# Substance over form
# in tax matters

**Anthony & Cie (France) - Prof. Robert Anthony**, Principal Partner
Chairman of "International Wealth Management, Trust and Estate Planning" PG

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Anthony&Cie
Financial Planning

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# Q1: What is a permanent establishment today in your country and how does that differ from the OECD model tax treaty?
# DEFINITION

| Germany | According to Article 12 of the AO (General Tax Code) a permanent establishment is defined as follows:<br><br>“Permanent establishment shall mean any fixed place of business or facility serving the business of an enterprise.<br>In particular, the following shall be considered permanent establishments:<br>1. the place of business management,<br>2. branches,<br>3. offices,<br>4. factories or workshops,<br>5. warehouses,<br>6. purchasing offices or sales outlets,<br>7. mines, quarries or other stationary, moving or floating facilities for the exploitation of natural resources,<br>8. building sites or constructions or installation projects, including those moving or floating, where<br>a) an individual building site or construction or installation project, or<br>b) one of several coexistent building sites or constructions or installation projects, or<br>c) a number of immediately successive building sites or constructions or installation projects<br>last (s) more than six months.” |
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# Q1: What is a permanent establishment today in your country and how does that differ from the OECD model tax treaty? DEFINITION

| France | The CGI (French General Tax Code) does not give any definition of a permanent establishment.<br><br>This concept is defined by case law, and is part of the largest concept of business carried out in France, including the permanent establishment, the representatives of a company acting on its behalf in France, and the fact of running a full commercial cycle in France.<br><br>The permanent establishment is defined by case law as follows:<br><br>“Permanent establishment shall mean any fixed place of business having some independence in the performing of its activity (separate staff and/or separate accounting and/ or separate financial-commercial-technical departments and/or business management).<br><br>In particular, the following shall be considered permanent establishments:<br>1. the place of business management,<br>2. factories or workshops,<br>3. offices,<br>4. purchasing offices or sales outlets,<br>5. branches, shops, agencies<br>6. mines, quarries or other facilities for the exploitation of natural resources,<br>7. building sites or constructions or installation projects |
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**Hungary**

The structure of the Hungarian definition follows the OECD structure as for the “basic rule”, contained in Article 5(1) OECD Model, and as for the “positive list”, contained in Article 5(2). The OECD agreed concept which explains the concept of “permanent establishment” by way of the “place of business” one, is inverted, in fact, in the Hungarian Act on Corporate Tax and Dividend Tax, the “place of business” is defined as a “permanent business establishment”. The difference shall be considered as a semantic one, since the structure of the “basic rule” is close to the OECD one.

Place of business is defined by law as follows:

a) a permanent business establishment, equipment, and accessories that is used by the taxpayer in whole or in part for business activities irrespective of the taxpayer’s entitlement to use them; the term ‘place of business’ shall cover, in particular, the place of management, representative offices established with a registered office in Hungary, offices, factories, plants, workshops, mines, crude oil or natural gas wells, and other facilities used to explore or exploit natural resources,

b) site of construction or assembly operations (hereinafter referred to collectively as “construction site”), including supervisory activities related thereto, if such construction continues for a total of at least three months (with or without interruption) with regard to individual construction sites irrespective of whether such activity is based on several independent contracts or whether it was commissioned by several parties; any construction project constituting one unit from an economic, business and geographical point of view shall be recognized as one construction site,

c) a foreign person shall be regarded as having a place of business in case of the direct utilization of natural resources in Hungary,

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d) a foreign person shall be regarded as having a place of business in cases of the utilization of any real estate property or natural resources in return for consideration, the transfer, sale and contribution in kind of any rights in immovables or in natural resources (hereinafter referred to as "utilization of real estate") in return for consideration,

e) a foreign person shall be regarded as having a place of business, in the case of activities which are undertaken by other foreign or resident persons on behalf of such foreign person, if they are entitled to enter into a contract in Hungary on behalf of the foreign person and exercise such right on a regular basis, or maintain stocks of commodities or products from which they regularly make deliveries on behalf of the foreign person,

f) without prejudice to the above provisions, a foreign person shall be regarded as having a place of business if another person takes out insurance on behalf of such foreign person - with the exception of reinsurance and the provisions of Paragraph g) notwithstanding - for risks occurring in Hungary,

h) a foreign person shall be regarded as having a place of business if engaged in business operations through a branch.

The following shall not be construed as a place of business:
1. establishments used exclusively to store and present the goods or products of a foreign person,
2. stockpiling of goods and products of a foreign person exclusively for storage, presentation and processing by another person,
3. establishments maintained exclusively for purchasing commodities and products or collecting information for a foreign person,
4. establishments maintained exclusively for carrying out preliminary or auxiliary activities,
5. activities carried out by an independent representative (including commission agents), if acting within the framework of his ordinary business activities.

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# Q1: What is a permanent establishment today in your country and how does that differ from the OECD model tax treaty? DEFINITION

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| USA | The term 'permanent establishment' is reserved for tax treaties, and the US has a model tax treaty latest version 2006. Under the Internal Revenue Code, the term 'engaged in a trade or business in the United States' is used by the Internal Revenue Code and Treasury Regulations. Treas. Regs. § 1.864-2 defines "trade or business within the United States." "Office or other fixed place of business' is defined in Treas. Regs. Section § 1.864-7. |
| India | Section 6(3) of the Indian "Income Tax Act, 1961", defines 'Residence in India' which determines whether an income of an assesse is taxable in India or not. Section 6(3) defines residence for the purpose of taxability of the income of a company as follows :<br><br>"(3) A company is said to be resident in India in any previous year, if:<br>(i) it is an Indian company ; or<br>(ii) during that year, the control and management of its affairs is situated wholly in India."<br><br>India has negotiated double tax avoidance agreements (DTAA) with various countries, and depending on their importance has taken or given away certain taxing rights. Therefore the definition of permanent establishment in the various DTAA's vary from country to country, with minor inclusions or exclusions. Some of the differences are on account of :<br>- Building or installation or construction site – some are based on period, some are based on percentage or material / machinery supplied.<br>-Services rendered other than those covered under the Article for "Royalties and Fees Technical Services" – some are based on period and in some DTAA's this particular item does not feature. |



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# Q1: What is a permanent establishment today in your country and how does that differ from the OECD model tax treaty? DIFFERENCES

**Germany**

In general the following elements constitute a PE:
- Time element, according to tax authorities all activities exceeding 6 months, acc. to court decisions/literature. 9-12 months, exceptions are possible (e.g. 2 months with film production that only took 2 months)
- Territorial element: a PE does not need a fixed connection to a place on the surface. Being for a certain time on a certain place is enough (e.g. repeatedly several hours on a market stand), staff is not needed (pipeline, server)
- Power of disposition: should not just be temporary. The firm should have a legal position that cannot be withdrawn or changed without further ado.
- Entrepreneurial activity: performing your own trade, serving a business activity

The German definition is tighter than the OECD model tax treaty and differs in the following points:
- The OECD model tax treaty does not list warehouses, (no. 5)
- The OECD model tax treaty does not list purchasing offices or sales outlets (no. 6)
- The OECD model tax treaty contains a 12 month (instead of 6 months) period for building sites or constructions or installation projects (no. 8)
- The OECD model tax treaty does not treat side and helping activities, that are not within the core business objective of the enterprise as a permanent establishment
-The OECD model tax treaty does not include any activities of access to information's ( not explicit listed in German legislation)

There are a lot of court decisions interpreting the law and also giving a kind of guideline if a business operation is treated as a permanent establishment or not, but in a lot of cases taxpayers face uncertainty how tax courts or national tax authorities will decide.



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# Q1: What is a permanent establishment today in your country and how does that differ from the OECD model tax treaty? DIFFERENCES

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| France | It differs from the OECD model tax treaty in the following points:<br>- The OECD model tax treaty does not list purchasing offices or sales outlets.<br>- The OECD model tax treaty contains a 12 month period for building sites or constructions or installation projects. |
| Hungary | Unlike Article 5(3) OECD Model which applies to “a building site or construction or installation project” the scope of the Hungarian rule is extended, also, to “assembly sites”.<br><br>To the same extent, the Hungarian rule follows the UN Model including in the construction clause the supervisory activities. In the absence of a relevant double taxation avoidance treaty (DTA), the scope of the Hungarian legislation is wider than the same case falling under DTA’s permanent establishment rules.<br>A construction site or the site of a capital investment constitutes a permanent establishment already after 3 months. |



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## Q1: What is a permanent establishment today in your country and how does that differ from the OECD model tax treaty? DIFFERENCES

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| USA | Income from sources within the U.S. is subject to taxation under IRC Sec. 861. Under IRC Sec. 864(b) and (c), when a foreign corporation is engaged in a trade or business in the U.S. (hereafter "ETB"), it is taxed on the portion of its income that is effectively connected with its trade or business (hereafter "ECI"). The tax is computed, in general, in the same manner as a U.S. corporation or individual doing business in the U.S.. Taxes are computed on a net income basis (gross income less deductions). In addition, if the foreign corporation operates a branch in the U.S., rather than a corporation, there could be a branch profits tax of 30% under IRC Sec. 884 (as though a dividend were paid to Parent under IRC Sec. 881(a)), in addition to the regular tax on ECI under IRC Sec. 11. The purpose of the branch profits tax is to equalize the tax treatment between a foreign corporation that uses a corporate subsidiary or an unincorporated branch in the U.S. Using a branch office in the U.S. will subject the foreign corporation to an immediate double taxation on its ECI. An excellent article on this topic can be found at “Engaged in a Trade or Business (in the United States)” Blanchard, Kimberly S., (March 2011, BNA Tax Management International Journal Vol. 40 No. 3). |
| India | It is tighter than the OECD model tax treaty and differs in the following points:<br><br>1. The OECD model tax treaty does not list warehouses, which appears in many India DTAA’s.<br>2. The OECD model tax treaty does not list purchasing sales outlets, which appears in many India DTAA’s.<br>3. The OECD model tax treaty contains a 12 month period for building sites or constructions or installation projects. Indian DTAA’s have period ranging from 6 months to 12 months and some are even based as a percentage of material / machinery supplied.<br>4. Other than the above, there are one or two changes in individual country treaties. |

