Principle 10

Using an intermediary taxpayer

Introduction

In certain cases, taxpayer A will use taxpayer C as an intermediary instead of creating a direct legal link with taxpayer B.

In the case of businesses, C does not always carry on an activity and is merely used as accounting evidence .

Many reasons justify the use of an intermediary. On an economic level, this can be a shortcut for the production or delivery of goods or services. The structure is often a means to reduce manufacturing costs or benefit from a favourable environment. In other cases, it is used in order to benefit local or international prescriptions in labour, environmental, social or intellectual property laws. The tax aspect is then merely incidental, and at most one of many determining factors.

Sometimes, however, tax considerations will prevail. In the case of companies. We shall examine the most common cases : using an intermediate company (section 1.1) and treaty shopping (section 1.2). Finally, we shall mention some of the options available to individuals.

1. Using an intermediate company

1.1 Transfer pricing

Using an intermediate company can result in a type of profit transfer called transfer pricing. This type of company is often in the hands of a majority shareholder, whether directly or indirectly. It is often registered in a low tax jurisdiction. If it does not carry on any activity in its country of domicile, selected solely on the basis of taxation, it lacks proper substance and is often referred to as a base company[1].

Transfer pricing can assume various forms which can be grouped under two main categories :

[1] This terminology has been introduced by Milton Grundy, Base Companies, London 1984

a) the dominant company is shown as the intermediate company's creditor : it generally requires excessively modest services of the intermediate company, either by selling commercial assets at low prices, or by waiving certain income, say by granting interest free or low interest loans, by providing insufficiently invoiced services, by granting a license without license fees or by letting premises at excessively low costs; sometimes the dominant company will even forego a claim against the intermediate company;

b) the dominant company is shown as the intermediate company's debtor. In that case, it receives exaggerated counter-services, either by selling overpriced assets, inflating its charges (including expenses in the books which cannot be attributed to it), or receiving excessive fees, interest, licence fees, commissions, bonuses, brokerage fees, insurance premiums or rentals.

In all transfer pricing cases, the company located in a relatively high tax jurisdiction underestimates its profits by omitting income or inflating charges.

A distinction is sometimes made between companies transferring services to a third party and companies converting such services into a profit to be distributed in the form of dividends.

Below is a list of some of the most common activities [2]:

- Invoicing company or operating company

  This company operates as a intermediary between buyer and seller. To maximise tax saving, it should buy at the lowest price acceptable to the tax authorities and sell at the highest price. By this transfer pricing, the supplier, located in a high tax jurisdiction, minimises its taxable profit. Sometimes the buyer, also located in a high tax jurisdiction, maximises the purchase price.

  However, the transaction in question appears in company books in several countries and each time the tax authorities can question either the purchase or sale price. Whenever possible, the tax authorities will make the necessary adjustments, based on the arm's length principle, namely the price paid to a third party, independent from the company in question. In the case of a transaction within the group for which no price comparison can be made, the tax authorities will resort to other methods such as the Resale Price method or the Cost Plus method. The OECD suggests the following two techniques based on the level of profits : the Profit Split method, which examines the normal amount of profit split between independent companies and the Transactional Net Margin method, where the tax authorities compare the company's profit margin with the usual profit margin of similar companies active in the same field.

[2] See in general Roy Saunders, International Tax System, C., D.1.4.

Provided adequate legal basis exists, the tax authorities can even resort to exchanging information, especially in order to ascertain the identity of the beneficial owner of the intermediate company.

- Finance company

This company is used as a financial centre for a group and its main activity is to lend or borrow at conditions permitting the generation of interest income in low taxation countries and/or of deductible interest charges in high taxation countries. Borrowing and lending companies are obviously part of the same group.

The tax authorities can counter this type of abuse in several ways. Whenever interest rates diverge without justification from market conditions for similar loans, they will treat the charge as transfer pricing. Equity/foreign funds minimum ratios are also applicable, failing which interest on the undercapitalised party will not be tax deductible.

