Chapter 7

Domestic and Treaty Anti-Abuse Rules as Applied to Dividends

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7.1. General considerations

7.1.1. Background

7.1.1.1. Scope

This paper arises from the Maisto Conference commemorating the 20th anniversary of the firm. Reports prepared by contributors representing selected countries at the conference provide excellent and detailed background on the taxation of dividends in various countries, together with provisions and doctrines that are relevant to address potential abuses of various kinds.

This paper will assume as background those reports and draw upon them where appropriate. Certain topics addressed in those reports that are relevant to the appropriate taxation of dividend income under the laws of the respective countries will not be addressed herein, as they are of a very broad nature and topics in themselves. These include, for example, the classification of an instrument as debt or equity for tax purposes, special regimes designed to address deferral or avoidance of passive income generally, such as controlled foreign corporation rules and passive investment company rules, and rules addressing the foreign tax credit generally.

The topic of this paper and the related session is narrower: "anti-abuse" regimes, rules and principles affecting the taxation of dividends. The nomenclature – "anti" and "abuse"– indicates that the rules target behaviour deemed by the tax administration, legislature and/or judiciary to be fiscally unacceptable.[2]

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2. The concept of abuse has been addressed comprehensively in certain texts; e.g. De Broe, L., *International Tax Planning and Prevention of Abuse*, Amsterdam: IBFD Publications BV, 2009, Vol. 14 Doctoral Series; Van Weeghel, S., *Improper Use of Tax Treaties*, London/The Hague/Boston: Kluwer Law International, 1998.

7.1.1.2. Some words on the concept of abuse

Abuse is, of course, a philosophical and judgmental concept. Within a country, the meaning of the concept as applied to taxation varies as between taxpayers, tax administrators and judges, and even among different taxpayers, tax administrators and judges. A perceived abuse for one person is tax planning for another. The effectiveness of anti-abuse rules will be affected by whether they are perceived as legitimate. The perception of anti-abuse rules as legitimate will tend to depend on how rooted and universal within the relevant jurisdiction are the norms of acceptable fiscal behaviour.

To the extent a practice perceived to be an abuse is addressed by the relevant tax authorities through an objective provision, this issue is resolved to some extent. Nevertheless, the contours of the provision – and the effectiveness of manoeuvres to come without those contours – will remain the subject of judgment, as will the many situations that are not even addressed by objective rules. As a result of the nature of the concept, there ultimately will remain a great deal of uncertainty as to the scope of proscribed abuse.

From the standpoint of taxpayers, taxes are an involuntary levy on their assets. As with any such rule in modern society, it is generally accepted that the subject of the government action is entitled to know the rules of the game. From that standpoint, taxpayers are entitled to know their tax liability under relevant fact patterns. It follows that taxpayers have the right to plan their activities to take into account the taxes imposed.

But there is a limit to such rights, which is based on the fact that the ideal of specific tax burdens for specific activities cannot be reached. There are a myriad of competing considerations, including policy, intersection with commercial consequences, etc. Activities do not fit neatly into boxes but the lines blur. Further, even if these issues were mitigated, the process of drafting involves issues of simplicity versus complexity as well as simple human frailty. As a result of these and similar considerations, it is generally agreed that limits must exist in respect of a taxpayer's right to plan in respect of taxes. At a minimum, intentionally exploiting loopholes is rightly vulnerable.

7.1.1.3. Effect of globalization of trade on notions of abuse

The tolerance for aggressive tax planning has traditionally varied by country. Different countries have different values and histories. The issues of different philosophies and judgments as to what constitutes abuse in respect of taxation referred to above are replicated at the national level.

On the other hand, in recent years, various factors have contributed to a migration and cross-pollination of concepts and views on what is abusive. These factors include, first, the simple fact of much greater cross-border trade and direct investment. Along with this has been the tendency of taxpayers themselves to import tax planning techniques, including base erosion techniques such as “debt pushdown” strategies, from other countries. Tax authorities have been similarly influenced by, and imported approaches taken by, tax authorities in other countries. Intergovernmental organizations, such as the OECD and the UN, have brought much greater awareness of such issues to tax authorities of certain countries. Cooperation among tax authorities in connection with perceived abuses has increased greatly, including via formal organizations such as the Joint International Tax Shelter Information Centre (JITSIC). Not the least factor is a need for governments to find revenue sources, and in that regard an easily justifiable source is closely perceived loopholes and impeding aggressive tax planning.