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## Q2: Does the signing of a contract effect the above?

| Country | Answer |
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| Germany | The substance is decisive, not the form. Nevertheless signing certain contracts will almost always be assumed by the fiscal authorities as existence of a permanent establishment, e.g. if a branch is registered in the German commercial register or contracts give power to the German staff. |
| France | The substance is decisive, not the form. Nevertheless signing certain contracts will almost always be assumed by the fiscal authorities as existence of a permanent establishment, e.g. if abranch is registered in the France commercial register or if internal documents show that the operational decisions (e.g. closing contracts with customers) are usually made in France. |
| Hungary | Branch office of a foreign company is regarded as established upon having been entered in the company registration records and may commence entrepreneurial activities following such registration. |
| USA | The mere place of signing of a contract is not determinative. Many more factors are taken into account. |
| India | Based on the definition of "Residence in India", if the Indian entity can bind the foreign enterprise in a contractual agreement, then this will mean that the effective control / management, even if not for the entire business, but atleast for that particular contract was in India, and it can be considered as a Permanent Establishment. |



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## Q3: What is considered substance and real management?

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| Germany | The activity should serve business purposes or support the business objective, e.g. commercial activities, production, distribution, R&D. Business activity does not only include core business activities. It is controversial if facilities that merely serve social purposes and interests of the employees can be permanent establishments, as these serve the business objective if at all, only indirectly.<br>Real management is where the centre of the management is located, i.e. the place where the will of the management is formed. This can be several places. Strategic decisions are not alone relevant but also the operational day to day decisions of the management. If the centre of management is in Germany there is always a PE. That is the case if important decisions (e.g. closing contracts with customers, organization, strategy, control, performance according to the articles of association) are usually made in Germany. This is normally checked by the tax authorities before issuing a German tax number. |
| France | The activity should serve business purposes or support the business objective, e.g. commercial activities, production, distribution, R&D. Business activity does not only include core business activities.<br>Real management is where the centre of the management is located, i.e. the place where the main decisions are taken. The place where the management is based is a key point. |
| Hungary | Any activities serving business purposes and/or supporting the business objective shall be considered as substance.<br><br>Real management is where the place of management is located. |



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## Q3: What is considered substance and real management?

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| USA | Under case law, in order to be considered “engaging in a US trade or business” the activity must be “regular, substantial and continuous”.<br><br>See IRS explanation:<br>http://www.irs.gov/businesses/small/international/article/0,,id=96409,00.html |
| India | The importance given to “control and management” brings out the intention of substance over form in India. With respect to real management, the word “effective” is generally added to “control and management”. Therefore if effective control or management lies in India, then it will fall in the ambit of ‘permanent establishment’. |

## Q4: Do you have recent case laws ?

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| Germany | BFH (German Supreme Tax Court) dated 13 October 2010, clarifying that a foreign company is an active company if it maintains business operations that are adequate to their business objective. In the case a German insurance company established an Irish daughter company, performing reinsurance business and just paying 10% tax on income in Ireland. Operational management was performed via a "management agreement" by another corporation in Ireland. The court decided that the Irish Ltd. is active.<br><br>ECJ dated 28 October 2010, C-72/09 (Etablissement Rimbaud SA). ECJ ruled that a German tax privilege may depend on proper legal and administrative cooperation with the relevant other country. The decision is relevant for all cases before exchange of information came into effect. |
| France | The French supreme High Court (Conseil d'Etat) has ruled that a UK company providing in France to professionals a training center for race horses, does not have a permanent establishment since: (i) there is no staff in France except a guard, and (ii) even if the training center has all the different rooms that are needed for such an activity (bedrooms for stable-lads, paddocks, forge, saddle room, forage barn and so on), their equipment was not provided by the UK company (Conseil d'Etat 31st July 2009, Sté Overseas Thoroughbred Racing Stud Farms Limited). |
| Hungary | – |

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## Q4: Do you have recent case laws ?

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| USA | The leading case of most recent vintage is Inverworld, Inc., et al 979 F.2d 868 (1997) which essentially outlines how a foreign corporation should not do business in the U.S. Inverworld Ltd (LTD) was an investment management and financial services company organized in the Cayman Islands, a tax haven. Its business was to provide U.S. and foreign investment opportunities to the Mexican clients of its sister Mexican company while avoiding (evading) tax in Mexico. LTD received clients' funds and placed such funds with third parties. A substantial part of the activities that produced LTD's income took place in San Antonio. The court held that LTD was engaged in a trade or business in the U.S. and was its income ECI.<br>Most of the other case law has been settled for quite a while. A foreign corporation engages in a trade or business in the U.S. when it is involved in a profit-oriented activity within the U.S., either directly or indirectly, or through agents, when the activity is regular, substantial and continuous. CM v. Spermacet Whaling and Shipping Co., 281 F2d. 646 (6th Cir. 1960). The court in Spermacet found that a company that hunted whales on the high seas for sale to a U.S. oil refiner was not engaged in a U.S. trade or business despite close financial links to the U.S..<br>Sales by a foreign corporation to U.S. customers directly, without the use of an office, agent or employees in the U.S. is generally not a trade or business. U.S. v. Balanovski, 131 F Supp. 898 (S.D.N.Y. 1955). Green Export Co., v. U.S. 285 U.S. 383 (Ct. Cl. 1961); Perry Group, Inc. v. U.S., 1980-2 USTC � 9603 (D.C. N.J. 1980). Use of a sales person in the U.S., however, will cause the foreign corporation to become ETB. Revenue Ruling 56-165, 1956-1 CB 849. |
| India | The recent globally known "Vodafone" case, where though the shares sold were of a BVI company, that BVI company was the ultimate parent of an Indian company, by virtue of which the ownership of the Indian company changed hands. The tax authorities have considered the substance over form and have launched proceedings to tax the capital gains from the sale of shares of the BVI company. The matter is currently in court. |



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# Q5: What is considered offshore?

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| Germany | CFC Legislation: According to the Foreign Tax Relations Law, low-taxed passive income of a foreign company will be added to the German taxable income of its German resident shareholders and this income will be imputed to the German resident shareholders proportionately under certain conditions. Income is low-taxed if both in the state of seat and of management of the foreign company it is subject to income tax at a rate of less than 25%. The taxable income has to be determined in compliance with the German tax law. Shareholders affected are German residents who (alone or together) hold more than 50% of a foreign company's capital or voting power. If, however, the foreign company derives income from the holding or administering of any kind of securities, currencies, participations (other than dividends from the participation in a company and, generally, capital gains on shares) and similar assets (passive portfolio income) and if this income exceeds certain thresholds, the rules apply already if one resident shareholder holds at least 1% of the company's capital or voting power. Even less than 1% suffices if the foreign company derives exclusively or almost exclusively passive portfolio income.<br>The income imputed to the German-resident shareholder (deemed dividend distribution) is added to the taxable income of the shareholder and taxed at the (income or corporate income) tax rate of the shareholder. The tax exemption for dividends does not apply to the deemed dividend distribution under the Foreign Tax Relations Law. However, if the foreign company actually distributes its profits, the tax exemption for dividends applies.<br>The CFC legislation does not apply if the tax payer can prove that<br>• the controlled foreign company is resident in an EU or European Economic Area (EEA) Member State and carries out a genuine economic activity ( the German legislation has listed their view of economic activities in 10 points).<br>• passive income otherwise subject to CFC taxation is derived in connection with such activities.<br>• the Mutual Assistance Directive or a similar agreement between Germany and the respective EU or EEA state is applicable. |
| France | Where there is not a tax treaty with France the foreign jurisdiction would be considered offshore. The exchange of information agreement can be sufficient in certain circumstances where there is purely property ownership. |

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# Q5: What is considered offshore?

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| Hungary | Hungarian legislation refers to offshore companies as “controlled foreign companies” (CFC).<br>From January 1, 2010 a foreign company which either:<br>(i) has a beneficial owner who is a Hungarian tax resident private individual holding a 10% interest during the majority of the tax year or<br>(ii) derives the majority of its income from Hungarian sources, will be treated as a CFC, provided that it does not meet the comparable taxes requirement, and it does not have real economic presence and tax residence in an OECD or treaty country.<br>Comparable taxes requirement means that the company in the given tax year pays or is required to pay taxes at the effective tax rate not lower than 10%. In case of results being zero or negative, the statutory income tax rate of the foreign country must reach this threshold. Consequently not only companies of low tax countries but of countries providing significant tax benefits with an otherwise high tax rate, may also be considered as a CFC.<br>A company not meeting the comparable taxes requirement but having a real economic presence in an OECD or treaty country shall not be considered a CFC. Real economic presence means when a nonresident company is engaged in gainful activities in another state - together with its affiliates established in that state, where applicable -, such as in manufacturing, processing, agricultural, service, investment and trading activities, using its own equipment and own workforce, where their revenues from such activities represent at least 50% of all revenues.<br>Any nonresident company in which a person that is listed on a recognized exchange for a period of not less than five years effective on the first day of the tax year, or its affiliated company holds a share of at least 25% on each day of the tax year shall not be recognized as a CFC. |
| USA | The term ‘offshore’ is not a defined or commonly used term. Something is either ‘foreign’ or ‘domestic” pursuant to IRC Sections 7701(a)(4) and (5) and Treas. Regs. Section 301.7701-5. |
| India | Though there is no definition of what is offshore, the general opinion is that whatever is not considered as a ‘permanent establishment’ is offshore. |

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# Q6: Do tax treaties apply to a letter box company i.e. UK, Cyprus, Malta?

