An Analysis of Beneficial Ownership Rules

By Athul Aravind, March 27, 2019

2018 AMENDMENT TO COMPANY LAW ACT- SECTION 90
‘AN ANALYSIS OF BENEFICIAL OWNERSHIP RULES’

This paper analyses the 2018 amendment which introduces ‘beneficial ownership rules’ and introduces ‘significant’ beneficial ownership in India. However, since it is recent, there is a lot of scope to determine how it should be interpreted, in a manner that should fall within the object of the 2017 amendment, which is to curb money laundering. The paper also assesses its impact on corporate layering and tax avoidance strategies used by companies. The introduction of the amendment changes certain ‘tax planning’ strategies to ‘tax avoidance’, which the paper will also scrutinize. The paper would ultimately like to offer a more ‘universal’ approach in tax matters, as opposed to the traditional ‘single entity’ approach that is usually followed while piercing the corporate veil.

The modern market has steadily become more integrated since the decolonisation era and the shift towards globalisation. This has resulted in many companies working among many jurisdictions and has often found it beneficial to operate amongst many jurisdictions. In fact, many companies have seen various advantages in working in other countries, as they may have friendlier working environments, such as favourable tax and investment treaties, or, are tax havens. These companies often incorporate subsidiaries in these jurisdictions to layer their investments and avoid the added burden of being non-residents in that state for ease in doing business and availing tax benefits.

The company which incorporates these subsidiaries are called holding companies, which are investment vehicles, and operating companies, which are the subsidiaries. The incentive for investment vehicles in forming this arrangement is that it reduces its risk, and often avails tax benefits that it is not theoretically entitled to. We will analyse these arrangements in this paper and assess its impact on the evolution of the concept of beneficial ownership, which is the one of the purposes for these types of arrangements.

2018 Amendment

The issue of the misuse of multi-layered corporate entities has grabbed attention of various policymakers and regulators and subsequently passed the 2018 amendment
which introduced various changes to address this issue. In fact, the object of the amendment was the following:

a) To Close the loop on Combating Money Laundering

b) Transparency

c) The mandate of the Rules is to “look through” the entire maze of intermediate entities and identify the ultimate individual owners of a company.

d) Identify individual who ultimately holding significant beneficial ownership.

To understand the implications of corporate structures on beneficial ownership, we must first look at a few key words and statues, such as the 2018 amendment, which has introduced ‘significant beneficial ownership’.

As per Section 90(1) of the 2017 Act, a beneficial owner is:

Every individual, who acting alone or together, or through one or more persons or trust, including a trust and persons resident outside India, holds beneficial interests, of not less than twenty-five per cent. or such other percentage as may be prescribed, in shares of a company or the right to exercise, or the actual exercising of significant influence or control as defined in clause (27) of section 2, over the company (herein referred to as “significant beneficial owner”), shall make a declaration to the company, specifying the nature of his interest and other particulars, in such manner and within such period of acquisition of the beneficial interest or rights and any change thereof, as may be prescribed.

Before Section 90 was introduced, disclosure was required by both the legal owner of the shares and the person holding beneficial interest in the company. But what constituted beneficial interest was not defined under law, which made it difficult to identify the real owner.

However, for the sake of understanding, a beneficial interest is the right to receive benefits on shares held by another party. Beneficial interest is often referred to in matters concerning trusts, whereby one has a vested interest in the trust’s assets. A beneficial interest is “that right which a person has in a contract made with another (third party)”.[2] An example would be to receive any dividend directly or indirectly from shares.

As per rule 2 of the ‘2018 beneficial ownership rules’ an ‘Individual’ means:

any person who is not a registered shareholder of the company (whose name is not entered the company’s statutory register of members) but:

I) either individually or jointly owns not less than 10 percent of the share capital of the company; or

II) directly or indirectly exercises significant influence or control over the company.
This is a major deviation under the 2018 Rules from Section 90(1) of the 2017 amendment, as the threshold provided for an individual being classified as a significant beneficial owner is 10 (ten) percent in contrast to the threshold of 25 (twenty-five) percent prescribed under 90(1).

**IMPACT ON CORPORATE STRUCTURES**

Since, the introduction of this rule was recent, there aren’t enough Indian cases that decide on ‘significant beneficial ownership’. Hence, we will analyse the commonly used structures by companies and assess whether it could be interpreted as beneficial owners or not. Since these rules have been modelled through the growing need to treat group companies as a ‘single or common entity’ as opposed to the ‘separate entity’ approach in the globalised market where there is tremendous velocity of money between nations, especially in the realm of beneficial interest. The UN and OECD have provided various action plans to curb the money laundering problem as well. We will assess how other countries have interpreted beneficial ownership, to examine how it should be evolved in India. We will assess EU nations as they have an integrated market.

As an example, let us take a basic corporate structure to clearly examine this concept.

- **A** is the holding company, let us say it is a company incorporated in Spain.
- **B** is a wholly owned subsidiary of A (100% ownership of shares) which is incorporated in Mauritius, which also happens to be a tax haven. It has one director, who is also an employee of Company A. Further, Company B has no employees.
- **C** is a wholly owned subsidiary of B (has more than 50%) and it is incorporated in India.

The main reason that places like Mauritius are tax havens is that they have business-friendly bilateral treaties with select countries, India being one of them. One example of this, would be that the dividends flowing from India to Mauritius are exempt from tax.

Company A would like to maximise its profits, so incorporating a subsidiary directly in India would mean it might lose 15% of profits in dividend tax, however if it
incorporates a conduit company in Mauritius, which in turn incorporates a subsidiary in India, then the dividends can flow to Company A from Company C without any tax. This is a common tax avoidance strategy.

Company B is a conduit company used for maximising profit and limiting risk, however these conduits merely facilitate profit-making, rather than actually make profit. In fact, their capital is usually a loan granted by the parent. So, let’s say that Company A loaned 10 million dollars to Company B as a 5-year unsecured loan. This is because in an international context it may often be more advantageous to arrange the financing of a company by way of loans rather than by way of equity.[3]

Another common occurrence to determine whether it is a sham company is to see whether the purpose for which the loan is given is followed through. Often, the conduit uses a small sum for the said purpose and pumps in the rest to its subsidiary. It is important to note that Company B is indebted to its sole shareholder in Company A.

Company C, which is located in India has made a profit of 500,000 dollars for which Company B has a majority shareholder will receive a significant chunk of the dividend. However, the dividend received by Company B will go into paying the debt to Company A.

Will Company A be the ultimate beneficial owner?

ANALYSIS

Section 2(27) defines ‘control’:

‘control shall include the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner’

Section 2(76) which defines related party, includes under sub-clause vii:

(A) a holding, subsidiary or an associate company of such company;
(B) a subsidiary of a holding company to which it is also a subsidiary; or
(C) an investing company or the venturer of the company;

An entity might indulge in ‘Treaty Shopping’ by setting up another entity in a state which has a favourable tax treaty with another state in order to derive the benefits out of that treaty which are otherwise unavailable to the original entity. The company which is set up to give effect to such pre-meditated treaty shopping is called a ‘Conduit Company’. [4] A conduit company should have these characteristics:[5]

a. It should be an intermediary between the source of income and the destination of that income.
b. The intermediary should be the legal owner of the income and shall own the income ‘beneficially’.

It is evident that Company B is a conduit or a sham company as it is used to funnel dividends. It is also evident that Company A and C are clearly related parties. Company B is definitely in control of Company C. Company A controls the management of B, as its employee is the director, and can be indirectly concerting with Company B. **The definition is also open to other manners of defining control.**

In fact, there is no clarification on what constitutes significant influence in the context of identifying a significant beneficial owner.

Under the 2018 amendment, Company A is not a registered shareholder of Company C, and in the section paper we will analyse whether it has exercises control over Company C.

Traditionally, the law would allow Company A to receive its dividends using the separate entity approach, as it is legally independent, the courts mostly look at ‘Legal Ownership’, which in this case is with Company B. However, the addition of ‘control’ can add another component in ‘Economic Ownership’, whereas a ‘certain degree’ of economic ownership is required for beneficial ownership to exist. Economic ownership can be determined by the ‘amount of risk assumed’. If the legal owner has assumed the risk of the asset, there is beneficial ownership. In this case, Failure of Company C will affect Company A directly, as Company B is 10 million dollars in debt to A, and the risk of which will drastically affect Company A as it is unsecured credit as well. Company B also has no control or dominion over its assets due to its indebtedness.

Since Company B was a wholly owned subsidiary of Company A and it did not have any employees of its own apart from its sole director. These facts are indicative that Company B could be a “shell” company without a management of its own, used by Company A (parent), to make profits from economic activities in India through Company C. Company B had very narrow powers which rendered it, in relation to the dividends, a mere fiduciary or administrator acting on account of Company A.

**THE FUTURE**

The insertion of 90(1) and the beneficial ownership rules can catch corporate structures like this using the economic ownership test.

The test of control, where courts have pierced the corporate veil and adopted a ‘single entity’ approach can be seen in Parle Bisleri[6] Case, where the court held that companies that are ‘interdependent’ and are related through ‘financial control’ are subject to piercing of the corporate veil.

The lack of definitions and flexibility is a result of lack of debate and discourse about this area. Many jurisdictions still stick to the separate entity approach and do not investigate further than the first layer. However, the concept of ‘economic ownership’
and financial control will help the courts in lifting the corporate veil in a market that is constantly integrating among many jurisdictions which gives a lot of leeway for creating smoke-screens and could significantly increase black assets around the world through layering companies to effectively launder money and justify it legally.

Notes:-


[4] Id. at 5.


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