International Tax Planning and Prevention of Abuse

A Study under Domestic Tax Law, Tax Treaties and EC Law in relation to Conduit and Base Companies

PART ONE : THE USE OF CONDUIT & BASE COMPANIES IN INTERNATIONAL TAX PLANNING

1. In this first Part of the study, a general description of the tax planning techniques involving the use of conduit and base companies will given and the contours of the study will be delineated. Because of the enormous diversities between the legislation of the different jurisdictions around the world, it is impossible to explore all possibilities offered by those jurisdictions to conduit and base companies. Accordingly, hereafter the tax planning techniques are discussed "*in abstracto*" and are not specifically linked to particular countries[1]. The purpose of this first Part is to introduce the various tax planning techniques and not to consider for which countries such techniques work. The different anti-avoidance measures enacted by jurisdictions (including Belgium) or developed by the case law to discourage such tax planning and to exclude the negative budgetary impact thereof will be discussed in the next Parts of this study.

1. CONDUIT COMPANIES

2. The study will only focus on conduit companies that are set up specifically for "*Treaty or Directive*"-shopping purposes with respect to dividends, interest and royalties. In this Section I will describe the terms "*Treaty shopping"* and "*Directive shopping*" as used for purposes of this study and define the term "*conduit company*". In essence, "*Treaty or Directive*"shopping refers to the situation in which a person resident of a given State who is not entitled to the benefits of a tax treaty or an EC-Directive sets up an entity in another State in order to obtain those treaty or Directive benefits that are not directly available to him. Such entity is called the "*conduit company*".

1.1. Treaty Shopping

1.1.1. Description of the term "treaty shopping" in relation to conduit companies

3. "*Treaty shopping*" connotes a premeditated effort to take advantage of the international tax treaty network and a careful selection of the most favorable tax treaty for a specific purpose[2]. There may be a variety of purposes for which taxpayers engage in treaty shopping: claiming an otherwise unavailable reduction or exemption of (withholding) taxes in the source State of the income; claiming an otherwise unavailable tax exemption in the residence State; claiming the benefit of a tax sparing credit; claiming taxation in the source state at a lower tax rate than the one applicable in the

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[1] For a recent detailed overview of tax planning techniques involving conduit and base companies used by Belgian resident companies and an overview of foreign tax regimes, see Minne, P., Douénias, S., *Planification fiscale internationale des sociétés belges*, Larcier, 2004, 365-540.

[2] Rosenbloom, H.D., *Tax Treaty Abuse: Problems and Issues*, 15 Law and Policy in International Business, 1983, 766.

residence State if the residence State gives relief for double taxation by way of exemption etc..

4. The most classical example of "*Treaty shopping"* occurs where a person resident of a given State (State R) who expects to derive dividends, interest or royalties sourced in another State (State S) sets up an entity in a third State (State C) that will receive the dividends, interest and royalties in a more tax beneficial way than if such income were paid directly from State S to the person resident of State R. The tax advantage results from the fact that the tax treaty between State S and State C provides for a more advantageous withholding tax rate in State S on dividends, interest and royalties paid to a State C resident than the rate that would apply in State S if the income were paid directly to the State R resident because there is either no tax treaty applicable between State R and State S or, if there is one, it provides for less generous withholding tax rates than those available to the State C resident under the treaty between S and C. The entity in State C operates as an intermediary between the source State (S) of the dividends, interest and royalties and its controlling shareholder in State R because it pays on the income received (in the same or another form) to such controlling shareholder. In view of its channeling function, the entity established in State C is typically, and also for the purposes of this study, referred to as "*a conduit company"* or "*a conduit*". State C will be referred to as the "*conduit state*".

5. Hence, this kind of "*Treaty shopping*" describes the situation in which a resident of a third State (i.c. State R) "*shops*" into an otherwise unavailable treaty between two other Contracting States (States S and C) to be able to enjoy the benefits of that treaty. For this purpose, such resident interposes a conduit company in a State which has a favorable tax treaty with the source State of the income[3]. The purpose of this kind of "*Treaty shopping*" is the avoidance or reduction of withholding taxes in the source State. In this case of "*Treaty shopping*", the tax advantage occurs to the detriment of the source State of the dividends, interest or royalties.

6. The number of States involved in a structure is not a criterion to define "*Treaty shopping*". In the above example it implies the involvement of three States, but, as is illustrated by the Schemes below, structures involving even more States are not uncommon in practice (see the "*stepping stone*"-structures under Scheme 2), while schemes involving conduit companies set up in only two States (such as "s*ame country holding"*- structures (see under Scheme 6) and "*quartet*" and "*quintet*"- structures) can also be categorized as "*Treaty shopping*" aimed at avoiding high withholding taxes in the source State[4].

7. In practice, one distinguishes between "*direct conduits*" and "*stepping stone conduits*"[5]. The structure discussed in the previous paragraph represents a "*direct conduit*"-structure.

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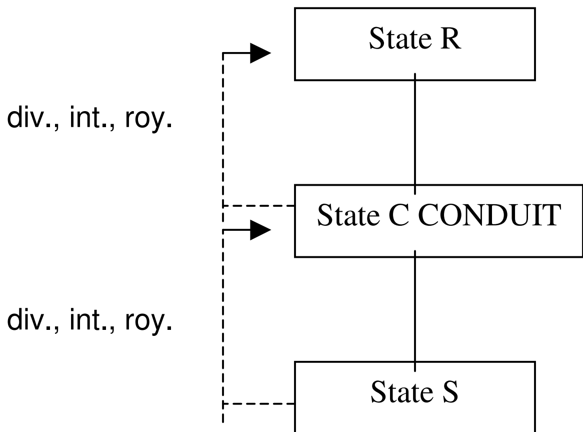
[3] Wurm, F.J., *Treaty Shopping in the 1992 OECD Model Convention*, Intertax, 1992, 658; Hinnekens, L., *Treaty Shopping en anti-misbruikregels in België en elders*, Actuele Problemen van Fiscaal Recht XV° Postuniversitaire lessencyclus W. Delva 1988-1989, Kluwer, 1989, 255.

[4] Although from a methodological point of view it is more appropriate to classify the quartet and quintet-structures as a form of "*Rule shopping*" (see infra margin no. 12).

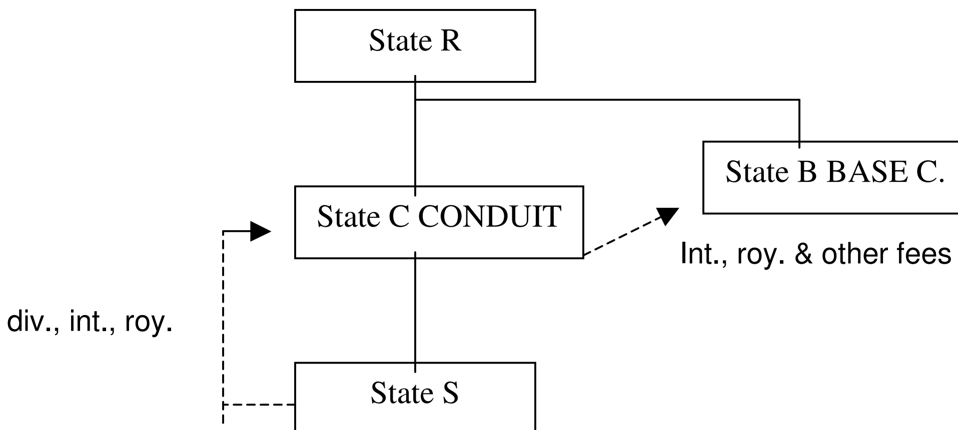
[5] OECD, *International Tax Avoidance and Evasion, Four Related Studies, Double Taxation Conventions and the Use of Conduit Companies*, Issues in International Taxation, No. 1, OECD, 1987, no. 4.

SCHEME 1: Direct conduit-structure



"*Stepping stone conduits*" are a variant of the direct conduit-structure. Residents of State R establish a company resident in State C where it is fully subject to tax on the income derived from State S. However, it pays high interest, royalties, services fees, commissions and other expenses to a second related foreign company set up in a fourth State (State B) and controlled by the shareholders of the conduit company. These payments are deductible in State C and are either not or very advantageously taxed in State B because the company enjoys a preferential tax regime there. The company in State B qualifies as a "*base company*" the characteristics of which are described in more detail below sub 2.

SCHEME 2: Stepping stone conduit-structure



8. Taxpayers can also engage in "*Treaty shopping*" and set up conduit companies in order to obtain tax advantages in their State of residence that would otherwise be unavailable. For instance, a resident of State R who owns a shareholding in a company based in State S (often a non-treaty country) can be denied the participation exemption

on dividends distributed by the State S subsidiary in State R because that subsidiary enjoys a favorable tax regime and falls within the anti-avoidance provisions on the participation exemption in R. The State R resident sets up an entity in State C and contributes his shareholding thereto. State C provides for a more favorable participation exemption on dividends originating in State S and the relief and non-discrimination provisions on dividends of the treaty between R and C (Art. 23 and 24 OECD MC) require State R to grant the participation exemption on the dividends distributed by the State C conduit company even if such dividend originates from the State S dividend[6]. Here, the State R resident "*shops*" into a treaty otherwise inapplicable to the dividend distribution, i.e. the one between his State of residence R and State C and for that purpose sets up an intermediary company in C with a view to channel the State S dividends to R. Such form of "*Treaty shopping*" is disadvantageous to the State of residence of the shareholder controlling the conduit.

9. "*Treaty shopping*" involving conduit companies can also occur to claim tax advantages in the conduit State itself and be disadvantageous to that State. For instance, where a resident of State R plans to loan funds or lease (in)tangible personal property to a State S resident, it sets up a conduit company in State C to which it borrows the funds or leases the property which the conduit subloans or subleases to the State S resident. The reason for setting up the conduit company is that the tax treaty between S and C provides that no withholding tax is levied on interest or royalties sourced in State S but that State C must grant a tax sparing credit (i.e. a tax credit for the tax not withheld in the source State) to the State C resident, while the treaty between S and R does not provide the grant of a tax sparing credit to the State R resident[7]. Like in the first case, the State R resident "*shops*" into an otherwise unavailable treaty (i.e. the treaty between S and C) but this time to claim tax advantages in the conduit State by setting up an intermediary company there to channel income from S to R.

10. These three forms of "*Treaty shopping*" involving conduit companies are a form of tax avoidance whereby one operation (i.e. the direct investment of the State R resident in S) is broken down in two (or more) operations (i.e. the indirect investment from the State R resident in S through the conduit in C) the economic effect of which, however, is the same as under the single operation: the State R resident ultimately receives the income sourced in S. Such forms of "*Treaty shopping*", all involving flows of passive income (dividends, interest and royalties), will be addressed in this study.

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[6] See infra Scheme 9. An example is Art. 23 (1) (c) jo. Art. 24 of Protocol 1 of the 2002 Belgium/Netherlands tax treaty according to which dividends distributed by a Dutch company to a Belgian company qualify for the participation exemption in Belgium if they originate from dividends from lower tier-subsidiaries that are subject to a tax similar to the Belgian corporate tax. Such provision only incorporates the first Belgian domestic anti-avoidance provision on the participation (and not the five others, see Part Two, 2.1.4) and prevails over the non-incorporated domestic anti-avoidance rules. For other examples see Part Three, 6.4.2.

[7] Developing countries often grant tax incentives to foreign investors for purposes of attracting foreign investment (e.g. an exemption of withholding tax at source). When the residence State of the investor gives relief for double taxation by way of credit, the benefit of the withholding exemption is annulled because the foreign source income is fully taxed and there is no credit because no withholding has been paid in the source State. To avoid such effect in the State of residence, that State agrees in its tax treaty with the developing country to grant a foreign tax credit for the taxes that have been "*spared*" under the source State's incentives programme. Tax sparing credits are a form of subsidy granted by the residence State of the investor because the grant of such credits leads to a loss of tax revenues in the residence State in connection with investments in the developing countries (see e.g. Art. 23 (3) (b) and (e) of Belgium/India tax treaty; Art. 23 (2) (b) of Belgium/Mongolia tax treaty; Art. 23 (2) (b) of Belgium/Tunisia tax treaty).

11. There are other forms of "*Treaty shopping*" that also concern the setting up of an entity in another State to claim the benefit of otherwise unavailable treaty benefits but do not concern flows of passive income, but rather the conduct of a business in the other State. For example, a building constructor resident of Luxembourg who will carry on a construction activity in Belgium that is expected to last for 11 months may set up a subsidiary in the Netherlands to do the job because under the Belgium/Luxembourg treaty he will have a permanent establishment and become taxable in Belgium, while under the Belgium/Netherlands treaty he will not[8]. A Belgian company wishing to set up an office in Ivory Coast solely for purchasing goods or merchandise there, will have a permanent establishment there, while it can avoid this effect if it sets up a subdiary in another State that opens the purchase office in Ivory Coast if that State has a treaty with Ivory Coast that follows the OECD Model[9]. Emigration is - at least by the OECD[10] - also characterized as a form of "*Treaty shopping*". For example, a resident of France owning an important shareholding in a French company may emigrate to Belgium in view of a later sale of those shares because under Art. 18 of the Belgium/France tax treaty the right to tax the capital gain is conferred to Belgium, but Belgium does not levy capital gains tax on individuals (except in case of a sale falling outside normal management of a taxpayer's patrimony (e.g. speculation)). Such forms of "*Treaty shopping*" will not be addressed in this study.

12. "*Treaty shopping*" concerns a situation in which a person who is not entitled to the benefits of a tax treaty makes use of another (normally legal) person to obtain those treaty benefits that are not available to him directly.

Some authors distinguish such "*Treaty shopping*" from "*Rule shopping*" [11]. In my view "*Rule shopping*" concerns a person who as such is entitled to the benefits of a certain tax treaty and who employs that treaty in the most favorable manner. "*Rule shopping*" is usually directed towards making a certain distributive rule of a tax treaty applicable rather than another one. For example, an individual resident of State A is a shareholder in a Belgian company that has important retained earnings. In order to avoid the payment of dividend withholding tax in Belgium upon distribution of the company's earnings (whether as a dividend or upon liquidation) (15% under Art. 10 of the Belgium/A treaty) he sells the shares at their fair market value to his wholly-owned Belgian personal holding company ("*Belco*"). The treaty follows Art. 13 of the OECD MC, but State A does not impose capital gains tax. The company acquires the shares against a promissory note. Subsequently the holding causes its subsidiary to distribute a dividend in an amount equal to its retained earnings. No withholding tax is due on the dividend and it enjoys the participation exemption in the hands of the parent company under the Belgian rules implementing the Parent/Subsidiary Directive (see Part Two, 2.1.4.). As the dividend is virtually tax free it is almost fully used to pay off the note to the former shareholder of Belco. By structuring a transaction under Art. 13 rather than Art. 10 of the

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[8] Under Art. 5 (2) (7) 1970 Belgium/Luxembourg tax treaty, a building or construction site gives rise to a permanent establishment if it lasts for 6 months, while under Art. 5 (3) of the 2002 Belgium/Netherlands tax treaty there is a permanent establishment only after 12 months.

[9] Art. 5 (3) of the 1977 Belgium/Ivory Coast tax treaty deviates from Art. 5 (4) (d) OECD MC. According to the latter provision a fixed place of business used solely for purchasing goods or merchandise does not give rise to a permanent establishment.

[10] OECD Commentary on Art. 1, § 9. For the contrary view, see De Broe, L., *The Transfer of Residence by Individuals*, Cah. Dr. F. Int., vol. LXXXVIIb, IFA, 2002 Oslo Congress, Kluwer, 2002, 65-68.

[11] Martin Jimenez, A., *Domestic Anti-Abuse Rules and Double Taxation Treaties : a Spanish Perspective – Part I*, Bulletin I.B.F.D., 2002, 543; Vogel, K., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, 1997, 3rd edition, 119.

treaty and making use of favourable domestic tax rules in both States, a tax saving is realized. The aforementioned "*quartet*" and "*quintet*"-structures are another example[12]. Such form of "*Treaty shopping*" or "*Rule shopping*" will be addressed in this study where they involve passive income or the conversion of such income.

[12] Quartet and quintet-structures have been used to circumvent provisions in German tax treaties providing for a reduction of dividend withholding tax only if the shareholder has a stake of maximum 25% c.q. 20% in the German subsidiary. A 100% shareholder resident of the other State sets up four c.q. five intermediary companies in that State each holding 25% c.q. 20% of the German subsidiary (see e.g. Art. 10 (3) of 1967 Belgium/Germany tax treaty). Such provision has become obsolete because of the enactment of the Parent/Subsidiary Directive according to which dividends distributed by a German subsidiary to a Belgian company having a 25% (now 20%)-stake in the subsidiary are exempt from German withholding tax (see this Part under 1.2.2.1). Because of changes in German domestic law (abolition of the split corporate tax rate) a 15% withholding applies under the tax treaty in case of lower shareholdings.
The "*same country holding*" and "*quintet*"-structures are discussed by van Weeghel, S., Improper Use of Tax Treaties, Kluwer Law International, 1998, 132-134 and 137-138.