## Germany

Rules that shall prevent zero or low-taxation in outbound cases are e.g.

a) Treaty override general
First it is to note that the double tax treaty itself could include clauses for the possibility of taxation for the two parties in opposition to the basic rules for the power to tax. These clauses give the treaty countries the right for a treaty override in the national legislation under the agreed conditions. These treaty clauses are:

- The subject to tax clauses = taxation in the other country, if the state with the power to tax does in application of the double tax treaty not really tax these transactions in his domestic tax legislation. Germany often has appointed such a subject to tax clause in its double tax treaties.
- The switch over clauses = crossing from exemption of the German taxation to the method of tax credit.
- The appointment of treaty abuse for certain conditions.
- Last but not least the appointment of activity clauses.

b) abbreviations

AO = German Fiscal code | AStG = German Foreign Tax Code
EStG = Income Tax Law | KStG = Corporation Tax Law

c) Abuse in taxation matters (§ 42 AO)
Since 2008 the German tax legislation has a legal definition for tax fraud and tax evasion by using legal arrangements. This definition is based on the fact of any “unusual arrangements” which leads to tax benefits in relation to a genuine arrangement. Because of this new regulation the taxpayer now has the burden of proof. He has to document his economic reasons for the selected legal transaction. The immanent problem is the evaluation by the tax authorities afterwards (often years later) and the busy economic development, especially in global business activities.
Before 2008 the tax authorities had to proof whether the chosen legal form was unusual and only for the reason of tax benefit.

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# Q6: Do tax treaties apply to a letter box company i.e. UK, Cyprus, Malta?

**Germany**

d) crossing tax exemption to tax credit - § 20 Abs. 2 AStG
This regulation is an example for treaty override in combination with the switch over clause. PE's normally are to tax under the jurisdiction of their business and in compliance with the conditions of Art. 5 OECD – MA (see above No. 1).
Under the conditions of article 20 paragraph 2 AStG the tax exemption of the tax treaty changes to the method of tax credit, because of the too low taxation (see above No. 5).

e) Anti treaty shopping provision - § 50d Abs. 3 EStG
Treaty provisions prevail over domestic tax law. A domestic law that became effective after the treaty, however, may override a treaty provision. For example Sec. 50d (3) EStG contains such an override provision: it is an anti-treaty-shopping provision which denies treaty benefits (mainly reduction of withholding tax) to a non-resident (intermediate) company if:

- it is not the beneficial owner of the income;
- the shareholders of the intermediate company (the beneficial owners) would not be entitled to the treaty benefit;
- the use of the intermediate company does not have economic or other important reasons;
- the intermediate company does not gain more than 10% of its gross earnings from its own business activity (no holding function) per fiscal year and
- the intermediate company does not maintain business operations that are adequate to their business objective (qualified staff, office space, communication equipment etc.).

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# Q6: Do tax treaties apply to a letter box company i.e. UK, Cyprus, Malta?

**Germany**

f) crossing tax exemption to tax credit - § 50d Abs. 9 EStG
This rule is another example for treaty override in assumed cases of tax fraud or tax evasion. Article 50d paragraph 9 EStG takes reference to article 20 paragraph 2 AStG. The aim of this regulation is the worldwide taxation of any income of taxable companies or individuals and to avoid the non taxation.
The assumptions are:
• a limited taxation in the other state • personal tax exemptions of the other state.

g) substance over form problems - § 50d Abs. 10 EStG
Further problems results from partnerships and their taxation in the different jurisdictions. Especially those countries taxing the partnership as a legal entity have another tax solution than Germany (□ taxation of the income on the level of the partners).
These qualification conflicts are listed in the partnership report of the OECD from 1998. Double taxation or Non taxation could be the consequences of qualification conflicts. Article 50d paragraph 10 EStG was the consequence of the jurisdiction of our highest tax court. It should fix the application of Art. 7 OECD – MA in Germany for the partners and avoid the taxation as dividends or interests (regarding the foreign income and its qualification there).

# Q6: Do tax treaties apply to a letter box company i.e. UK, Cyprus, Malta?

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| France | Tax treaties apply to residents and, in principle, a company duly registered and that cannot be considered as fictitious is under the scope of tax treaties. |
| Hungary | DTAs concluded by Hungary refer to residents. The conditions of residency are defined in accordance with the OECD Model, in some cases in accordance with the UN Model (e.g. DTA between India and Hungary). Consequently companies' residency shall be identified due to their place of management which is usually judged by substance provided. Accordingly tax treaties can apply to a letter box company if substance can be justified according to the relevant country's legislation. |
| USA | No. Tax treaties define the meaning of fiscal residence. |
| India | Indian Tax Authorities are looking carefully at Letterbox companies. All outward (foreign) remittances made from India are reported to the Indian tax authorities. The tax authorities have the power to call for further information from such payer to satisfy that the payee is the beneficial owner of the sum remitted. |

# Q7: Do you have a black list for treaty jurisdictions/ information exchange and if so what does this mean?

| Germany | The OECD introduced its black list on the base of the OECD – report 1998 and as a consequence in 2000 on the G20 meeting an international applicable tax standard according to the before defined criteria's of tax haven zones. The international tax standard was endorsed by the G20 Finance Ministers at their meeting 2004 in Berlin.<br>Germany itself has not any internal own black list. Germany has adopted the black list of the OECD and signed the OECD Agreement for Tax Information Exchange (= TIEA) at 17.04.2008. The aims of TIEA are bilateral treaties with tax haven countries and rules for the information exchange. This should guarantee the transparency and the compliance of the international tax standard. Until now TIEA is not yet ratified in Germany.<br><br>Instead of bilateral contracts with those countries noted from the OECD Germany adopted in its corporation tax law and the income tax law new rules for anti tax evasion in 2009. In the case of taxation of a PE, enterprises or participations in a tax haven zone Germany now has the following regulations:<br>• Cutting of the tax free dividends (§ 33 Abs. 1 Nr. 2 e) KStG)<br>• Refusal of deduction of operating expenses (§ 51 Abs. 1 Nr. 1 f) EStG) |
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# Q7: Do you have a black list for treaty jurisdictions/ information exchange and if so what does this mean?

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| France | According to article 238-0 A of the French General Tax Code, that came into force in 2010, are considered as non cooperative States or territories that:<br>- are outside of the European Union,<br>- and that have been under a close examination from OECD in respect of their transparency and their exchange of information system for tax purposes<br>- and that have not entered into a tax agreement with France stating exchange of tax information,<br>- and that have not entered into such an agreement with at least 12 States<br>The official list on 1st January 2010 included 18 territories such as Panama, Liberia, Marshall Islands, Belize, Brunei. It should be updated for year 2011.<br>Tougher tax rules are applicable to incomes received from/paid to entities based in these States/territories. |
| Hungary | Hungary has a white list of countries that are not considered as low tax jurisdictions for purposes of the CFC rules, (these are EU and OECD member states and countries that have concluded a DTA with Hungary) if the foreign entity has real business presence in that country. |

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## Q7: Do you have a black list for treaty jurisdictions/ information exchange and if so what does this mean?

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| USA | Not as such. The proposed "Stop Tax Haven Abuse Act" that was superseded and enacted in different form had a proposed blacklist, but this aspect of the proposed legislation was roundly criticized and never enacted. |
| India | In the latest budget announced last week, there is a new provision for transactions with persons in notified jurisdictional areas. The government will issue a list of such jurisdictional areas based on the cooperation it has received from the countries in signing the DTAA or the Information Exchange agreement. Most probably, tax havens which have refused to sign either of the agreements will be notified. The proposed provision goes to the extent of taxing any receipt from an entity in such jurisdiction or to disallow any expenses paid to an entity such jurisdiction. |

## Q8: How do you see the evolution in your domestic Law relating to these issues?

| | |
|---|---|
| Germany | In fact the German parliament has reported in August 2010 in the official document “Drucksache 17/2743” about the efficiency of the measures against tax fraud/tax evasion and tax havens. One part includes a set of statistics about the numbers of requests regarding the EU and international mutual assistance in tax matters (from/to Germany).<br>It is to note that this report leads to the significant result, that Germany receives more requests for mutual assistance than Germany requests for mutual assistance in tax matters in other states.<br>So regarding this report you can assume that Germany will still prefer to tax dubious businesses using treaty override or the tax clauses of a double tax treaty rather than asking for mutual assistance. Germany prefers its own strict national legislation (see above No. 6) instead of signing bilateral treaties with tax haven zones with the consequence of mutual assistance with these countries (see above No. 7 – TIEA). |
| France | Like all countries France is trying to collect more revenue. It is publicly known it wishes to harmonize its taxation with Germany. It is strengthening its legislation against offshore jurisdictions by putting pressure on the EU and the USA as seen by the G20 exchange of information legislation. It is more the international routes than simply domestic legislation. |
| Hungary | Following the world trends Hungary also intends to strengthen continuously its tax avoidance schemes so to reveal and acquire hidden revenues of private persons and companies as well. Along with the even stricter rules the Hungarian government provides also tax allowances (flat rate tax of 10% under certain circumstances) for private persons transferring their hidden “offshore” revenues back to Hungary – with modest success. |



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## Q8: How do you see the evolution in your domestic Law relating to these issues?

| | |
|---|---|
| USA | There has been discussion of whether to continue with the US model of determining the status of an entity (foreign or domestic) based purely on situs of formation and not its “mind and management.” Recent legislative proposals aimed at foreign activities of US companies address this issue. |
| India | The above mentioned provision is a bold step which the government has taken to curb unaccounted income, offshore income, treaty shopping, and the entire intent to move to substance over form. |