7.1.2. Nature of dividends

A dividend is by definition a distribution on a share of equity of a corporation. Hence, like, for example, interest or royalties, dividends are derivative of an underlying property right. In that sense, dividends have been likened to the fruit from a tree, in the context of determining whether it is proper to permit dividend income to be reported by a person other than the owner of the underlying shares.

As in the case of interest and royalty flows, dividends are property rights that under the commercial laws of many countries may be severed and assigned separately from the underlying corpus. This has given rise to certain transactions designed to place the tax reporting of dividends in the hands of a taxpayer for whom the treatment is more favourable than would be the case if retained by the equity owner.

Unlike in the case of interest and royalties, dividends are paid only by an entity that is itself a taxpayer. Entitlement to dividends arises from ownership of the entity, though this feature may be less realistic in the case of dividends on non-voting, non-participating preference shares that are relatively debt-like. Because dividends are, generally speaking, a feature of ownership of the entity rather than considered business expense of the entity like interest or royalties, dividends are typically paid on a non-deductible basis out of income that has been subject to a corporate income tax at one level or another.

More than in most contexts in which tax issues arise, concentration of ownership of a company greatly affects the ability to plan for dividends. A widely held publicly traded company generally pays dividends to public holders of its common stock and does not, practically speaking, have a great deal of flexibility as regards the amount or timing of those dividends. However, holders of publicly traded shares are able to take advantage of the liquidity and availability of hedges afforded by a public float to engage in transactions with unrelated parties for long or for very short periods and with no or little equity risk at relatively low cost. Such transactions may exist under various labels (e.g. equity swap, total return swap, forward contract, financial contract, stock loans, etc.).

In the case of privately held companies, there is more flexibility to engage in transactions in respect of dividends or dividend equivalents on shares that are customized in timing and amount. However, it is generally much more difficult and expensive to engage in transactions which involve potential risk to a counter-party due to the lack of a market and the inability to hedge on a cost-effective basis. A collateral consequence is that the forms of transaction in a private context may appear more engineered than natural.

7.1.3. Tax treatment of dividends as relevant to tax planning

The tax treatment of each of the issuer and the holder are relevant to planning for dividends. As regards the issuer, dividends generally are non-deductible. (Exceptions exist in the case of, e.g. the US regimes for REITs and RICs, respectively.) The treatment of dividends at the holder level usually assumes the non-deductible treatment at the issuer level. If in fact an instrument can be structured to provide a deduction at the issuer level yet enjoy the regime afforded to non-deductible income, taxpayers benefit from the arbitrage.

As regards the holder, the relevant tax treatment depends on the context and the holder's fiscal posture. A major focus is the situation in which a taxpayer may seek to avoid being the recipient of a taxable dividend under its domestic law. This phenomenon presupposes a classical concept of corporate income tax and a second level dividend tax imposed on the shareholders. Under certain such systems, the tax rate on dividends may exceed the tax rate on capital gains under the applicable domestic law. The United States, for example, has a long history of combating attempts of individuals to convert potential dividend income into capital gain, although, domestically, the attempts are of lesser significance in recent years because the tax rate on many dividends has been reduced to the same rate as applicable to long-term capital gains.

Not every country has such a system, of course. For example, Brazil, Mexico and the United Kingdom are examples of countries that generally do not levy a tax on cross-border dividends or, taking account of exemptions, dividends received by domestic corporate recipients.[3] Even in the case of dividends to domestic individuals, Brazil does not levy a tax, Mexico allows credit for the corporate tax in an amount which suffices to eliminate taxation at the recipient level and the United Kingdom allows a credit for one-ninth of the dividend. Even if a country has a classical system generally, it may allow a participation exemption for dividends from certain holdings. In these contexts, the need for anti-abuse rules regarding dividends is moot or at least lessened.

Further, even under a classical system, in certain cases, it is advantageous for a taxpayer to receive a taxable dividend. In particular, this may be the case where the dividend is taxed more favourably than capital gain, in order to provide relief from double taxation. Such relief may be provided in a domestic context, as where the dividend may be partially or wholly untaxed (e.g. by reason of an inter-corporate deduction for dividends received) to alleviate double taxation of dividends received by a domestic corporation from corporate profits taxed domestically.[4] Relief also may be provided in a cross-border context, providing an exemption or allowing a foreign tax credit, to alleviate double taxation of dividends received by domestic corporations from corporate profits taxed abroad. Relief may (as in the United States) assume exposure to risk of stock value change in such cases. Dividends also may be sought in a closely held situation, where the dividends supplement amounts otherwise payable as compensation. The applicable anti-abuse rule may be one that prevents a dividend, or prevents a particular taxpayer from reaping the foreign tax credit that normally would accompany a dividend.[5]

3. In Mexico, if the dividend is not paid out of the CUFIN account, however, it is taxable.
4. E.g. IRC §§ 243-46.
5. E.g. IRC § 901(k).

Of particular relevance in a cross-border context, the tax systems of most countries allow for a dividend withholding tax on dividends and bilateral income tax treaties typically allow the source country to impose a dividend withholding tax under its domestic law on dividends paid to residents of the treaty partner. Typically, however, bilateral income tax treaties prevent the source country from imposing a capital gain tax on shareholdings held by a resident of the treaty partner (unless, under certain treaties, such shareholdings reach a minimum threshold level such as 25%).[6]

7.1.4. Survey of taxpayer planning objectives and tools in respect of dividend income

Below are listed certain advantages that may be sought be a taxpayer under certain circumstances (depending on the relevant tax regime and its own tax attributes). Certain tools that a taxpayer might use to achieve its objectives are indicated.

7.1.4.1. Change dividend to a capital transaction

A taxpayer may avail itself of various tools to engage in a capital transaction in respect of a particular dividend. Whether any particular type of transaction can be effective depends upon the tax laws of the jurisdiction. Broadly speaking, however, instead of receiving a particular dividend, the taxpayer might consider, for example:

– company repurchase of shares;
– company reduction of capital;
– wash sale of the shares;
– redemption of the shares for cash;
– recapitalization of shares into shares and a note or shares and preferred stock;
– waiver of cash dividend for increase in share ownership, or similar transaction; and
– reorganization of company into "cash-rich" subsidiary and operating business and distribution of cash-rich subsidiary as demerger.

6. Arts. 10 and 13.

7.1.4.2. Change classification and source of investment

A second type of planning that a taxpayer might consider would involve not holding stock at all but having a different income stream. This might be accomplished by transferring stock in a securities loan and receiving substitute payments. It also may be accomplished by disposing of shares and entering into a total return swap providing equivalent economics.

In a structured finance transaction between private parties (typically financing institutions), the classification issue involves an instrument with debt-like features that from a tax-optimization standpoint would have “hybrid” treatment (debt in the source state and equity in the other state). Besides hybrid securities, transactions structured to achieve the same result, such as sale-repurchase (repo) transactions, are in this category.

7.1.4.3. Reduce tax rate imposed on dividend

This objective could be accomplished through the use of a tax treaty-eligible holding company or investment company to derive dividends. If the taxpayer’s ownership of the company would not permit it to qualify under the treaty, it might consider a financing transaction designed to avoid any applicable conduit financing rules.

7.1.4.4. Change timing of dividend inclusion

The timing of dividend income can be controlled in a closely held company, as it arises only when the board or relevant managers determine to pay a dividend.

Structurally, subject to applicable controlled foreign corporation, passive foreign investment company and similar types of rules, dividend income can be deferred indefinitely.

7.1.4.5. Transfer of dividend rights to tax-favoured taxpayer

Sales of usufructs have been used to achieve this type of transaction, but have been restricted by legislative changes.

7.1.4.6. Special purpose entities designed to generate foreign tax credits

Engineered transactions of various sorts have been employed to allow a financial institution in each of two different jurisdictions to benefit from taxes paid by the vehicle.

7.1.4.7. Capture dividend and foreign tax credit in traded stock/ claim capital loss

A transaction of this sort might involve a purchase of publicly traded shares shortly before they go ex-dividend and a prearranged sale of the shares immediately thereafter. The dividend might carry with it a tax advantage such as a foreign withholding tax entitling the holder to a foreign tax credit and the sale of the shares might trigger a capital loss that could be used to shelter unrelated capital gain.

7.1.5. Survey of tax administrator's arsenal for combating tax planning for dividends

7.1.5.1. General

For those countries that want to prevent treaty shopping in one or more respects, the theoretically best approach would be to renegotiate the treaties to, e.g. include provisions adequate to address the targeted abuse. An example would be a comprehensive LOB article in the case of perceived misuse of holding companies. But renegotiation may be difficult if not impossible, and in any event a time-consuming process, and the OECD Model Treaty and its history are not especially conducive of that approach with respect to, e.g. what may be the misuse of holding companies.

As a result, the adoption of domestic anti-abuse rules or extension of existing judicial anti-abuse concepts by courts to address the problem seem attractive alternatives. The best approach would be for domestic legislation to be prospective only, but that generally would not be the case if the attack is via the judicial system.

Although generally not practical,[7] in theory, a contracting state retains the ability, in a worst case scenario, itself to terminate the treaty. Given the choice between a termination and domestic legislation that may be a treaty override, contracting states generally would prefer the latter.

7.1.5.2. Objective rules

Under a classical system of double taxation, the tax law may periodically target schemes that would have the result of avoiding dividend income or converting dividend income into capital gain. Often, as in the United States, the targeted behaviour may first come to light in a challenge of treatment claimed by a taxpayer and then addressed in case law. Certain such behaviour may be considered of a sufficiently generic sort to be codified or reflected in a regulation.

The US tax system contains numerous rules of this sort. These include rules governing dividends disguised as redemptions or as sales, rules governing attempts to avoid taxable dividends in favour or increases in value of shares, rules governing attempts to capture favourably taxed inter-corporate dividends or dividends carrying foreign tax credits without bearing the risk of loss in respect of the shares, and so forth. Many of these rules are set forth in the country report (see Chap. 24).

Certain rules apply in a cross-border context, including rules recharacterizing payments under certain derivatives as income of a character of the income for which they substitute and rules disregarding the participation of certain "conduit financing entities" in multiparty financing transactions.

An example of generally applicable objective rules in certain bilateral income tax treaties is the limitation on benefits (LOB) article contained in treaties entered into by the United States and certain other countries. Of particular relevance to the topic of this paper, US treaties permitting a 0% dividend withholding rate on dividends to affiliates holding a specified percent of controlling shares of the payer include additional restrictions that must be met to claim the 0% rate, which are designed to prevent restructurings that would permit otherwise ineligible holdings to qualify.

7. The exception may be where the EU directives and the EC Treaty and EU case law provide relief; a few bilateral income tax treaties between EU countries have been terminated, though not for reasons discussed herein.

Other restrictions on eligibility for dividend relief include:

- remittance clauses, under which a UK resident is entitled to relief from withholding tax of the other state only if and when the income from such state is remitted and taxed in the United Kingdom;
- provisions excluding specific tax-exempt entities from treaty benefits (e.g. 1929 Luxembourg holding company);
- provisions providing special withholding tax rates for certain entities that enjoy reduced or even freedom from corporate level tax if earnings are distributed (e.g. RICs (regulated mutual funds) and REITs);[8]
- provisions in, e.g. German treaties excluding the applicability of the exemption method to certain income earned from foreign sources (e.g. dividends received from a Swiss subsidiary earning passive investment income);
- provision targeting repo transactions in the UK–US treaty, which is discussed at 7.2.8. below; and
- Art. 23(4) of the Germany–US treaty ("switch-over provision"). In principle, Germany applies the exemption method for income earned by a German resident from a US permanent establishment, US real estate, dependent services performed in the United States and certain dividends paid by US corporations. As an exception, Germany switches over from the exemption method to the credit method, where the United States (also) exempts the US-source income from its tax per treaty or its domestic law, or where conflict of classification is not resolved per the mutual agreement procedure, or Germany has notified the United States that it wishes to apply the credit method.[9] The intent behind the switch-over clause is that German residents should not escape *all* tax on foreign-source income. A targeted case of such double exemption of income would be the granting of a dividends paid deduction to the US payer of a dividend (e.g. a REIT) and a correlative exemption of such dividend in Germany.[10]

8. Previously, a non-US corporate investor could hold a captive REIT or RIC and enjoy a 5% dividend withholding tax rate and no corporate level tax.

9. The provision is supplemented by domestic rules calling for a switch-over overriding treaty-based exemption from German income tax.

10. The Treasury Technical Explanation for the treaty states that, for example, the fact that a US corporation pays a reduced level of US corporate-level tax because of the nature or source of its income (e.g. because it is entitled to a dividends received deduction, a net operating loss carry forward or a foreign tax credit) will not entitle Germany to switch from exemption to credit.

7.1.5.3. Subjective rules

Perhaps the most common type of subjective weapon in the arsenal of many tax administrators is the so-called "general anti-avoidance rule" (GAAR). Such a provision may be broadly or narrowly applied, depending on the positions taken by the courts. A GAAR of long standing is that of Canada.[11]

As an example of a domestic law subjective rule directed at dividend abuse, the Dutch 2012 Tax Plan includes a provision that would impose Dutch withholding tax on dividends paid by a Dutch cooperative in narrow circumstances where the cooperative is passively holding shares of a company with a main purpose of avoiding Dutch dividend withholding tax or foreign withholding tax and the cooperative shares are not held as part of an active business enterprise. The provision is unlikely to have much application.

In the absence of such a statutory provision, certain subjective anti-abuse doctrines have been invoked by tax authorities to achieve similar results. These include, for example, doctrines of beneficial ownership, economic substance, *abuse du droi, fraud à la loi*, *fraud legis*, abuse of legal rights, sham and *simulation.*

In a treaty context, many treaties that do not include an LOB article include a subjective test in the form of a "main purpose" clause, at least in Arts. 10, 11 and 12.

In the case of any treaty, it generally is agreed among the signatories to the OECD Model Income Tax Treaty that domestic anti-abuse provisions or doctrines may be invoked by the tax authorities,[12] within limits.[13] These limits are perforce left extremely loosely defined in the Commentaries to the Model Treaty and expressed only in terms of "a guiding principle" that benefits should not be available if "a main purpose" was to obtain tax treatment that "in these circumstances would be contrary to the object and purpose of the relevant provisions." Hence, the true scope of a treaty's tax benefits in contexts that may be perceived as aggressive is a major uncertainty.

11. Income Tax Act, § 245.
12. OECD Committee on Fiscal Affairs, Model Tax Convention on Income and on Capital, Commentary on Art.1, at Paras. 7.1-9.4 (2003).
13. Id., at Para. 9.5.

As one example of a considered application of a domestic subjective anti-abuse rule in a treaty context, the Supreme Court of Canada held that the Canadian GAAR could be applied to deny treaty benefits.[14]

7.2. Analysis of specific types of transactions

An assumption in the fact patterns that follow is that a principal purpose of transaction is a tax benefit. One may reasonably question whether a withholding tax (particularly at a rate comparable to that of the underlying corporate income tax, as under US domestic law) is optimal from a tax policy standpoint. Nevertheless, as long as such a tax exists, rules to prevent its avoidance through alternative forms of transaction seem appropriate. It is suggested here that in analysing these transactions from a tax standpoint, one should ask the following question: If there is no anti-avoidance rule (statutory, judicial or treaty), is the tax in effect voluntary or only imposed on the ill-advised?

The first four types of transactions analysed – capital transaction (which includes various subsets), securities loan, total return swap and hybrid security – involve the issue of whether source-state dividend income is avoided under the laws of the source state in favour of a different type of income. These involve issues of classification, but, in the securities loan and total return swap cases, in which payments are received pursuant to a contract referencing shares rather than directly from the shares, the question of whether the taxpayer actually might be viewed as the beneficial owner of the dividend income also is touched upon.

The next two types of transactions (which are conceptually similar but arise in different contexts) address circumstances in which an entity included in a transaction in an attempt to have a more tax-favoured owner of shares might not be respected as being entitled to reduced rates under any of various theories.

The final four types of transactions addressed involve attempts to capture credits or obtain exemption of income.

14. *MIL (Investments) S.A. v. R.,* 2006 TCC 460, [2006] 5C.T.C. 2552, aff'd 2007 FCA 236, 2007 D.T.C. 5437.

7.2.1. Avoiding dividend income classification via capital transaction

The first category of transactions is the most straightforward of all and simply involves various ways of transforming a dividend into a capital transaction. In a domestic context, the taxpayer if successful may achieve favourable capital gain treatment or return of capital treatment. In a cross-border context, the benefit may be avoidance of source-country tax as well. Various techniques may be employed depending on the jurisdictions involved and the situation. These can include simply having the company buy back shares rather than paying a dividend; having it make a payment in reduction of capital rather than as a dividend; engaging in a wash sale; converting ordinary shares into a combination of notes and ordinary shares, or into a combination of preference shares and ordinary shares and selling the preference shares; selling shares of one affiliate to another; and so forth. Not every jurisdiction views these transactions as abusive, even though they may have the effect of avoiding a dividend.

