Recent Developments in International Tax Law: Cases decided by Foreign Courts which could have a bearing in India

Chapter 135

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Synopsis

1. Introduction

Indian courts have often recognized the persuasive value of international jurisprudence with respect to the application of Indian statutes, particularly when the Indian legal regime contains a

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lacuna with respect to which clarity is sought. It has become all the more important to keep an ear out for international developments on account of the fusing of international borders, and specifically in the context of international tax jurisprudence, on account of the substantial similarities in the language of Double Taxation Avoidance Agreements ("**Tax Treaties**") and the principle of reciprocity in interpretation of Tax Treaties which has been recognized in the past in cases such as *Daimler Chrysler*[2].

In light of this background, the cases below are discussed in order to highlight key developments in international tax law as evolved from foreign court judgments dealing with beneficial ownership, permanent establishments, validity of a holding structure in an intermediary jurisdiction, implications of GAAR and so on. These cases are relevant from an Indian law perspective as they provide an insight to legal jurisprudence on highly debatable issues in international taxation.

2. Grappling With Treaty Source Rules

2.1. Capital gains from the deemed disposition of assets

The recent case of ***Commissioner for the South African Revenue Service vs. Tradehold Ltd.***[3] would be relevant to consider in light of the amendments introduced by the Indian Finance Act, 2012, which seek to tax the disposition of offshore assets if such assets derive a substantial portion of their value from Indian assets. In this case, the issue was whether Article 13(4) of the Luxembourg-South Africa Tax Treaty pertaining to capital gains, was capable of covering exit taxes applicable upon the deemed disposition of South African assets. The South African Tax Court held that the capital gains article in the Luxembourg-South Africa Tax Treaty was capable of covering deemed gains and that the benefits of the treaty should accordingly be allowed.

Facts: A brief description of the facts is as follows. Tradehold Limited ("**Tradehold**") is a company listed, incorporated and registered in South Africa. During the relevant assessment year, Tradehold's only asset was its 100% shareholding in Tradegro Holdings which, in turn, owned 100% of the shares in Tradegro Limited ("**Tradehold Sub**"), a company incorporated in Guernsey which owned approximately 65 per cent of the issued share capital

2 547 U.S. 332 (2006)

3 [2012] ZASCA 61

in the UK-based company, Brown & