Principle 2

Modifying the taxpayer's status

Introduction

The status of the taxpayer has played a major part in the history of taxation science. This applies to all jurisdictions where progressive poll tax was applied. Taxpayers were classified into categories such as officers, members of nobility and clergy, domestics and servants, to name but a few. Professional taxes such as trading licenses resemble this type of poll tax and sometimes combine with it.

To this day, many taxpayers, whether physical persons or legal entities, enjoy a special fiscal status, of which there would be little point in drawing an exhaustive list as they are not all relevant for tax planning reasons. International agreements recognise some of them in determining the state’s right to tax. No one chooses to work on a ship or an aircraft, or to make a career as a sportsperson or an artist for tax reasons. The same applies to employees of a foreign organisations, members of diplomatic or consular missions and directors of foreign companies. Students will ensure that they do not generate any tax liability, e.g. by using external sources of income for their upkeep.

In this chapter, we shall examine the types of status that the taxpayer may try to obtain in the context of tax planning. Individuals (1) and companies (2) will be studied separately.

1. Individuals

1.1 <u>Special status</u>

In many countries, foreign taxpayers have a special status. The granting of such a tax status is therefore linked to a change of fiscal sovereignty, as described in principle 11 hereunder.

For instance, *Switzerland* is to some extent a tax haven for individuals eligible for a forfeitry taxation basis. In several cantons, foreigners who either elect domicile or stay in Switzerland without lucrative activity, and do so for the first time, are entitled to pay a tax calculated on the basis of their expenses instead of their income. This privilege is also granted to Swiss citizens returning after at least 10 years abroad, but it is only valid until the end of the current tax period.

In practice, forfeitry tax is negotiated with the tax authorities, who will take into account the taxpayer's standard of living. When the taxpayer owns his home, the minimum tax basis will be 5 times the estimated annual rent or, if he rents his home, 5 times the market rental value, or else 1.5 times his boarding or hotel expenses. The amount is then taxed at the standard rate applicable to income tax.

Moreover, forfeitry tax cannot be inferior to the following : the tax liability resulting from Swiss source gross income, and the income for which the taxpayer is requesting partial or total foreign tax exemption under a double taxation treaty to which Switzerland is a party. Forfeitry taxation is now available in most Swiss cantons and in certain cases reduces the inheritance tax liability.
For a proper tax planning, the emigrant should check any anti abuse provisions in the relevant double tax treaty or any “exit taxes” provisions in the country of departure.

Lastly, the Swiss “Establishment permit” is much easier to obtain if the retired person is over 55 years old.

In other countries, taxpayers may enjoy a *de facto* tax privilege because of the distinction made between residence and domicile. In *Great Britain*, resident taxpayers do not pay tax on income (capital gains included) generated outside the country unless remitted into the country.

In order to reduce tax, the UK taxpayer may consider opening an income account in addition to the capital account and remitting only from his capital account. Under certain circumstances, it may be possible to capitalise income by closing the capital account prior to April 5 and reopening it after April 6.

The criteria for assessing domicile are subjective; it is important that the individual does not intend to take up permanent residence in Great Britain and that his ultimate intention is to return to his country of origin. This could be substantiated by, for instance, buying a property for own use or a concession in the graveyard in that country. Notwithstanding the above, income and capital gains from UK situs assets will be subject to tax regardless of the taxpayer's resident non domiciled status.

A similar distinction exists in *Ireland*. However, the resident non domiciled taxpayer will only be subject to inheritance and gift tax on assets located in that country, whereas residence for a period of 17 tax periods in the UK, gives rise to an inheritance tax exposure on world wide assets.

In *Belgium*, privileged tax status is granted to foreign executives, who are taxed on the basis of the regulations applicable to non residents. European communities civil servants are subject to a special tax regime.

Apart from tax havens, several countries are attractive to foreign pensioners, among which *Spain*, *France*, *Canada*, *Australia* and *New Zealand*.

1.2 Non professional -v- professional

Many jurisdictions differentiate between several categories of income. The taxpayer's status may play a decisive part, since the tax authorities will not consider the income of a non professional as they would a professional's and this will be reflected in the tax treatment.

Other countries, such as Switzerland, base their approach on the concept of global income. The question of whether a taxpayer carries on a second, independent activity or simply manages his own private wealth becomes mainly relevant in the case of portfolio and real estate management.

2. Companies

In this section, we shall see how a company can be used as a tax planning tool (2.1); we shall address the issue of tax status in international company locations (2.2); we shall examine some special privileges available to companies (2.3). Within the context of international tax planning, such considerations are intimately linked to the transfer of either the taxpayer or the taxable assets (see principles 11 and 12 below).

2.1 Legal form

It is true that tax should only play an ancillary role when deciding on a company's legal form, while the legislator should attempt to respect tax neutrality in the legal system.

However, the gap between ideals and reality widens as the overall tax burden increases and companies become increasingly international, and this leads business people to pay greater attention to the choice of legal form.

The classic dilemma is to decide between a partnership and a legal entity, the latter including limited partnerships and limited companies.

In some cases, it is hard to distinguish one legal form from another : in the *United States* for example, a foreign partnership is treated as a legal entity provided it fulfils more than two of the following criteria (established according a “check the box” procedure):

1. Limited liability;
2. duration for unlimited period;
3. Unrestricted transfer of partnership shares;

4. Centralised management.

Despite it could be considered as a corporation in the United States, the legal form could be characterised as a normal partnership in another jurisdiction, with all the ensuing positive and negative consequences at an international tax level.

In principle, partnerships are not treated as independent taxpayers under most tax systems, whereas legal entities are taxed separately on their profits and on their capital. Shareholders are taxed separately from the company in which they have an interest. The company's profits are therefore taxed twice when they are distributed in the form of dividends. This economic double taxation is *a priori* not advantageous for the taxpayer. Assets can also become liable to double taxation, when the company's capital is taxed at company level and the shares are taxed as part of the shareholder's assets.

Most jurisdictions provide for various forms of tax relief: part of the company's profits or dividends could be either tax free or enjoy tax privileges; the company can be transparent from the tax viewpoint, either partially or totally; a dual taxation rate can favour distributed profit; last but not least tax credits reduce the shareholder's liability. *Switzerland* is the only country where there is no concession reducing economic double taxation.

2.2 Status and location of company

Deciding on the legal form of a company is also a decisive issue at an international level and a company will need to ascertain the tax status of its foreign branches.

We shall use the terminology of the OECD 1992 model treaty, while keeping in mind that the definitions diverge in some double tax treaties[1].

As an illustration:

a) In the absence of any legal entity, the parent company creates an overseas branch which will only be liable to tax as a permanent establishment (business premises through which the company runs part or all of its activity);

b) the company creates an overseas legal entity, a subsidiary, which is fully taxable where it is tax resident.

The choice will result in very different tax treatments.
In some double tax treaty, a permanent establishment is treated as a separate taxpayer for withholding tax purposes.
It is essential to ascertain how each contributes to minimising tax, avoiding international double taxation, showing profits in the jurisdiction offering lower tax.

[1] See e.g. Art. 8 and 15&3; 17; 19; 27; 16; 20 of the Model OECD Convention.

Tax liability at the time of creation, tax incentives and even tax loopholes will also influence this decision.

By and large, it can be said that the creation of a branch does not result in any capital tax. Conversely, the creation of a subsidiary often results in various taxes (1% tax on issue as advocated throughout the European Union, capital taxes, etc.).

Pursuant to the OECD's model treaty, the profits made by a *branch* are, in principle, only subject to tax if the branch is a permanent establishment. However, the branch's profit will be taken into account to fix the tax rate of the head office. The rate will be calculated by means of either the direct method (frequently used in the EU) or the indirect method. Each method has an influence on the treatment of reported losses.

Profit transfers are not usually liable to withholding tax, whereas a *subsidiary*'s profits are subject to the same tax treatment as other local companies. Profit transfers are generally effected by means of dividend distributions, often subject to withholding tax, which may sometimes be reduced on a contractual or legal basis. Most OECD countries have negotiated tax treaties with member states.