7.2.1.1. Share buy-back

An obvious approach to seek sale rather than dividend treatment for earnings extracted from a company is a redemption of a company's shares. As an example of one country's approach to this issue, US tax law allows the entire gain on redemption to be treated as sale gain *provided* the transaction more closely resembles a sale than a dividend as that distinction is applied in the statutory tests (e.g. a complete termination or even a meaningful reduction of the holder's interest in the company).[15] Under such tests, if a controlling holder of common stock that also owns preferred (preference) shares and sold the shares to the company, the proceeds would be taxed as a dividend.

An August 2011 decision in India held that a taxpayer that held preference shares of two companies which were redeemed at par was entitled to capital treatment on the redemption, rather than treatment as a distribution (dividend and reduction of capital) as had been asserted by the Indian tax authorities.[16] Based on indexation adjustments, the taxpayer was permitted a capital loss.

15. IRC § 302.
16. Mumbai Tax Appellate Tribunal [ITA Nos. 5318 & 5319/Mum/2006] (involving Parle Biscuits Pvt. Ltd.).

7.2.1.2. Reduction in capital

Under the laws of certain jurisdictions (but excluding the United States), a company may pay out amounts as a reduction in capital. The ordering of distributions as dividends or reductions of capital is purely a question of a country's domestic law. There would be no abuse in paying an amount in a manner that would take advantage of such laws. If, however, additional transactions are undertaken to achieve such a result and such additional transactions are inconsistent with the purpose of the relevant statute, a different result may obtain.

For example, in the *Copthorne* case,[17] the taxpayer claimed that no dividend withholding tax resulted on a distribution to a non-resident shareholder on the theory that the amount distributed did not exceed the distributing company's "paid-up capital" (PUC) account (basically, an account measuring for tax purposes amounts received by the corporation on the issuance of shares). The taxpayer group relied on the fact that PUC may be duplicated (or more) in a corporate chain under Canada's separate corporation tax system. However, the Canadian statutes recognize that that may result in double-counting, and so provisions exist to eliminate the duplicate PUC in certain contexts. In this case, the taxpayer group took steps to avoid the anti-duplication provision that applies in a vertical amalgamation of a subsidiary with its parent corporation (parenthetical language in Sec. 87(3) of the Income Tax Act eliminating the PUC of the subsidiary's shares) by having the parent first sell the subsidiary's shares (with the duplicate PUC) to the parent's own parent company and then completing a horizontal amalgamation with the now sister company rather than a vertical amalgamation, such that, apart from the GAAR, the subsidiary's PUC was preserved and added to the PUC of the amalgamated entity's shares. In effect, a transitory change in ownership among affiliates was undertaken to preserve a tax attribute and benefit from it in a way that was not intended, as evidenced by a specific anti-duplication rule. The question was whether the Minister could prevent circumvention of the anti-duplication rule (in effect, broaden the rule) by using the GAAR.

The Supreme Court of Canada (afffirming the result of the lower courts) held unanimously that the sale of the shares of the subsidiary to the seller's parent company to make the subsidiary a "sister" corporation of the seller, which was undertaken to "artificially" preserve PUC on the subsequent amalgamation and not for any *bona fide* business purpose, frus-

17. *Copthorne Holdings Ltd. v. The Queen*, 2011 SCC 63.

trated the purpose of the parenthetical anti-duplication language in Sec. 87(3). The taxpayer's double counting of PUC would enable a return of capital, without liability for tax, in an amount exceeding the equity investment of tax-paid funds into the corporate chain, rather than a dividend to which non-resident withholding tax would apply, contrary to the object, spirit and purpose, or underlying rationale, Sec. 87(3). Because the taxpayer structured the transactions to achieve this result rather than for any *bona fide* business purpose and the result circumvented the anti-duplication rule, the transaction was "abusive" and the GAAR was properly applied.

7.2.1.3. Dividend wash transactions

An investor wishing to avoid dividend income on publicly traded shares may sell the shares immediately before the ex-dividend time and repurchase the shares immediately after such time ("wash sale"), in order to convert dividend income into capital gain. Even if a jurisdiction has rules limiting recognition of loss on a sale and repurchase in the public markets,[18] it generally does not limit transactions in which gain is recognized. If there is not a public market, the resale may be pursuant to an agreement to repurchase, although in such a case the transaction may be more vulnerable to a recast as something other than a true sale.[19]

