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Tax treaties and tax avoidance

Specific anti-avoidance provisions
CFC legislation

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Domestic Anti-Avoidance Rules

- General Anti-Avoidance Rules (GAARs)

- Specific Anti-Avoidance Rules (SAARs)
  - Thin Capitalization
  - Recharacterization of income
  - Exit taxes and deemed disposals (e.g. of shares) or deemed receipts (e.g. of accrued pension rights)
  - Controlled foreign companies-legislation (CFC)
  - Others

OECD Commmentary on SAARs

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- OECD Commmentary on Article 1 (§23), Article 7 (§13), Article 10 (§37 to §39)
  - "*Whilst some countries have felt it useful to expressly clarify, in their conventions, that CFC-legislation did not conflict with the Convention, such clarification is not necessary. It is recognised that CFC-legislation (…) is not contrary to the provisions of the Convention*"
  - *"Taxation by State imposing CFC-legislation on its own residents by reference to profits of a subsidiary that is a resident of the other State, is out of scope of Articles 7 and 10 of the OECD MC"*
  - *(…) it should be noted that [Art. 10 § 5] is confined to taxation at source and, thus, has no bearing on the taxation at residence under [CFC-legislation]. In addition, the § concerns only the taxation of the company and not that of the shareholder"*

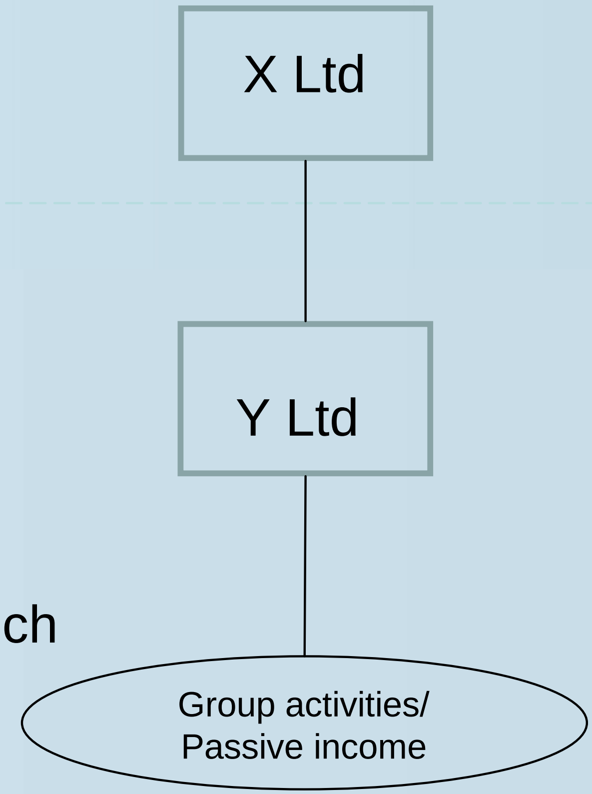
UN Model: Improper Use of Tax treaties (June 2009)

- Modelled on OECD Commentary with some differences
- Easier to follow that OECD Commentary
- Clarification of OECD Commentary
  - e.g. on reference to domestic law definitions with respect to SAARs (e.g. Art. 3 (2) and 10 (3) UN Model) (§18)
- Recognizes legal certainty and taxpayers' rights (§100-103)
- Detailed examples of improper use (§40 – 99)

The basic CFC Case

State A

State B



<u>CFC: the basic case</u>:

•State A is a high tax jurisdiction

•State B is a low tax jurisdiction in which (certain) income is accumulated on a low or no tax basis

CFC-legislation: different techniques

- Two legislative techniques attempting to strike down tax deferral by using separate legal entity that accumulates profit and enjoys favorable tax regime:
  (i) Look-through-approach (attribution of undistributed profits of the subsidiary to the shareholder)
  (ii) Deemed dividend approach

- Two approaches in scope:
  (i) Low-tax jurisdictions
  (ii) Tainted income

Different approaches by judiciary

- Three approaches by domestic judiciary in assessing tax treaty compatibility:
- (i) No conflict with Article 7 (France v. Brazil)
- (ii) Out of scope tax treaty (Japan / Finland / UK)
- (iii) Potential conflict, but treaty override permitted (Sweden)

Conflict with Article 7

Schneider Electric (France 2002)

- French parent taxed in France on proportionate share of overall profits of Swiss subsidiary (“look through”).
- Conseil d’Etat
  - Domestic law analysis
    - Effect of rule
    - Characterization of income (“profit”)
  - DTC interpretation: does Art. 7 restrict F taxing rights?
    - Art. 3 (2): domestic meaning > Art. 7 F/Swiss DTC
    - Identity between profits of Swiss sub taxable in Switz (Art. 7) and profits of Swiss sub taxed in F in name of F parent
    - Art. 7(1) precludes F from taxing profits of Swiss sub with no PE in F