Hidden and open reserves will often be taxed (differently according to each jurisdiction) in the event of liquidation, transfer of residence, and sometimes when assets are transferred from a branch or a subsidiary. Since the scope of investigation enjoyed by the tax authorities varies according to the jurisdiction, this will be another selection factor when deciding on the legal structure[2].

The choice is not limited to a subsidiary or a permanent establishment; it is possible to adopt structures free of any foreign tax liability. Storage, exhibition or delivery installations are not considered as permanent establishments, neither are any installations of a preparatory or auxiliary nature, such as marketing or public relations. For instance, a business cannot be considered as a permanent establishment on the sole basis that it has a contract with an independent agent, a broker or a commissioner, since they act on their own account and at their own risk. Even in cases when the agent has no power to close a deal in his own name, the concept of permanent establishment does not apply, provided the overall activity of the permanent establishment retains its preparatory or auxiliary character.

2.3 Special companies

2.3.1 Holding companies

The aim of holding and investment companies is to have interests in other companies. A holding company will deal with sizeable interests and, like head offices, will often carry out co-ordinating, management or financing activities.

[2] See Ruding Report, IFA Resolution 1988.

When a holding company also has a commercial or industrial activity, it becomes a mixed holding company which logically should no longer enjoy the full tax advantages granted to pure holding companies.

Finally, international structures often include intermediate holding companies built into a pyramid of related companies.

The main objective of the tax exemption granted to holding companies is to avoid triple taxation on the same economic profits, since the profits made by the subsidiary (manufacturing) company are taxed prior to distribution to the holding company. The latter's shareholders must also include dividends distributed to them in their taxable income. Taxing the holding company could therefore mean that the same profit has been taxed three times.

The tax advantages of a holding structure vary considerably according to the jurisdiction. A holding company may, for instance, grant loans to its undercapitalised, subsidiary companies, which can then deduct the interest from profits. Instead of paying out non-deductible dividends, they can pay out (deductible) its interest. However, many jurisdictions impose a debt-equity ratio as well as an obligation to pay interest in accordance with market practices (arm’s length).

Another tax advantage exists when capital gains are either tax exempt or less heavily taxed at holding company than at subsidiary company level. It then becomes attractive to move taxable items into a holding company. As we shall see later on, an intermediate holding company may also position itself favourably within a network of double taxation treaties.

Amongst countless examples of holding company regulations, let us cite 1) the *Luxembourg* 1929 holding company, 2) the SOPARFI, a financial participation holding company which requires a minimum capital of Luxembourg francs 1,250,000.—and 3) the billionaire holding company *“Holding milliardaire*” which requires a minimum capital of Luxembourg francs 1 billion.

Incorporation costs include a 1% tax on capital contribution, as well as relatively low notary and publication fees. Annual costs vary depending on the advisors used. Unlike the SOPARFI, the 1929 holding company cannot benefit from Luxembourg's double taxation treaties.

Although holding companies are subject to a 2 per thousand subscription rate on their paid-up capital and premium, they are not liable to withholding tax. The debt ratio, exclusive of debenture loans, must not exceed 3 times the equity. A 10 to 1 ratio applies to debenture loans. In the case of a SOPARFI, a 6 to 1 debt/equity ratio is deemed acceptable by the Luxembourg tax authorities.
Other jurisdictions will be considered in Chapter 10 Section 1.2. on treaty shopping.

2.3.2 Headquarters, co-ordination centres

The tax treatment of permanent establishments offering administrative services (directorship, management, marketing, financing, accounting, training, research, co-ordination or control) to a group of related companies, often located in one given geographical zone, varies considerably.

Headquarters are granted a forfeitry taxation basis by the *French* tax authorities. In principle, only 8 to 12% of their expenses are assessed as profit. Their running costs are determined in accordance with the provisions of normal tax law applicable to French companies, i.e. a maximum rate of 41.66%, inclusive of special taxes and 10% tax (in 1998). No VAT is charged for services rendered to the foreign registered office; 18.6% is due on services to companies invoiced in France; a nil rate is due on companies outside the group and invoiced abroad. Headquarter employees also enjoy tax privileges.

Belgian tax authorities use the so-called cost plus method : the 8% forfeitry taxation rate is based solely on the expenses of the co-ordination centre, exclusive of personnel and financial charges. However, these privileges are reserved to international consortiums of a certain level, depending on the group's turnover, the amount of equity, the number of staff in Belgium and abroad.

In *Switzerland*, auxiliary, domicile and mixed companies also carry out administrative duties. A special status is granted to companies provided they carry out mere administrative activities in Switzerland. These legal entities may carry out a wide range of activities : international trade, financing or management of intellectual property; they sometimes carry out headquarter duties for multinational groups. Pursuant to recent legal changes (article 38, para. 3 LHID) privileged status can be granted even if the company carries out an ancillary activity in Switzerland, regardless of whether the shareholding is Swiss or foreign.
To this day, terminology, tax treatment and eligibility varies from canton to canton. To illustrate :
Zoug grants the following privileges to a domicile company without any activity, office or staff in Switzerland : tax exemption on profits and a capital tax between 0.10 and 0.15%, with a minimum of CHF 300.--. Profits of Swiss origin of up to 20% of global profits are tolerated and taxed at a base rate of 3.5 to 7%.
In the case of an auxiliary company, namely a company held by a foreign shareholder, where 80% of the profits are of foreign origin and no production activity is carried out in Switzerland, the above mentioned capital taxes apply. However, only 25% of all profits of foreign origin are taxed at base rates between 3.5 and 7%, the remaining 75% being entirely tax exempt.
In *Fribourg*, the same distinction exists between domicile and auxiliary companies : domicile companies have a registered domicile in the canton; their shareholders are not domiciled in the canton and the Swiss turnover of the company amounts to less than 20%. Auxiliary companies carry out activities subordinated to the foreign group companies. In both cases, capital tax is due at the rate of 0.35% for the first CHF 200,000.--, then 0.075% for all capital in excess of CHF 6.7 million, with a minimum of CHF 300.--.
In *Geneva*, service companies whose activity serves the main group abroad, are taxed at a maximum of 20% of the standard rate on profits, calculated as 5% of the

expenses incurred abroad. 5% of expenses incurred in Switzerland are normally taxed as profit. If expenses are incurred for staff resident in Switzerland, 50% of the profits – calculated as 5% of expenses - are subject to the standard tax rate and the remaining 50% at 20% of the standard rate.
Vaud favours companies which carry out commercial or industrial activities abroad. Profits of Swiss origin must not exceed 25 to 30% of all profits and are subject to a 14% base rate tax, multiplied by a cantonal and communal coefficient, i.e. approximately 2.34, 30% being the maximum rate. Tax on capital is approx. 0.09%, cantonal and communal coefficient must be taken into account. In all cases, the maximum limit is 0.7%.

2.3.3 Other privileges

These vary considerably from country to country. In Belgium for instance, the following types of company exist :

- *conversion companies*, which undertake to invest in new technologies or in the improvement of industrial processes, and to generate employment.

- *Companies located in an employment zone*, i.e. whose registered office and business is located in an employment zone as defined by the Belgian authorities.

- *Innovating companies* which exploit and market high technology processes new in Belgium.

- *Distribution centres*, which carry out an auxiliary activity exclusively related to the companies of a group.

This chapter would not be complete without a brief mention of offshore companies or base companies, both tax exempt under certain conditions :

- *exempt companies* in the *British Virgin Islands,*
- *exempt* or even *ordinary non resident companies* in *Panama*,
- *International Business Companies (IBCs)* in *Nives*, *the Seychelles*, *the British Virgin Islands*, *the Bahamas*, *the Barbados*,
- *International Holding Companies* or *International Trading Companies* in *Malta,*

and many more.

The above jurisdictions privilege foreign investors who do not carry out any lucrative activity locally.

Conclusion

Determining the tax status is often the key to tax planning, whether for individuals or companies. Several jurisdictions must be examined and compared, while monitoring their constant evolution. Any tax privilege must be ascertained in terms of duration and in the light of the resulting indirect consequences. At international level, these issues require close co-ordination between tax experts both in the country of origin and the country of destination, and, in some cases, even in jurisdictions where certain assets are located. A multi-disciplinary and cautious approach is required at national level, in order to take into account other important, non tax, factors.