ECONOMIC SUBSTANCE

The OECD in its commentary to a "model treaty" states: "a guiding principle is that the benefits of a DTC (Double Tax Convention) should not be available where the main purpose for entering into certain transactions or arrangements is to secure a more favourable tax position and obtaining that more favourable treatment would be contrary to the object and purpose of the relevant provisions".
It was also made clear that the OECD approves of domestic anti avoidance provisions taking precedence over double tax treaties.

The beneficial ownership requirement is an anti-avoidance clause which is normally included in double tax treaties. It has been a long standing assumption that the recipient of dividends, interest and royalties is the beneficial owner. A new direction now is emerging, no longer agents and nominees can qualify as beneficial owners of received income. In the well-known "Indofoods" case, beneficial ownership of interest income was found to be lacking because the recipient had no alternative but to pass on the income to another. The recipient who was clearly a proxy for the beneficial owner, did not enjoy the privilege to benefit from the income.

The question is "who is the beneficial owner"? Only a few examples of situations in which the recipient is not considered to be the beneficial owner were included in the OECD commentary to the model tax treaty - namely if the recipient is an agent or nominee, then it is not the beneficial owner of received income. It has been left to case law to fill in the gaps as to whether there are other circumstances in which the recipient is not considered to be the beneficial owner.

While countries differ to the extent to which they allow anti avoidance legislation to take precedence over tax treaties, and case law is still not conclusive on beneficial ownership, a clear direction has emerged that if an entity does not have economic substance, there is an increasing risk that it will not hold up upon review by tax authorities and, therefore, will not achieve the intended tax benefits. Essentially substance is increasingly necessary to counter the argument that an entity or structure set up solely for tax reasons is artificial, or is not set up for bona fide reasons which can trigger the anti-avoidance legislation.

Economic substance is necessary to justify that an entity or structure set up mainly for tax reasons, is bona fide.

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