Conflict with Article 7

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- ***Schneider Electric* (France 2002) (Cont'd)**

  - DTC interpretation: does Art. 7 restrict F taxing rights? (cont'd)
    - Purpose of DTC (elimination of double taxation) does not justify incorrect application of Art. 7 (1) on sole ground that taxation in F is made against parent, a separate legal entity to which undistributed profits of CH sub are attributed
    - Even if goal of DTC is to counter tax avoidance and evasion, such does not permit to derogate from terms of DTC
    - French CFC-legislation changed subsequently (deemed dividend)
      - Potential debate on treaty override (impossible under F Constitution)

Conflict with Article 7

Eagle I (Brazil 2006)

- Brazilian parent with Spanish CFC
- 2001 Brazilian CFC-rule applies to any controlled corporation, wherever resident, and regardless of type of income earned, even if company carries on genuine business activity, has substance or there is a business purpose for setting up CFC
- Federal Administrative Tax Court
  - Brazil CFC-rules tax profits of Spanish sub: violation of Art. 7 Brazil/Spain DTC: such profits are only taxable in Spain
  - Even if a deemed dividend. Spanish dividend exempt in Brazil (Art. 23 (4) DTC)

No conflict with Article 7

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Eagle II (Brazil 2008)

- Brazilian parent with Spanish CFC holding two subs
  - Subs in Uruguay and Argentina proceeded to equity adjustments. No distribution of profit to Spanish CFC
  - Brazilian tax authorities attribute profit of Argentina/ Uruguay subs to Brazilian parent
- Federal Administrative Tax Court
  - Also profits earned by CFC (controlled indirectly) are to be taken into account and added to the income of Brazilian parent
  - Art. 7 Brazil/Spain DTC not applicable
    - Profit earned by indirectly controlled companies in third countries. Profit not earned by Spanish CFC
- Criticism in Brazilian doctrine: unlawful disregarding of Spanish CFC; why not testing under Brazil/Argentina?

Out of scope tax treaty

Glaxo Kabushiki Kaisha (Japan 2009)

- Japanese parent with Singapore subsidiary. Japanese parent taxed in Japan on prorata share of Sing sub's profit
- Japanese Supreme Court
  - Purpose of Art. 7 Japan/Sing DTC: avoidance of international juridical double taxation of profits of Sing company in Japan
  - Japan cannot tax profits of Sing company with no PE in Japan
  - But CFC rule taxes the income of the Japanese shareholder and not the income of the Singapore CFC > no breach of Art.7
  - Rule not disproportionate: exceptions for CFC with genuine business activity

Out of scope tax treaty

A Oyj Abp (Finland 2002)

- Finnish parent with low taxed Belgian sub
- Finnish Supreme Administrative Court
  - CFC legislation does not violate Art. 7 Belgium-Finland DTC
  - Reliance on 1992 OECD Commentary to construe 1976 DTC
  - CFC-rule: "*part of the basic domestic rules set by national tax law for determining which facts give rise to a tax liability and (…) these rules are not addressed in tax treaties and are therefore not addressed by them*"
  - Out of scope of tax treaty

Out of scope tax treaty

Bricom Holdings Ltd (UK 1997)

- UK parent with Dutch CFC receiving UK source interest
  - UK parent taxed on “*sum equal to corporation tax*” on all of CFC’s “*chargeable profit*” (i.e. UK source interest)
- UK Court of Appeal
  - UK interest not included in UK parent’s income. Interest is only a measure by which a notional sum is calculated and apportioned to UK shareholder and on which it is taxed.
  - Not a taxation of actual income of Dutch CFC in the hands of UK parent > no conflict between CFC legislation and tax treaty

Potential conflict but treaty override permitted

X AB (Sweden 2008)

- Swedish parent of Swiss insurance company
- Extended Swedish CFC-rules 2004 (with a white list for excepted countries, not Switzerland)
- Taxpayer's argument: CFC rules not in accordance with Art. 7 of 1965 Sweden-Switzerland DTC
- Swedish Supreme Administrative Court:
  - Sweden is a dualistic country
  - Subsequent statute of equal rank as statute implementing DTC
    - If rules cannot be reconciled > normal conflict of law rules (lex posterior; lex specialis)
  - Court suggests conflict between CFC-rule and Art. 7
  - But endorses treaty override

Indian CFC legislation proposal

- Draft bill introduced in Parliament August 2010
- Not yet passed. Referred to Standing Committee for review
- Income of CFC attributed to Indian resident
  - All (active and passive) income in proportion to the equity interest and the period of the financial year during which the equity is held
  - Would not retain original character but would be qualified as "*other income*"
  - Direct attribution of the CFC income to Indian resident
- No specific debate on interaction CFC-rule with DTC's
  - Treaty override provision to be enacted in bill to avoid conflict?