# Contact

| | | |
|---|---|---|
| Germany | **Oliver Biernat**, Managing Partner<br>Chairman GGI Practice Group International Taxation<br>Benefitax GmbH – StBG, WPG<br>**o.biernat@benefitax.de** / www.benefitax.de<br><br>**Brigitte Jakoby**, Senior Partner of Jakoby Dr. Baumhof<br>brigitte.jakoby@jakoby-baumhof.de | <br> |
| France | **Prof. Robert Anthony**, Principal Partner<br>Chairman of “International Wealth Management, Trust and Estate Planning” PG<br>Anthony & Cie<br>**robert@antco.com** / www.antco.com | |
| Hungary | **Anita Ihász Kovácsné Dr.**<br>Kovács Réti Szegheő Attorneys at Law<br>ihasz.anita@krs.hu | |
| USA | **Steven L. Cantor**, Partner<br>Cantor & Webb P.A.<br>Miami, Florida USA<br>Steve@cantorwebb.com / www.cantorwebb.com | |
| India | **Ashish Bairagra**, Partner<br>Regional Chaiperson - Asia<br>GGI Practice Group International Taxation<br>M. L. BHUWANIA & Co., Chartered Accountants<br>**ashish@mlbca.in** / www.mlbca.in | |




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# Various case studies for discussion if wished…



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# American Bar Association
# Section of Taxation

# Committee on U.S. Activities of Foreign Taxpayers and Treaties

September 23-24, 2010
Toronto, ON, Canada

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# *Economic Substance and Inbound Treaty Planning*

## ***Panel***

**Sam Kaywood, Jr.**
*Alston & Bird LLP*
Atlanta, GA, USA
sam.kaywood@alston.com

**Kathleen V. Penny**
*Blake, Cassels & Graydon LLP*
Toronto, ON, CANADA
kathleen.penny@blakes.com

**Stanley C. Ruchelman**
*The Ruchelman Law Firm*
New York, NY, USA
ruchelman@ruchelaw.com

**Leonard Schneidman**
*WTAS LLC*
Boston, MA, USA
Len.schneidman@wtas.com

## ***Commenting***

**Kristine Roth**
Legislation Counsel, Joint Committee On Taxation
Kristine.Roth@mail.house.gov

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# New Section 7701(o) – Clarification of Economic Substance Doctrine

- In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if--
  - The transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position and
  - The taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction

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# New Section 7701(o) – Clarification of Economic Substance Doctrine

- The potential for profit of a transaction is to be taken into account in determining whether the foregoing tests are met only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected
- Fees and other transaction expenses are to be taken into account as expenses in determining pre-tax profit
- Regulations are authorized requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases

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# New Section 7701(o) – Clarification of Economic Substance Doctrine

- State or local income tax effect which is related to a Federal income tax effect will be treated in the same manner as a Federal income tax effect
- Achieving a financial accounting benefit will not be treated as a purpose for entering into a transaction if the origin of the financial accounting benefit is a reduction of Federal income tax

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# New Section 7701(o) – Clarification of Economic Substance Doctrine

- The term “economic substance doctrine” means the common law doctrine under which tax benefits with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose
- The determination of whether the economic substance doctrine is relevant shall be made in the same manner as if Section 7701(o) was not enacted

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# New Section 7701(o) – Clarification of Economic Substance Doctrine

- Section 6662 penalty is 40% percent where any portion of an underpayment is attributable to one or more non-disclosed non-economic substance transactions
- The penalty is 20% where the non-economic substance transaction is disclosed

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# Joint Committee Staff Commentary

- The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages
- Illustrative examples:
  - The choice between capitalizing a business enterprise with debt or equity
  - A U.S. person’s choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment
  - The choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C

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# Joint Committee Staff Commentary

- Illustrative examples (Cont.):
  - The choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied
- As under present law, whether a particular transaction meets the requirements for specific treatment under any of these provisions is a question of facts and circumstances
- Also, the fact that a transaction meets the requirements for specific treatment under any provision of the Code is not determinative of whether a transaction or series of transactions of which it is a part has economic substance

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# Notice 2010-62

- The I.R.S. advises taxpayers of the following:
  - The law will be applied literally
  - Once it is determined that economic substance is relevant, both prongs of the legislative economic substance test must be met
  - Application of existing case law that applies only one leg of the new test will be challenged

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# Notice 2010-62

- The I.R.S. will continue to analyze when the economic substance doctrine will apply in the same fashion as under prior law
  - If authorities under prior law concluded that the economic substance doctrine was not relevant to whether certain tax benefits are allowable, the I.R.S. will continue to take that position
  - ***N.B. --*** The I.R.S. anticipates that case law will continue to develop; this may be a euphemism that existing case law will be challenged
- The I.R.S. does not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply

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# Introduction to Canadian GAAR

- General anti-avoidance rule (GAAR) enacted over 20 years ago (1988)
- Three cases decided by Supreme Court of Canada between 2005 and 2009, many lower court decisions and CRA advance tax rulings
- Specific anti-avoidance rules also being used, including:
  - qualification as foreign affiliate for exemption system (s.95(6))
  - partnership allocations (s.103)
  - tax shelter rules (s. 237.1)
  - transfer pricing (s. 247)

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# Introduction to Canadian GAAR

- To permit application of GAAR, there must be (a) tax benefit, (b) avoidance transaction, and (c) abusive tax avoidance
- Most court cases focus on (c), analyzing the provisions giving rise to the tax benefit to determine whether there is abuse
- Concept of "avoidance transaction" is similar to U.S. enquiry into whether non-tax purpose, looks at whether transaction (or each transaction included in a "series" of transactions) "may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit"

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# "Avoidance Transaction" Cases

- If primary purpose is non-tax (e.g. business or investment), it does not matter that transaction is effected in a tax-effective manner
- Not every transaction that leads to a tax benefit necessarily forms part of a "series", some degree of connectivity is required
- Focus on an objective assessment of the relative importance of driving forces of transaction

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# Canadian GAAR:
# Role of Economic Substance

- Economic substance is not part of the GAAR tests
- May be relevant in the context of the “abuse” analysis, but only if the statutory provisions focus on economic concepts
- Transactions are not collapsed into one transaction or recharacterized

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# Introduction to Subsection 95(6) of the *Income Tax Act*

- Key cases in international context have been challenged under specific anti-avoidance rule in subsection 95(6) of the *Income Tax Act* which focuses on qualification for treatment of a non-Canadian corporation as a “foreign affiliate” that is eligible for exemption system for foreign active business earnings
- Test is whether it can reasonably be considered that the principal purpose for the acquisition of shares of the non-Canadian corporation is to avoid, reduce or defer the payment of tax that would otherwise be payable

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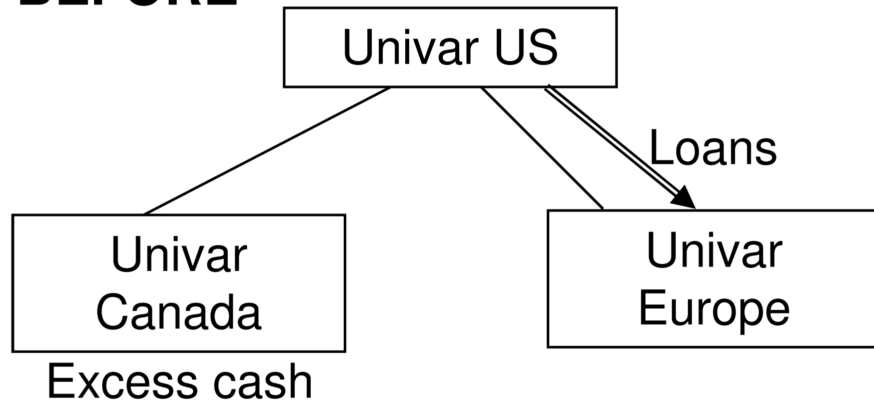
# *Univar Canada Ltd. v. The Queen* (2005, TCC) – Facts

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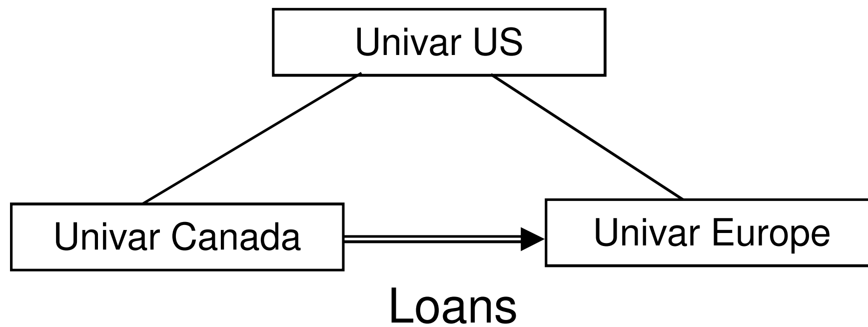