In certain cases, a country may consider the benefits derived from such sales in certain contexts to be inappropriate. For example, the US Congress enacted a "wash sale" provision addressed to attempts to avoid taxation of, in particular, real estate investment trust (REIT) distributions to foreign shareholders that otherwise would have been taxable under the FIRPTA provisions. The provision applies if the REIT shareholder, within 30 days prior to the ex-dividend date for a distribution, sells shares free of tax because the REIT qualified as "domestically controlled" and repurchases (or acquires an option to repurchase) the shares after the ex-dividend date and within 61 days of the first day of the 30-day period.[20] The foreign shareholder must pay FIRPTA tax in an amount equal to the portion of the distribution the shareholder otherwise would have received that would have been treated as FIRPTA gain.[21] The wash sale provision also applies to sub-

18. E.g. IRC § 1091.
19. In a private transaction, the expected treatment under the tax laws of both jurisdictions would be relevant. See discussion of certain "repo" transactions at 7.2.8. below.
20. IRC § 897(h)(5).
21. IRC § 897(h)(5)(A). A transaction is not treated as an applicable wash sale transaction if it involves the disposition of any class of stock in a REIT that is regularly traded on an established US securities market, as long as the foreign shareholder did not own

stitute dividend payments received by a non-US transferor in a securities lending or sale-repurchase transaction.

7.2.1.4. Recapitalization of shares into shares and notes

Suppose a corporation offers to exchange debt instruments for a portion of the shares held by all shareholders, pro rata. Thus, Reg. Sec. 1.301-1(l) generally recasts the pro rata exchange of common stock for new common stock and bonds as a dividend of the bonds.

In the United States, a pro rata exchange of common stock for common stock and bonds or other debt instruments is a dividend with respect to the bonds even if the common-for-common exchange is treated as a tax-free recapitalization. The rule, embodied in a regulation,[22] is based on a well-known US Supreme Court case[23] which held that an exchange by the shareholders of a family corporation of all of the corporation's common stock for new common stock plus debenture bonds was not a recapitalization. If, however, the transaction were not pro rata, then at least as to non-controlling shareholders it should result in capital gain or loss with respect to the shares exchanged for bonds.

7.2.1.5. Recapitalization into or distribution of preferred shares and sale of such shares

Suppose a corporation with substantial retained earnings (hidden reserves) and liquid assets distributes a dividend of preferred shares to its shareholders and the shareholders sell the shares to a third-party purchaser, from whom there is a plan for redemption by the corporation at some point in the future. The economic effect of this series of steps is essentially a cash dividend to the shareholders of the corporation. However, unlike the taxation of a dividend of cash as ordinary income, the sale of the distributed shares is intended to result in capital gain treatment.

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more than 5% of the class of stock at any time during the 1-year period ending on the ex-dividend date of the distribution, because the shareholder in such case would not have been subject to FIRPTA tax if it had received the dividend instead of disposing of the stock. Conference Committee Report, Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222); H.R. Conf. Rep. No. 109-455.

22. Treas. Reg. § 1.301-1(l).

23. *Bazley v. Comm'r*, 331 U.S. 737 (1947).

This kind of tactic was eliminated in the United States years ago. A category of shares, so-called "section 306 stock," was defined to include shares that do not participate substantially in corporate growth (e.g. typical preferred shares) received in various tax-free transactions, including tax-free distributions, recapitalizations and reorganizations.[24] Sec. 306 does not provide for immediate taxation of a shareholder who receives a distribution of section 306 stock. Rather, when the shareholder sells or otherwise disposes of such stock, the amount realized is treated as ordinary income. To avoid possible avoidance, for purposes of the sourcing rules, such ordinary income is treated as derived from the same sources as if money had been distributed as a dividend at the time of distribution of the section 306 stock; as that generally will be US source, the amount will be considered to be subject to US withholding tax.[25]

7.2.1.6. Multiple classes of stock

In the case of a tax system in which the distribution of shares to shareholders generally is non-taxable, there arises the possibility of having a shareholder in effect elect whether to receive taxable dividends or instead increase their residual share in the company. The United States had such a system prior to the 1969 enactment of Code Sec. 305.[26]

To avoid abuses, under current law, a distribution is taxable if one or a series of distributions results in some shareholders receiving cash or property and other shareholders increasing their proportionate interest in the corporation's earnings or assets.[27] Specific statutory examples include where shareholders may elect to receive shares or cash, where common shares are distributed to some shareholders and preferred shares to others, where stock is distributed on preferred stock and where convertible shares are distributed. Regulations treat a wide variety of transactions as "constructive" or "deemed" distributions of stock with respect to the stock of any shareholder whose proportionate interest in the corporation's earnings or assets is increased by the transaction. The transactions include changes in conversion ratios, changes in redemption prices, differences between redemption price and issue price, redemptions that are treated as a distribution to which the taxable dividend rules of Sec. 301 apply and any

24. IRC § 306(c).
25. IRC § 306(f).
26. IRC § 305(a); *Eisner v. Macomber,* 252 U.S. 189 (1920) (holding that the distribution of common stock by a corporation having only common stock outstanding could not be taxed constitutionally as income to the shareholders).
27. IRC § 305(b)(2).

other transactions (including recapitalizations) having a similar effect on the relative equity interests of any shareholder.

