

International and EC Tax Aspects of Groups of Companies

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Chapter 6 Treaty Recognition of Groups of Companies

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6.1. Introduction

This chapter focuses generally on the issue of whether and how groups of companies are recognized for purposes of bilateral tax treaties. The underlying perspective is on groups of companies and not on group regimes per se.

A good starting point in discussing the tax treaty recognition of groups of companies is the more fundamental question of the legal nature of the company. What is the legal reasoning that justifies the conclusion, which underlies tax treaties, that each company should constitute a separate person for purposes of the application of tax treaties? Angelo Nikolakakis touched upon this issue earlier (see Chapter 2).

One simple legal view is that a company is merely a legal fiction and, since the law can create fictions, it can also eliminate them. That, however, ignores the many different legal theories about what is a company, whether it is a way to represent reality or whether it is a pure fiction. Some writers and commentators have spent considerable efforts discussing this point. I will not go into the detail of these, but, as we are in Italy, it may be interesting to refer to Pope Innocent IV, who in the 13th century already espoused the theory of the legal fiction by saying that corporate bodies and universities could not be excommunicated because they only exist in abstract.

6.2. The separate entity principle

Looking at the practice (and ignoring the theory), domestic tax laws generally recognize the separate entity principle, i.e. treat a company as a separate person for purpose of their application, but as some of the speakers have already indicated, there are many circumstances where the separate existence of different companies that are part of the same group will be totally or partly ignored and a number of these are relevant for purposes of tax treaties.

¹ This chapter has been prepared on the basis of a first draft by Richard Casna that summarized an oral presentation made by the author, who is Head, Tax Treaty Unit, OECD Centre for Tax Policy and Administration. It reflects the personal views of the author and these should not be attributed to Mr Casna, the OECD or to any of its Member countries.

The separate entity principle is the norm in domestic tax laws but there are many limits to that principle. As previous speakers have noted, there are basically two sets of circumstances where individual companies that are part of a group will not be treated as separate entities. These may be summarized as cases of “not enough tax” and cases of “too much tax”. As regards cases of not enough tax, the best example is probably CFC rules. An example of too much tax is where you recognize an exemption for intercorporate dividends paid by one company to another company.

6.3. The separate entity principle in tax treaty provisions

There is generally less recognition of groups of companies in tax treaties than under domestic tax laws and the treaty exceptions address primarily cases of “not enough tax”, i.e. to prevent tax avoidance. The overall principle of the OECD Model Convention is clearly the separate entity and recognition of groups of companies is rare. As Jean Pierre Le Gall discusses in more detail in Chapter 21, paragraph 7 of Art. 5 confirms the principle by expressly stating that the fact that one company controls another does not, in itself, make one company a permanent establishment of the other. Although it has not always been the case, nowadays it is fairly well accepted – except perhaps in some countries – that for tax treaty purposes, a subsidiary and its parent are totally distinct taxpayers.

While some bilateral treaties differ (which is discussed later in this chapter), there is only an indirect and occasional recognition of groups of companies in the OECD Model. One example is Art. 9, which refers to associated enterprises. The article, however, does not directly define the concept of “associated enterprises”; Paragraph 1 simply indicates that it applies where one enterprise “participates directly or indirectly in the management, control or capital of” another enterprise and these two enterprises are not dealing at arm’s length. The reference to an enterprise that “participates directly or indirectly in the management, control or capital of” another enterprise is very broad and could potentially apply to one company that owns only one share in another company. The second requirement of the paragraph (that the “conditions ... made or imposed between the two enterprises ... differ between those that would be made between independent enterprises”, i.e. the arm’s length principle) is clearly more restrictive; the result, however, is that it is technically more accurate to say that paragraph 1 applies where enterprises are not dealing at arm’s length than to say that paragraph 1 provides that the arm’s length principle applies to associated enterprises.

It is interesting to speculate on the reason why Art. 9 was inserted in the OECD Model. One view is that it was a by-product of the introduction of the “arm’s length principle” in Art. 7. In Art. 7, the arm’s length principle has a clear treaty function as the fictional basis for determining the profits that are attributable to a permanent establishment and that may therefore be taxed by the State in which the permanent establishment is located. It is not clear, however, what was the exact treaty role of Art. 9 in the 1963 Draft Convention. Article 9 did not, at that

time, include the corresponding adjustment provisions of paragraph 2 and simply allowed one State to adjust profits of enterprises in non-arm's length situations. Since such adjustments are almost always made with respect to resident enterprises, it is not clear why the drafters felt the need to clarify their power to make them. It may well be that this is because the 1963 Draft was essentially drafted by European countries and many of these countries closely followed the accounting records of a company to determine the taxable profits of that company. These countries most likely wanted to confirm that they could rewrite the accounts of a company not only as regards non-arm's length dealings between a permanent establishment and the rest of the enterprise but also as regards non-arm's length transactions between two companies.

Other provisions of tax treaties that take account of relationship between companies are the special relationship clauses of paragraph 6 of Art. 11 (Interest) and paragraph 4 of Art. 12 (Royalties). These provisions apply if there is "a special relationship between" the payer and the beneficial owner (or between both of them and a third person); like Art. 9, they therefore have a potentially very broad scope as they do not directly define the group of companies to which they could apply.

Another important provision is subparagraph 2a) of Art. 10 (Dividends), which provides for a lower rate of tax on direct dividends. That provision implicitly recognizes that a parent is not totally different from its subsidiary. Whilst the normal treaty rule for the taxation of cross-border dividends is that the State of source may levy tax up to 15% of the dividends, a special maximum rate of 5% applies where the shareholder is a foreign company that owns 25% or more of the capital of the company that pays the dividends. This, of course, is one example where tax treaties acknowledge that an exception to the separate treatment of companies is needed to avoid excessive taxation.

Paragraph 4 of Art. 13 can also be seen as a provision that implicitly recognizes groups of companies because its drafting addresses scenarios where the use of a chain of companies could allow a taxpayer to benefit from the application of paragraph 5 with respect to the alienation of shares of a company that primarily holds immovable property.