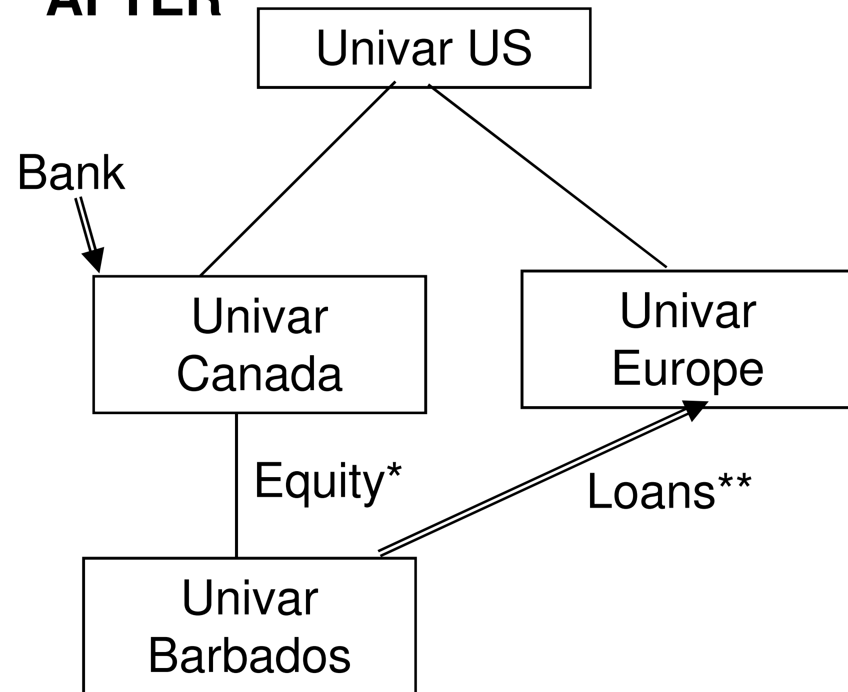


*Equity investment funded with excess cash and new borrowing

**Purchased from Univar US

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# *Univar Canada Ltd. v. The Queen* – Tax Results

- Interest deductions in Europe and Canada (partial double dip)
- Interest income taxed at 2.5% in Barbados
- Dividends received by Univar Canada from Univar Barbados tax-free under Canadian exemption system
- No longer works in Canada due to change in Canadian technical provisions if non-Canadian parent of borrowing affiliate

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# *Univar Canada Ltd. v. The Queen* – No Tax Avoidance

- Both 95(6) and GAAR were argued, and both rejected for reason that no purpose of reducing or avoiding Canadian tax
- Acquisition of loans by Univar Canada was never considered as an alternative
- Univar Canada had excess cash and was under-leveraged, Univar policy was not to require payment of dividends to parent, various U.S. tax concerns to be addressed, etc.
- Investment (partially leveraged) by Univar Canada in Univar Barbados was to earn better return

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# Economic Substance and Inbound Treaty Planning in Light of Codification

- How are existing cases and rulings affected?
  - Code Anti-Conduit Regulations
  - Treaty LOB Provisions
  - Treaty Planning Structure
  - Cross border tax reduction plans

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# Aiken Industries

Aiken
ECL
Bahamas
(Non-Treaty)
CCN
Equal
Interest
MPI
Industrias
(Honduras)
(Treaty)

- ECL loaned $2.25 million to MPI at 4% interest; ECL assigned the loan to Industrias in exchange for Industrias notes at same interest rate and mirror terms
- Court held: Industrias was a corporation and a resident of Honduras for purposes of the Treaty.
- Industrias a mere conduit and not the beneficial owner
- Industrias did not "receive" the interest since no dominion and control
- Court referred to "same corporate family" in concluding no valid economic or business purpose.



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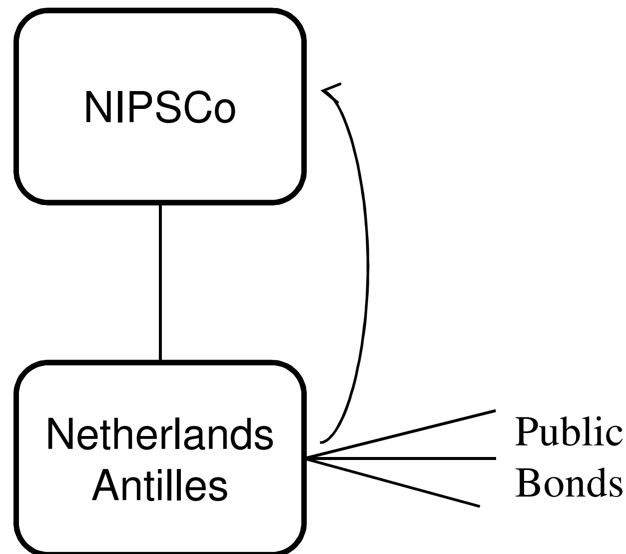
# Northern Indiana Public Service Co.




- Plain vanilla Netherlands Antilles finance company.
- Rejects I.R.S. contention of lack of economic substance
- Distinguishes *Aiken*
  - Transactions between unrelated parties
  - 1% spread
  - Adequate capitalization
- Background of well established practice to utilize a N.A. finance subsidiary to access the Eurobond market
- Precedes "portfolio income" exclusion
- See *Ambase Corp. v. Commr* approving N.A. finance subsidiary which met the grandfather requirements of Section 127 (g)(3) of the 1984 Tax Act.

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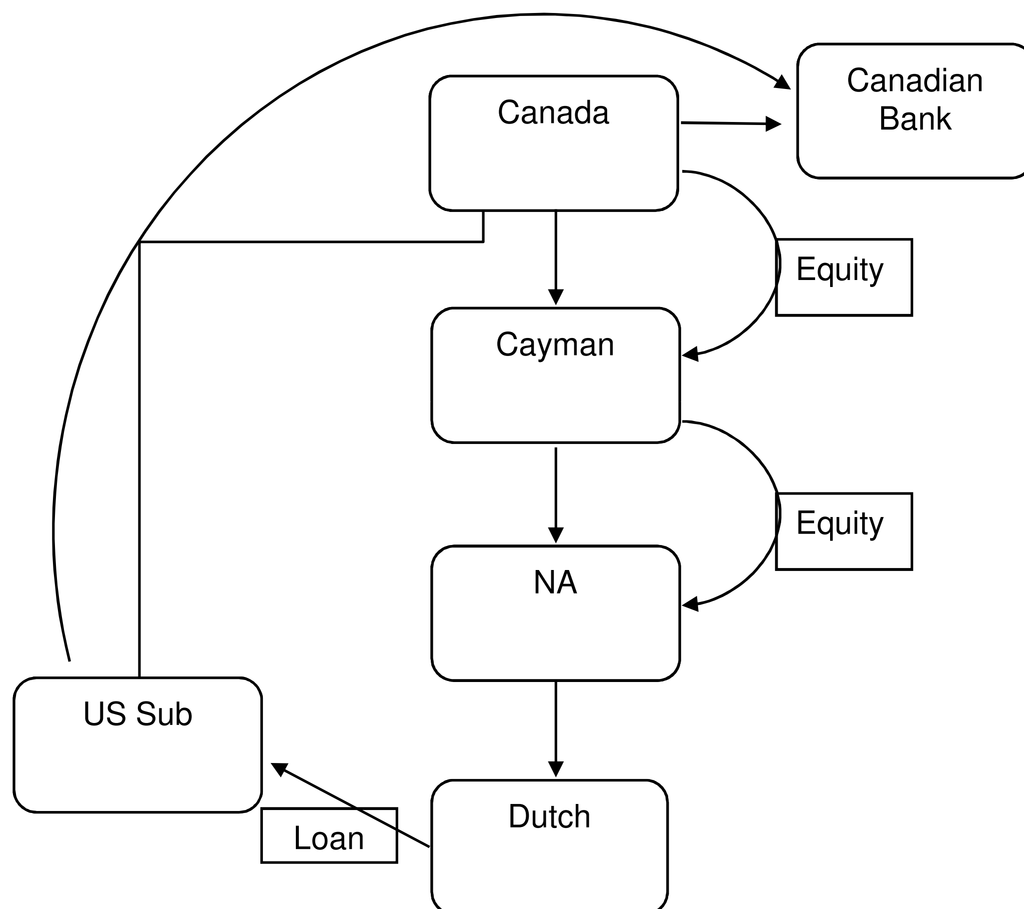
# Del Commercial Properties, Inc.




- Purpose of arrangement was to avail of U.S. – Dutch Treaty at 0% withholding instead of U.S. – Canada Treaty at 15%.
- Tax Court (and D.C. Circuit) used the step transaction doctrine to collapse the arrangement holding Dutch company had no purpose other than tax avoidance.
- Court cited *Aiken* and distinguished *Northern Indiana*.
- Parties themselves treated the transaction as a direct loan from the Canadian Bank to the U.S. Sub.
  - U.S. Sub guaranteed Canada's debt to Canadian Bank
  - U.S. Sub gave a mortgage to Canadian Bank and provided financial statements to Bank.
  - U.S. Sub insured the property making Canadian Bank the beneficiary.
  - U.S. Sub agreed to use any proceeds on sale of property to pay down the loan.

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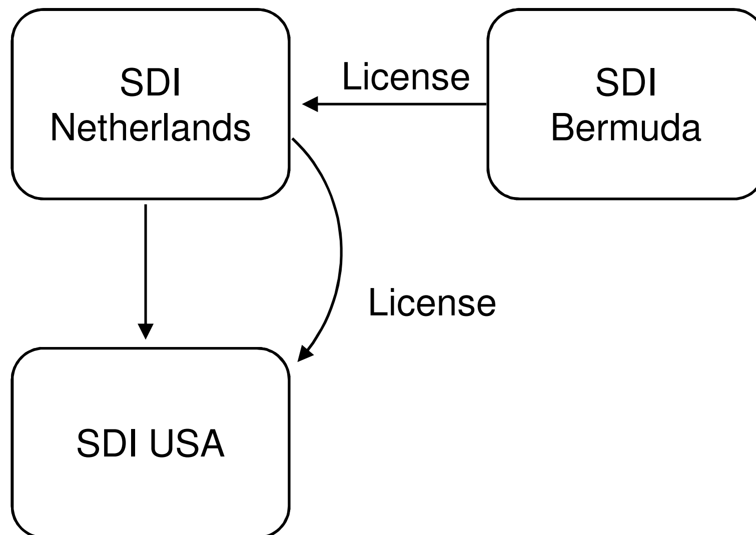
# *SDI Netherlands v. Commissioner*




- Back-to-back license
- Court ignored §861(a)(4) sourcing rule and instead treated the issue as a conduit question.
- Held case controlled by *Northern Indiana* rather than *Aiken*.
  - Licenses had separate and distinct terms.
  - Royalty spread of 5-6 percent.
  - Affiliated status of parties noted by court but found not controlling.

