

Beneficial Ownership Provisions Newsletter– 10.12.2019

As the tax residency of a company is comparatively easy to substantiate, another tool at the disposal of foreign tax authorities with which to attack a structure, would be through strict implementation of the Beneficial Ownership provisions introduced into Double Tax Treaties.

Under these provisions, instead of attacking the residency of a company, the foreign tax authority would instead argue that a Cyprus company is not the Beneficial Owner of this income, and on this basis would deny the treaty benefits to the distribution made to the Cyprus company.

1. OECD Commentary on Beneficial Ownership Articles

Based on the OECD commentary on Article 10 of the Model Convention, the general understanding is that the *‘State of source is not obliged to give up taxing rights over dividend income merely because that income was paid direct to a resident of a State’* – Paragraph 12. Furthermore, *‘where an item of income is paid to a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the direct recipient of the income as a resident of the other Contracting State. The direct recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence’* – Paragraph 12.2. Specifically, *‘a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties’* – Paragraph 12.3.

Finally, the OECD offers several examples of non-beneficial owners, including agents, nominees and conduit companies acting as a fiduciary or administrators, stating that *‘the direct recipient of the dividend is not the "beneficial owner" because that recipient's right to use and enjoy the dividend is constrained by a contractual or legal obligation to pass on the payment received to another person’* – Paragraph 12.4. However, the OECD clearly states that *‘Where the recipient of a dividend does have the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person, the recipient is the "beneficial owner" of that dividend’* – Paragraph 12.4.

2. Insight from Russian Court Cases

Based on recent court cases where the Russian Tax Authorities challenged the beneficial ownership status of a Cyprus company, we have come to see that particular attention is placed to the following items, in determining whether a foreign company is the beneficial owner of any income received from Russian sources:

Factors **weakening** a foreign company's BO Status

- Income received does not remain within company;
- No employees or assets;
- No typical business expenses;
- Authority and capacity of company management restricted;
- Russian dividend received are the company's main source of income;
- Assets of company consist of mainly Russian companies' share capital;
- Minimal taxes paid;
- Management and control of company exercised by third parties;
- Nominee management team who are also involved in several other companies as well.

Factors **strengthening** a foreign company's BO Status

- Income received is reinvested at company's discretion;
- Existence of personnel and tangible assets in foreign jurisdiction;
- Incursion of typical business expenses in foreign jurisdiction;
- Company holds right to dispose of investments and use income received as it sees fit (i.e. not restricted through Memorandum and Articles of Association or separate legal agreement);
- Russian dividends not company's major source of income, and Russian company shares not only major asset;
- Historic ownership of Russian company shares for several years;
- Foreign company pays sufficient taxes;
- Foreign company is listed in foreign jurisdiction.

3. Recommendations

Over the past few years there has been a surge of large multinationals increasing their substance in Cyprus, marking a positive trend. At the same time however, there has been a strong decline in the use of basic letter box conduits with no substance, as such companies will most likely be denied treaty benefits when receiving distributions from foreign sources if challenged. It is thus recommended that (especially when large amounts are involved) the recipient Cyprus company be a substantial company, with genuine presence in Cyprus, and authority to use the funds it has received however it deems fit. AROSAL can offer a review of a company's presence and operations in Cyprus, offering an opinion as to the probability that its Beneficial Ownership status will be denied by a foreign tax Authorities.