7.2.1.7. Sale of shares of one affiliate to another by controlling shareholder

Suppose that a shareholder owns each of two companies. Rather than distribute a dividend from one of the companies, it might consider selling an asset to that company and extracting earnings as sale proceeds. Among the significant assets that might be able to be sold without great difficulty or (absent a special rule) tax cost is shares of an affiliate.

Under US law, Code Sec. 304(a)(1) provides that if one or more persons controlling each of two corporations sell the stock of one corporation to the other corporation, the sales proceeds are considered as distributed in redemption of the stock of the acquiring corporation. For purposes of these redemption rules, sales proceeds received by a corporate transferor may be treated as a dividend to the extent of the acquiring corporation's "earnings and profits," and then to the extent of the "earnings and profits" of the corporation the stock of which was sold (the "issuing corporation").[28] For purposes of the control requirement, one or more individuals are considered in control of a corporation of they own, directly or indirectly, stock which represents at least 50% of the total combined voting power of its outstanding stock, or at least 50% of the total value of shares of all classes of stock.[29] In determining control, constructive ownership rules apply.

7.2.1.8. Liquidation of holding company

Under the tax laws of certain countries, withholding tax is not imposed on the distribution of a company's earnings to a foreign corporation in a complete liquidation because the distribution was treated as made in exchange for shares and not as a dividend. For example, this is the case under US law. This rule is regularly used to allow private equity investors to exit from a direct US holding without incurring a second level of tax.

A foreign corporate investor may wish to repatriate earnings via a liquidation without terminating the investment. For example, the investor may cause its US holding company to establish a subsidiary US holding

28. IRC § 304(b)(2).
29. IRC § 304(c)(1).

company from which it could receive tax-free dividends and, in a separate transaction, liquidate the upper tier US holding company to distribute the US earnings, with the intention of escaping US withholding taxes; if the holding company is a "United States real property holding corporation", the liquidation into a foreign parent company generally would not result in a US corporate income tax. The Code Sec. 332(d) rules are intended to address these withholding tax abuses[30] (though they are not considered very effective and create problems in other contexts). Under Sec. 332(d), any distribution of "earnings and profits" by an "applicable U.S. holding company"[31] to a foreign corporation in a complete liquidation generally is treated as a dividend.[32]

7.2.1.9. Cash-rich demerger/spin-off

Suppose that a country's tax laws allow a corporate group to distribute stock of a subsidiary tax free to some or all shareholders under certain circumstances. If there are not rules to prevent abuse, a company could transfer passive assets, even cash (which could have just been borrowed), to a subsidiary and distribute the shares of that subsidiary to its shareholder or shareholders, who then could use the company as an investment vehicle, access the cash, sell the company or transfer it for shares of another company. Alternatively, the active business assets could be transferred, encumbered by debt, to a separate company and that company distributed by the cash-rich company.

Under US law, for example, such a transaction would be treated as a taxable dividend unless, among other requirements, there is a valid business purpose for the transaction, each company has conducted an active business for at least 5 years and the transaction is not a "device" for the distribution of earnings.[33]

30. S. Rep. No. 108-755, at 761-62 (2004) (Conf. Rep.).
31. An "applicable holding company," for this purpose, means any domestic corporation that (i) is a common parent of an affiliated group; (ii) whose stock is directly owned by the distributee foreign corporation; (iii) substantially all of the assets of which consist of stock in other members of such affiliated group; and (iv) which has been in existence for less than 5 years immediately preceding the date of the liquidation. IRC § 332(d)(2)(A).
32. IRC § 332(d)(1). In cases where the foreign distributee is a controlled foreign corporation, the liquidating distribution is not treated as a dividend, but is instead subject to the Sec. 331 rules. IRC § 332(d)(3).
33. IRC § 355. See also IRC § 355(g) (cash-rich split-offs/redemptions).