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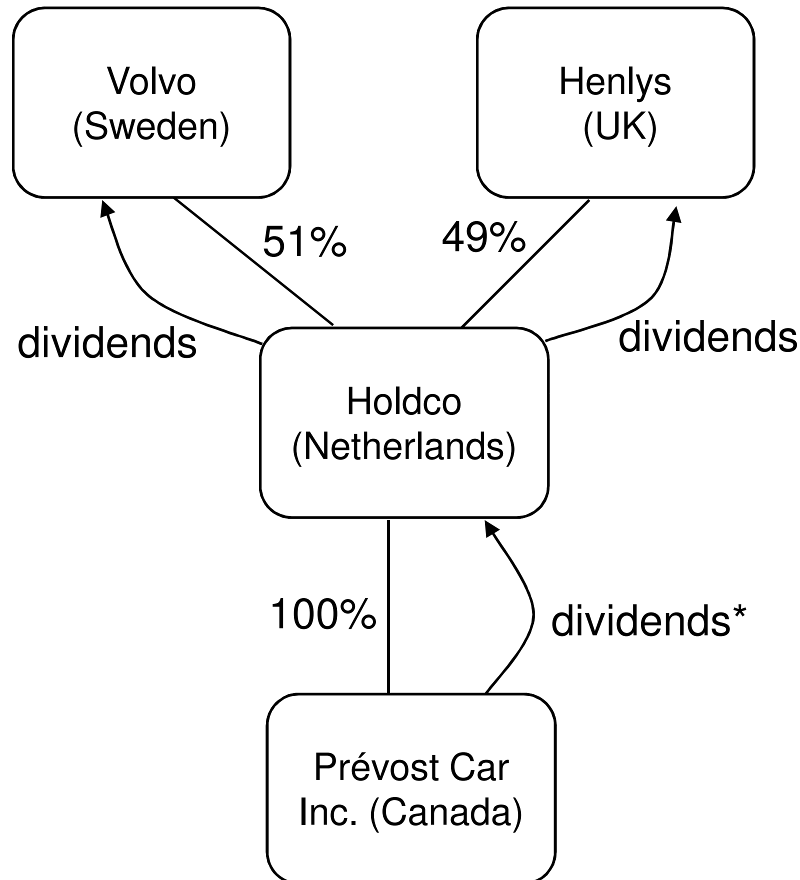
# *Prévost Car Inc.*
# (2008 TCC; affirmed 2009 FCA)




- CRA’s position was that Holdco not “beneficial owner” of dividends (not a GAAR case)
- Courts held Holdco was “beneficial owner” and not a “conduit”, since received dividends for own use and enjoyment, and had control over them

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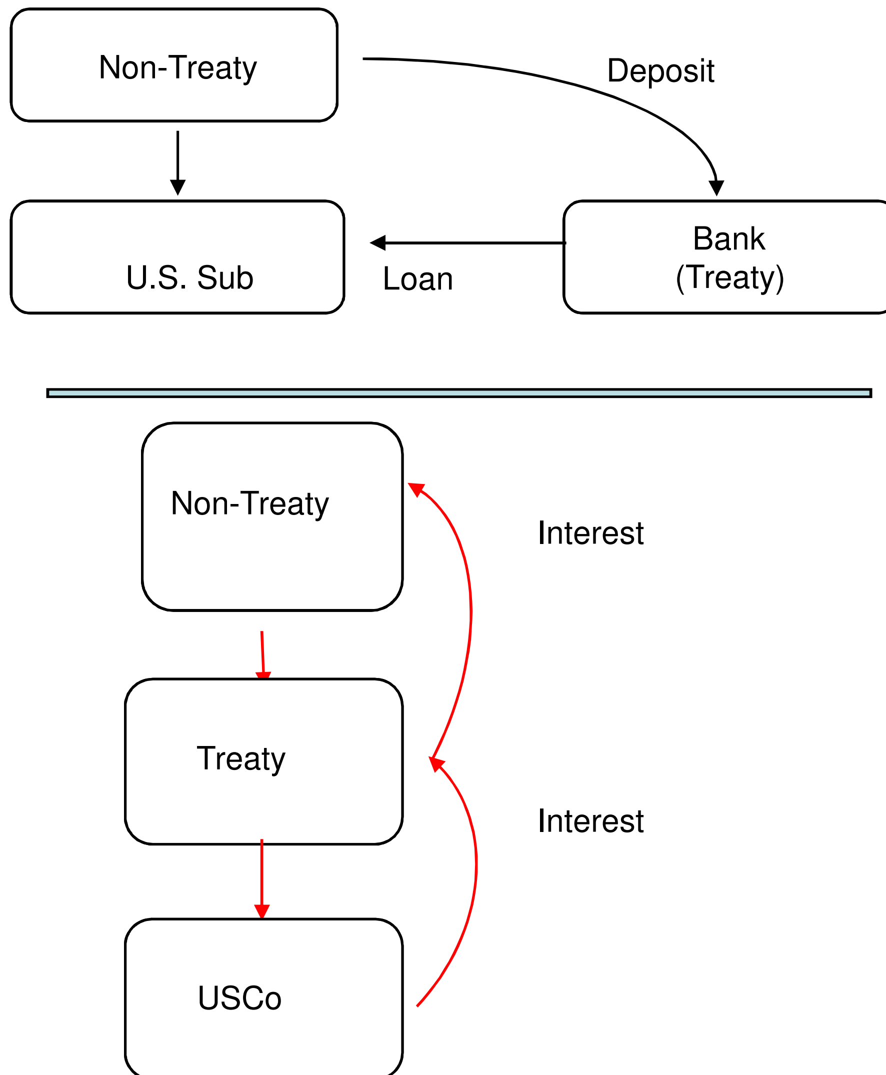
# Anti-Conduit Regulations




- Applies to determine the proper U.S. withholding tax on U.S. source payments in a multiple-party "financing transaction".
- Principal application is to debt arrangements (e.g. "back-to-back" loans) but also applies to leases, licenses and other arrangements.
- Conduit regulations intended to preempt prior authorities in the case of payments covered by the regulations.
- Conduit entity may not claim tax treaty benefits.

  - Treasury position is that conduit regulations "supplement" but do not conflict with tax treaties.

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# Treaty LOB Provisions

- Designed to counteract the use by third parties of U.S. income tax treaties, i.e. “treaty shopping”.
- Three principal tests
  - Public company test
  - Ownership/base erosion test
  - Active business test
- Extension of derivative benefits to residents of other countries, e.g. the European Union
- Self-certification of LOB compliance - Form W-8 BEN

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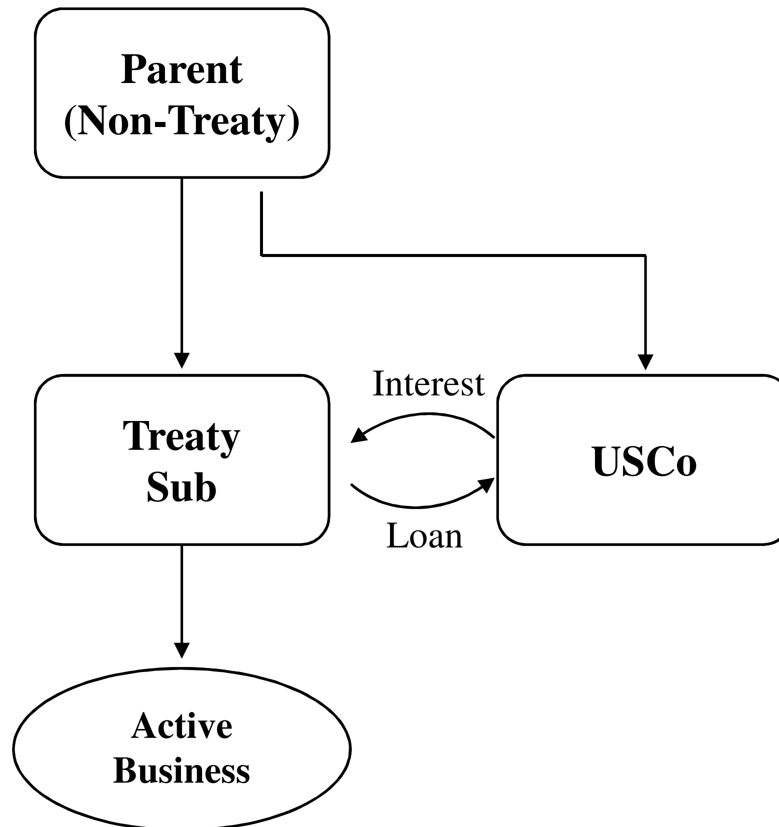
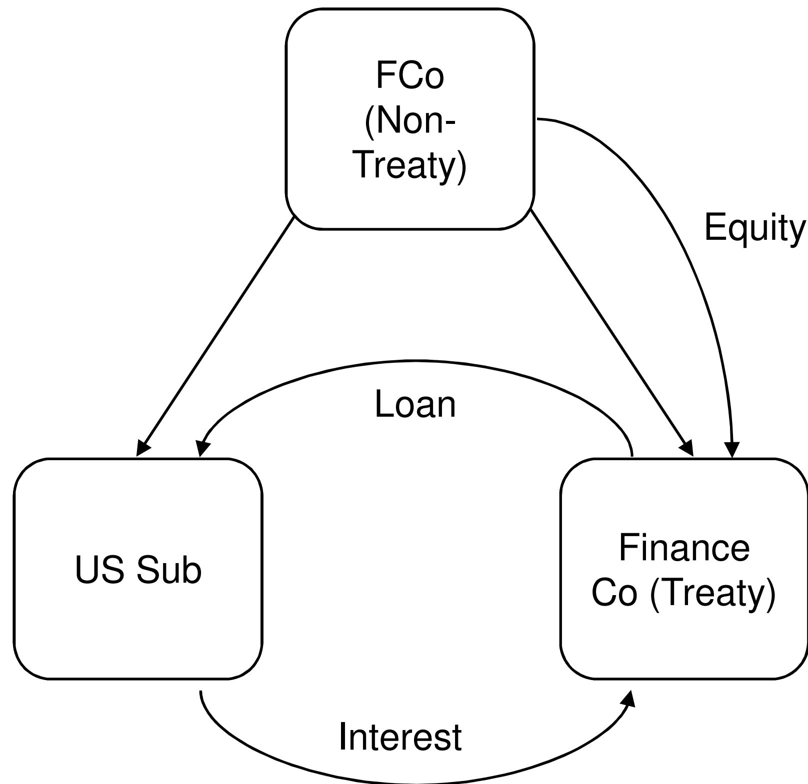
# Treaties – Active Trade or Business




