficial owner. According to the OECD discussion draft on Clarification of the Meaning of Beneficial Owner, the term is intended to be interpreted in the context of tax avoidance and tax evasion and not in a narrow, technical sense. 41

34. [1977] C.T.C. 230, affirmed on appeal by the Supreme Court of Nova Scotia (Appeal Division) in [1978] C.T.C. 557. See also Montana Catholic Missions v. Missoula County, 200 US 118 (1905), where the US Supreme Court held that “The expression, beneficial use or beneficial ownership or interest, in property is quite frequent in the law, and means in this connection such a right to its enjoyment as exists where the legal title is in one person and the right to such beneficial use or interest is in another, and where such right is recognized by law, and can be enforced by the courts, at the suit of such owner or of someone in his behalf.”
35. Id. at para. 47.
38. Id.
Furthermore this discussion draft argues that a beneficial owner is someone who has the full right to use and enjoy an asset, and is – in substance – unconstrained by any obligation to pass the payment received to another person. This use and enjoyment, however, is to be distinguished from legal ownership.

The UK Court of Appeals in the case of *Indofood International Finance Ltd. v. JPMorgan Chase Bank N.A.* was confronted with a situation where a subsidiary company, which issued loan notes to various bond holders, had a back-to-back loan agreement with its parent company. As part of the loan agreement, the subsidiary was bound to pay the bond holders whatever interest amounts were received from its parent company. The subsidiary therefore had no power of disposition over the funds received from the parent company and thus was held not to be the beneficial owner thereof. The *Indofood International* case is well contrasted with the *Swiss swaps case*, in which the Danish Bank was held to be the beneficial owner. However, the latter dealt with net swaps which become payable only upon maturity or termination. Thus, the bank was not required to pay the holders on an intermittent basis. Furthermore, even though the Danish bank had hedged its position in the swap contract, the Court did not consider such an action to deprive it of beneficial ownership of the dividends. On the other hand, the role of the subsidiary in *Indofood International* of merely passing along payments deprived it of any beneficial ownership whatsoever.

Further, in discussing the concept of beneficial ownership and the doctrine of piercing the corporate veil, in the English case of *The Evpo Agnic* it was held that where a transaction is shown to be a sham or a fraud, the Court will look at the beneficial ownership to determine who the actual owners are. The UK Court of Appeals held as follows:

The purpose of s. 21(4) is to give rights of arrest in respect of “the particular ship”, ships in the ownership of the owners of “the particular ship”, and those who have been spirited into different legal, i.e. registered, ownership, the owners of “the particular ship ” retaining beneficial ownership of the shares in that ship. This was the situation in *The Saudi Prince*, [1982] 2 Lloyd’s Rep. 255 and was alleged to be the situation in *The Aventicum*, [1978] 1 Lloyd’s Rep. 184.

None of those cases was on all fours with this on the facts, but, in my judgment, they support the proposition that, where an alleged transfer of a vessel is in the relevant sense a sham or façade, the Court will hold that the original owners retain the beneficial ownership in the vessel. That approach is consistent with a number of authorities which have considered the circumstances in which it may be appropriate, as it is sometimes put, to pierce the corporate veil. The leading cases are *Woolfson v. Strathclyde Regional Council*, 1978 S.L.T. 159 and *Adams v. Cape Industries Plc.*, [1990] 1 Ch. 433. In Woolfson the House of Lords stressed that: the relevant principle is that it is appropriate to pierce the corporate veil only where special circumstances exist indicating that it is a mere facade concealing the true facts.

In the English case of *The Tjaskemolen (now named Visvelet)*, the Queen’s Bench Division (Admiralty Court), after examining a number of leading authorities on piercing the corporate veil and beneficial ownership, set out the relevant principles as follows:

The cases have not worked out what is meant by “piercing the corporate veil”. It may not always mean the same thing. But in the present context the cases seem to me to show that, where the alleged transfer is a

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42. [2006] EWCA Civ 158.
44. Id.
sham or a façade, it will not have the effect of transferring the beneficial ownership of the transferor in the vessel concerned. What, if any, effect the alleged transfer of the legal title may have in the absence of an order under s. 423 of the Insolvency Act, 1986 or its equivalent elsewhere, can be considered when it arises. It may be that, if the legal title is transferred, the transferee would hold the vessel as trustee for the transferor so that the beneficial interest in the same sense described in The I Congreso del Partido, [1977] 1 Lloyd's Rep. 536; [1978] Q.B. 500 is retained by the transferor.46

Therefore, the attributes that a person should possess for being perceived as a beneficial owner are (a) to possess the actual right to enjoy and use the assets; (b) to bear the risks and rewards associated with the assets remain with the beneficial owner; (c) to exercise the powers over the disposition of the asset or income arising from such asset and (d) to not possess or exercise such powers and obligations in the capacity of an agent or nominee of another entity.

46. Id.
6. Conclusion

Since the determination of beneficial ownership is primarily a question of fact, a myriad of inconsistencies can arise owing to inadequate and often conflicting, source rules while determining the tax related consequences for both the issuer and counterparty to an ODI. It is clear that benefits of treaty provisions should be limited to entities that are the actual beneficial owners. However, till a consistent international definition or terms of reference have been formalized, determination of ‘beneficial ownership’ should be based on treaty provisions only and not unilaterally determined by the source state. To state the obvious corollary, persons that are not the beneficial owners may be denied such treaty benefits by the source state. The driving fundamental being that an ‘outsider’ should not claim benefits of a ‘bargain between two contracting states.’

While it may be difficult to expect formal clarity on the subject of beneficial ownership in an international context, it is imperative that such clarity be obtained from a domestic law perspective, given the many situations in which it is increasingly being applied, as it is the local tax authority of the source state that applies it and the local court that examines it.

The domain of beneficial ownership concerns the question of treaty entitlement for eligible entities, and the denial thereof to intermediate structures seeking treaty shopping. However, it should not be confused with treaty abuse (which is a matter dealt with in the economic “substance” of the entity claiming treaty benefits). Further, an investigation into identifying the true beneficial owner should commence only if the structure under scrutiny is not the legal or registered titleholder, does not enjoy the right to receive distributions on the concerned assets, does not exercise the voting rights attached to such assets or merely acts as an agent or nominee for some other person. A de facto duty to pass on the income is indicative of no beneficial ownership, and a look-through approach may be adopted in such situations.

Given the level of sophistication of structures currently being used internationally, an exhaustive examination will have to be conducted objectively, with certain “subjective” criteria also considered on a case-by-case basis. In swap transactions, proper tests would be to identify whether the issuer of the swap (long party) (i) bears the risk if no distribution has been made on the underlying assets or whether such risks been decoupled and passed on to the counterparty and (ii) continues to assume control over voting and disposition of the underlying assets or whether the same have been passed on to the counterparty to exercise. Factors such as why a particular transaction structure was used or the duration of such structure in existence should not be considered in this exercise.

47. ‘Beneficial Ownership in Tax Treaties: Judicial interpretation and the Case for Clarity’ by Jinyan Li.
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