Further measures are possible depending on the applicable legislation and include for instance the general application of principles deriving from abuse of law, unusual financing or application of criteria based on economic reality. Last but not least withholding tax gives the tax authorities an advantage, especially to counteract structures involving a tax haven : withholding tax can only be recovered under a double tax treaty and tax havens do seldom have a large treaty network if any.

Notwithstanding the above, some European international financing services centres enjoy to this date certain tax breaks authorised by the European Union. This is in particular the case for the duty free zones of *Dublin*, *Madeira* and *Malta*. However, a code of conduct was recently published by the EU with a view to reducing tax competition. The OECD did a similar study on harmful competition published in 1998.

- Service companies

These companies are paid for the training or research services they provide. They sometimes receive license fees or copyrights for the use of patents or other intellectual property rights.

Profits are shown in a tax haven. The question remains whether or not the various services are acknowledged as tax deductible for the provider. The anti-abuse measures mentioned earlier become applicable whenever a direct or indirect link can be identified between creditor and debtor.

In the case of intellectual property companies, treaty shopping is often a must in view of the importance of withholding tax.

* Captive insurance company

  These companies carry out reinsurance, refinancing, co-ordination activities or else cover insurance risks.

  Such activities require little investment and can therefore be carried out from any country with minimum infrastructure. The civil and fiscal law in many tax havens are advantageous for such companies.

  To illustrate, let us take the case of *Luxembourg*, where these companies are required to maintain a solvency ratio, currently set at 40% of net own premiums. The company must be limited, with a minimum capital requirement of Flux. 50 million and subject to Luxembourg legal requirements in terms of accounts and audit. The "Commissariat aux Assurances" acts as supervising body. Since the company is subject to ordinary Luxembourg tax, it does not appear to enjoy any tax privilege. However, the Commissariat aux Assurances specifies the amount of provision – and related changes – necessary to cover risk, which can incidentally reduce considerably the amount of taxable profit. Moreover, once the shareholding reaches 10% (or at least Flux. 50 million), the company is granted holding company privileges. Finally, capital gains resulting from the sale of shares are tax exempt provided the latter exceed 25% of the company or Flux. 250 million and the holding period is at least of one year.

1.2 Treaty shopping

The aim of treaty shopping is to grant the benefits of a double tax treaty to a taxpayer by using an intermediate company of which he is usually the beneficial owner. Three jurisdictions are usually involved : the investing taxpayer's country, the investment country and the country where the intermediate company will be registered to enable the investor to benefit from its double taxation treaty(ies). The third country should enjoy a mild tax climate and moderate anti-abuse measures. However, such jurisdictions are few. Furthermore, the privileges granted are the subject of heated discussions with their treaty partners. Pressures are likely to increase noticeably in Europe following the European Union's identification of measures to reduce harmful tax competition.

United Kingdom

United Kingdom modified its company tax liability criteria on March 15, 1988. The Central Management and Control test used to be the only determining factor. Since that date, the place of incorporation has become an additional criteria.

Some British companies have therefore become dual residents: in their place of registration, namely the *United Kingdom* and in their foreign situs of management.

Since English double taxation treaties prevail over local law, the central management and control test prevails at international level.

Many tax advisors have therefore incorporated British companies which are taxable in another country, where central management and control is carried out under the relevant tax treaty.

Cyprus

Cyprus is one of the low tax countries which have signed a double taxation treaty with the *United Kingdom*.

There is no withholding tax or capital gains tax in Cyprus, where profits are taxed at the rate of 4.25%.

The taxpayer can create a UK incorporated (place of registration) whilst taxable in Cyprus (country of central management and control).

Cyprus has an extensive double taxation treaty network, although some treaties had to be renegotiated in order to insert anti-abuse clauses. Cyprus remains an advantageous jurisdiction, especially with respect to double taxation treaties with *Eastern European countries*. Even in cases where the treaty partner country implements strict anti-evasion measures, Cyprus can still be used in an international structure, for instance with a holding company recognised in the country in question (say *Germany*) and used as an investment vehicle in third party treaty countries.