- Treaty Sub generally meets LOB provisions if it has an active trade or business
- Treaty Sub must be funded with equity rather than debt

# Anti-Conduit Regulations – "Equity Wall"




- "Equity Wall" generally avoids conduit treatment.
- Exception for:
  - Redemption at specified time
  - "More likely than not" issuer redemption
  - Third-party right to acquire stock
- Two anti-abuse provisions.
  - "But for" test
  - "Principal purpose" test

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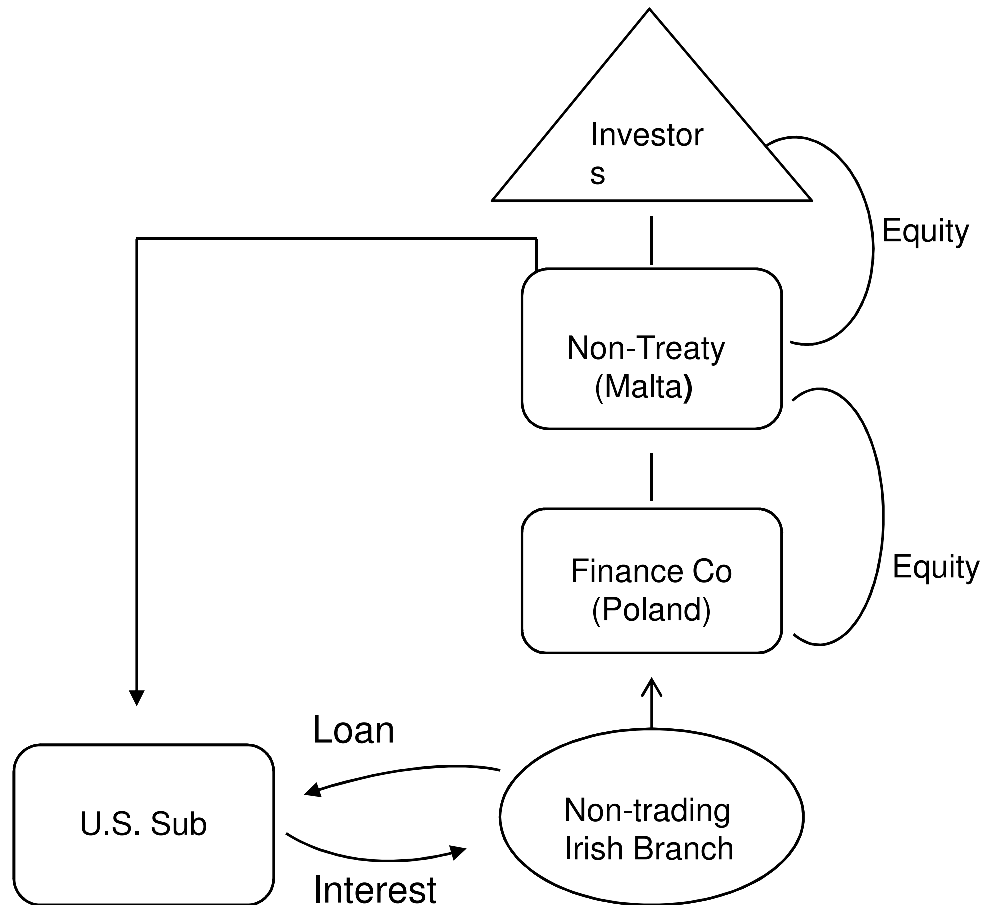
# Inbound Taxation Treaty Planning – Example




- No U.S. withholding tax on interest paid to Irish Branch of Polish Finance Co.
- Anti-conduit rules don't apply because of equity contribution to Finance Co.
- Tax in Poland on 5% of interest income
- No tax in Ireland on interest income of "non-trading" Branch.
- No withholding on dividends paid by Finance Co. to Malta pursuant to EU Parent/Subsidiary Directive.
- Combined Poland/Irish corporate tax approximately 1%
- New treaty with Poland will contain an LOB provision.

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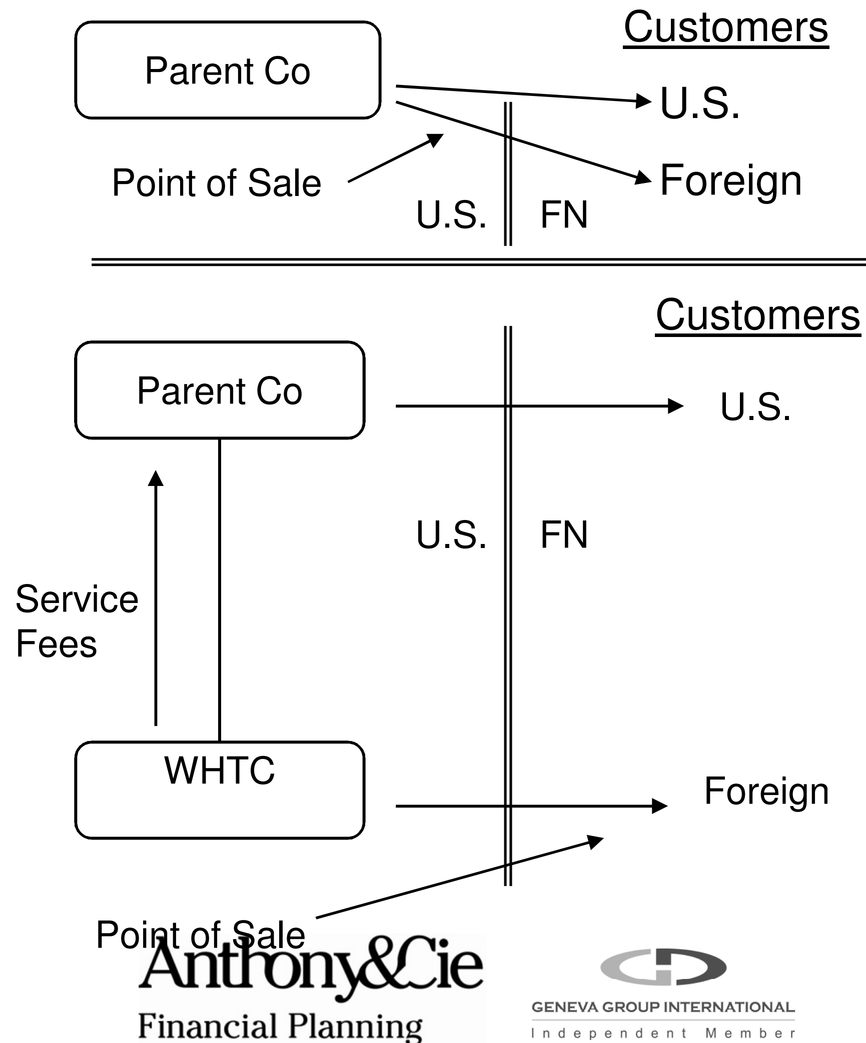
# Restructuring to Obtain Specific Tax Benefit




- *Barber-Greene Americas, Inc. v. Commr.,* 35 TC 365 (1960); *Commr. v. Pfaudler Inter-American Corporation*, 330 F.2d 471 (2d Cir. 1964) involve restructuring to become a WHTC in order to obtain 14-point tax reduction
- 3 Tests for WHTC
  - All business carried out in Western Hemisphere countries
  - 95% of income derived from sources outside the U.S.
  - 90% of its gross income had to be derived from the active conduct of a trade or business
- The taxpayers established subs that were accounting centers for Latin American sales
  - WHTC sales made by independent reps in Latin America
  - WHTC's contracted with parent to accept orders and to ship on their behalf
  - WHTC's took title in the U.S. and sold with title passing outside the U.S.