Scotland

Under most legislation, including English law, partnerships are not themselves taxpayers; partners add their share of profits to their other taxable income. This does not apply to Scotland, where a partnership is seen as an independent taxpayer that can therefore invoke double taxation treaties.

A Scottish partnership requires at least one unlimited responsible partner, the General Partner, and another limited partner. The General Partner will tend to be an offshore company and the limited partner a Scottish company, thus permitting an advantageous profit split between both partners; the UK profit tax of 25% will apply to the limited partner. One will obviously avoid to carry out effective management in the UK.

Holland

Holland has one of the most extensive double taxation treaty networks.

Taxpayers try often to benefit from the so-called *Dutch* Sandwich structure in which dividends, interest and royalties are distributed to the *Dutch* company and then redistributed to a *Netherlands Antilles* company. This structure allows for use of double taxation treaties signed by Holland, whilst avoiding excessive profit tax liability on *Dutch* and *Antilles* companies. The 35% rate applicable to the former is only applied to a relatively low amount (determined in agreement with the Dutch tax authorities by means of a Ruling), the remaining profit being transferred to the *Netherlands Antilles*. The taxpayer often chooses to be taxed at the rate of 5.5% to benefit from a withholding tax rate limited to 5%, instead of the usual 7.5%. No withholding tax, whether on interest or intellectual property, is applicable in Holland. In the Netherlands Antilles, the tax burden is lightened by substantial forfeitry deductions. Given the absence of withholding tax in that country, benefits can be exported to any country under ideal tax conditions.

In view of the above, several partner countries have adopted anti-abuse measures, such as the *United States* which thoroughly modified their double taxation treaty to counter treaty shopping.

The *French* ministry of Finance stressed that the objective of the treaty was not to permit double tax exemptions ! Artificial structures void of any economic justification are openly fought (Ministry response dated 19.12.1996).

In *Switzerland*, article 9, para. 2 limits to 20% the refund of the 35% Swiss withholding tax when the relationship between the two companies has been created or maintained mainly for refund purposes. Interest is refunded up to 30% of the 35% paid. Moreover, all obvious abuses of rights pursuant to article 2 of the Swiss Civil Code remain reserved.
Swiss practice apply these rules to Luxembourg as well.

Luxembourg

Luxembourg SOPARFIs are subject to ordinary tax and can therefore claim relief according double taxation treaties. Under certain circumstances, they can also invoke the European Community parent - subsidiary directives dated July 23, 1990[3]. Dividends are tax free provided the SOPARFI is subject to a 15% tax rate at least <u>and</u> the subsidiary shareholding is at least 10%, i.e. FLUX. 50 million minimum. The 12 month minimum holding period is questionable, whilst other, sometimes more advantageous treaty clauses do not apply.

The same applies to wealth tax exemption.

When the shareholding reaches 25% (or FLUX. 250 million), capital gain also becomes tax free under certain conditions.

[3] See Directive 90/435

Under European Union requirements, a SOPARFI must hold at least 25% of the capital for a two year period. It can be advantageous to convert dividends into liquidation proceeds.

Given the absence of anti-abuse measures taken by treaty partners, a SOPARFI is an interesting international tax planning structure. It competes with the Dutch company, especially when high nominal holding is nevertheless inferior to 5% of the company's capital.

Other countries try with varying success to attract foreign investment by offering the use of their double taxation treaties network.

Madeira thus benefits from *Portugal*'s double taxation treaties. Pure holding companies structures (SPGS) are particularly advantageous when located in the so-called International Business Centre. Under certain conditions, European Union states will apply the parent-subsidiary directive. It is then enough to be taxed at the standard *Portuguese* rate (currently 36%) on at least 5% of the profits. The actual tax burden therefore amounts to 1.8%.

Malta has signed double taxation treaties with 27 different countries, whilst negotiating its membership in the European Union. Foreign withholding tax credit is granted by *Malta*'s tax authorities as an incentive to foreign investment, provided no recovery can be effected on the basis of double taxation treaties. Trade or international service companies whose profits derive solely from activities carried out abroad, enjoy a special privilege combining tax credit and recovery, with a resulting rate of approximately 4.17%.

In addition to a series of treaties with ex-Commonwealth states, *Mauritius* has carefully negotiated treaties with other countries. To illustrate : the treaty signed with China grants a 5% withholding tax reduction on dividends and 10% on interest and intellectual property rights. A *Mauritius* company can also carry out construction, assembly and supervision activities over a 9 month period without falling into the permanent establishment category. *Mauritius* enjoys a beneficial geographical location to be a credible platform for using the treaty signed with *South Africa*, as the latter sometimes requires that board decisions be taken and contracts implemented at the registered office of the *Mauritius* company. Finally *Mauritius* is a useful investment vehicle into *India* and *China*, both countries which are not famed for encouraging tax havens.

Labuan, part of *Malaysia*, enjoys, in principle, the Malaysian double taxation treaty network.

It appears that treaty shopping offers several possibilities. The taxpayer will, however, avoid the pitfalls of possible changes in law, practice or jurisprudence, which can affect the intermediate as well as the co-contracting states. Such changes are all the more likely as the OECD countries offers several anti-treaty shopping measures[4].

2. Individuals

There are fewer opportunities for advantageous structures in the case of individuals, partly because of the reduced tax consequences incurred by the transfer of private assets and services, partly because of the difficulty in using an intermediate.

In theory, this technique could be used in the context of succession and gifts since an indirect donation, provided it is admitted by the tax authorities, can generate a lesser tax liability than a direct gift.

To illustrate, depending on the legislation, a donation in favour of one's daughter- or son-in-law could first be gifted to the final beneficiary's spouse (i.e. the direct descendant), the latter's transfer to the final beneficiary being subject to the tax rates applicable between spouses. These rates are very often low, or even nil, whereas the rate applicable to a donation in favour of one's daughter or son-in-law could be rather high depending on the jurisdiction.

The same applies to donations in favour of a spouse's children from a first marriage who are not usually seen as part of the donor's family. It can therefore be advantageous to gift to one's spouse who in turn gifts to his/her children from the first marriage.

Similarly, gifting to one's brother or sister is often more expensive than gifting to a common parent who then transfers the gift to the final beneficiary.

Under certain legal systems, donations between spouses are tax exempt, but not those in favour of children. Depending on the financial circumstances, a wealthy spouse could firstly gift to his spouse, prior to gifting the maximum tax exempt or privileged amount.

A structure can be advantageous provided the parties' tax domicile is taken into account. In the context of long term tax planning, the donor will use an intermediate heir domiciled in a country with low inheritance tax rates.

However, in all the above, the tax authorities might *inter alia* consider that the intention to give (the "*animus donandi*") is lacking at the time of the first donation and that the only economically relevant transaction is the transfer to the final beneficiary.

In terms of estate tax, it is possible in some countries to appoint someone as reversionary heir whereby the heir must transfer the estate to a third party, named

[4] See in general Peter Cusson, Harmonization and Treaty Shopping in the OECD, in International Tax Planning 225ss.

the *"appelé"*[5]. Tax law provisions vary considerably from country to country in this respect. Sometimes the donor can avoid tax on his death and on the heir's death.

In the context of ordinary income tax, tax advantageous structures require a certain imagination and a marked taste for artificial constructions and we cannot recommend their use.

The return of an expatriate or his emigration is, however, a special case, where an intermediate country may generate perfectly legal tax advantages, often by using skilfully double taxation treaties.

Conclusion

Advantageous structures come in various forms and it is probably where most mistakes are made. Indeed, many taxpayers tend to under-estimate the tax authorities' experience in such matters. The latter will often spot an unusual structure quite easily, and is often more knowledgeable than the taxpayer in terms of tax havens. The taxpayer may sometimes be tempted to order an offshore company "on shelf" by simply sending a fax ! However, if there is no substance, the tax authorities are bound to intervene, in addition to which civil law provisions must be strictly adhered to.
As we can see, the right choice of a consultant is more important than the choice of the tax haven !

[5] See for example art. 488 and sequ.Civil Code for Switzerland