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# Restructuring to Obtain Specific Tax Benefit

- Holdings:
  - Intentionally changing point of sale to obtain Congressionally enacted tax benefit is not tax avoidance
  - Taxpayers have the right to arrange affairs to keep their taxes as low as possible, *Gregory v. Helvering*, 293 U.S. 465 (1935);
  - A taxpayer is not obliged to pursue a course of action giving rise to a greater tax liability if another is open which will give rise to a lesser liability
  - The legislation involved imposes no requirement that a corporation, to be entitled to its benefits, must maintain a foreign warehouse or factory or pay foreign taxes.
  - The WHTC's assumed the risk of delays in transit or loss or damage en route, the responsibility of engaging freight forwarders and of arranging many other details

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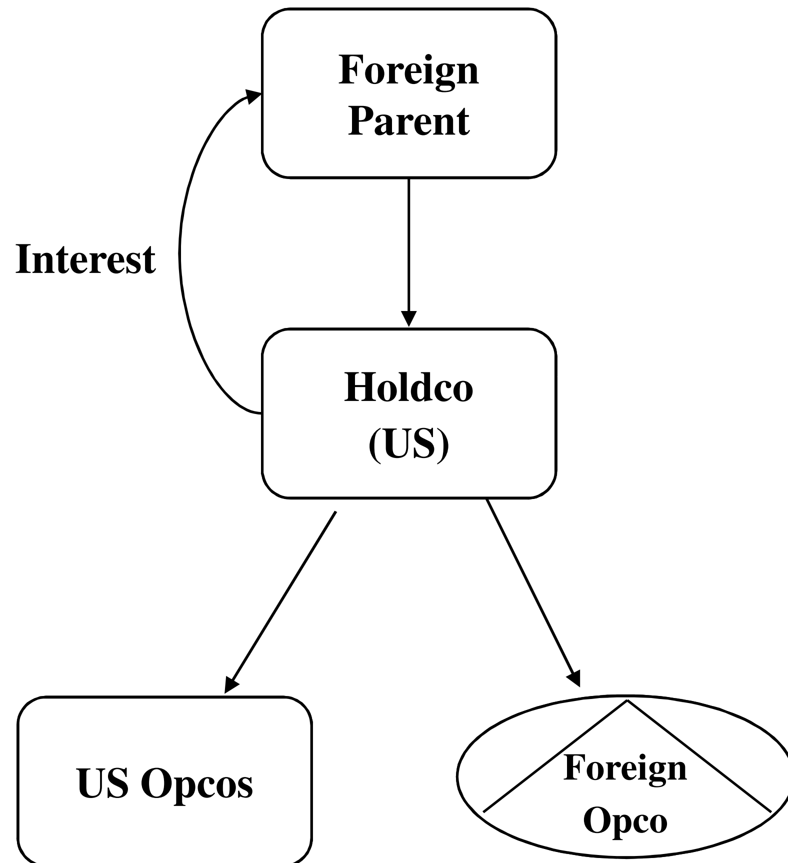
# 80/20 Companies




- Foreign Opco checks the box to be disregarded for U.S. tax purposes
- If Holdco meets the 80% foreign gross receipts test, dividends and interest are foreign source– no U.S. withholding
- H.R. 4849 repeals the 80/20 rule
- Also used for outbound planning purposes

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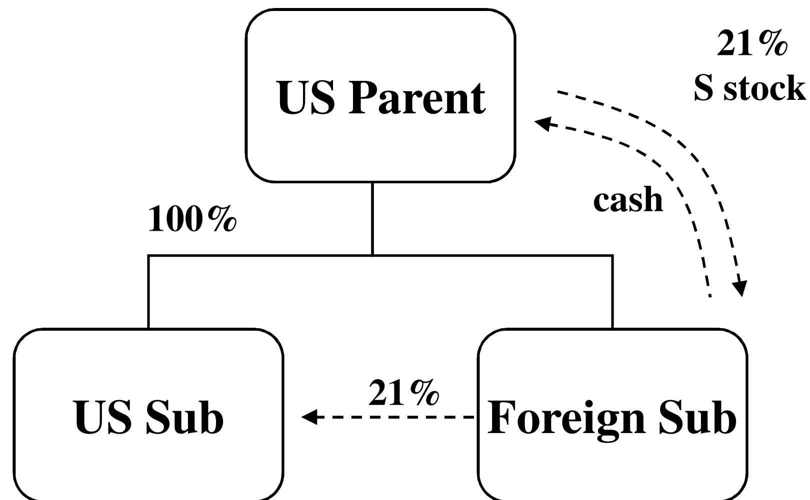
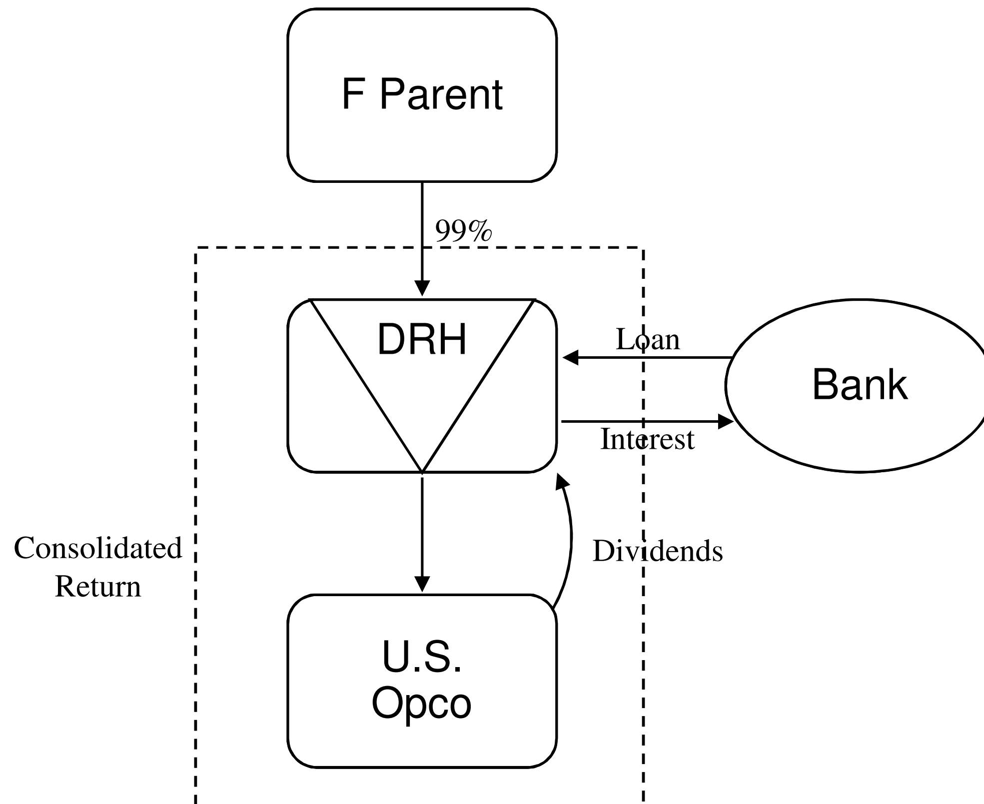
# De-Consolidation




- Useful to elect out of §332 to trigger §331 loss. *See, Granite Trust, Day & Zimmerman*, Rev. Rul. 78-285
- NSAR 010012: Lack of business purpose "probably irrelevant"
- PLR 9206005 allowed de-consolidation for foreign tax credit purposes (prior to §904(i))

# Double Dip Structures
# Domestic Reverse Hybrid




- DRH is a Delaware general partnership that elects to be a U.S. corporation for U.S. tax purposes
- F Parent treats DRH as a pass-through entity as a 99% GP
- DRH deducts interest paid to Bank on U.S. consolidated return
- F Parent deducts interest on foreign tax return
- See Reg. §1.894-1(d)(2)(iii), Example 7

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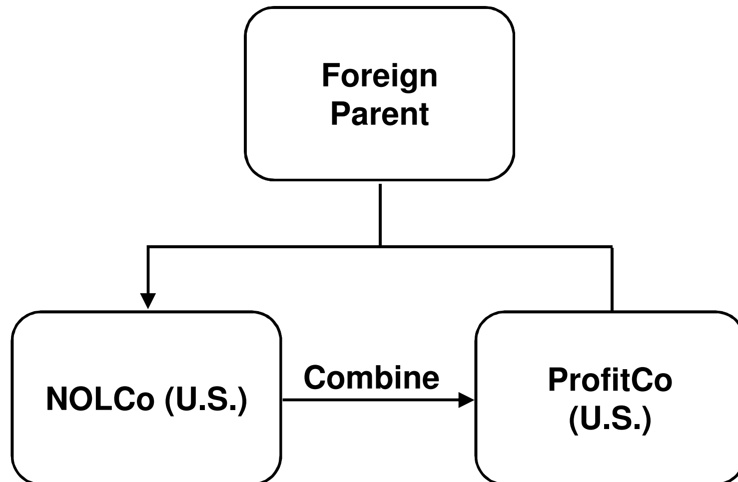
# NOL Movement




- NOLCo and ProfitCo are not consolidated due to having a foreign parent
- NOLCo merges into ProfitCo
  - Could be done as a “drop-down” of NOLCo stock into ProfitCo followed by converting NOLCo into an LLC
- Done to move the NOLs of NOLCo to ProfitCo for more efficient usage

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# Areas for Clarification

- Notwithstanding plain meaning of the statute, is tax an expense that can and should be planned for?
- If not, is the statute an uncompensated taking of property that violates the Fifth Amendment?
- If a taxpayer is faced with two choices to accomplish a goal, is it forced to choose the higher tax cost option once it identifies the tax issue?
- If a foreign corporation meets the active trade or business tests in a robust LOB provision of a treaty, can it rely on the treaty to claim benefits?
- Is the structure subject to the codification of the economic substance doctrine, or is it the transaction once the structure is in place?
- If foreign tax is an expense, will a plan that reduces both foreign tax and U.S. tax be acceptable if the foreign tax reductions change the taxpayer's economic position in a meaningful way?
- Will there be centralized IRS review of assertion of economic substance doctrine?
- Have we adopted the Gordon Brown view of tax planning?
  - Shoot first, hit duck -- taxpayer keeps duck
  - Aim first, shoot second, hit duck -- taxpayer gives duck to government

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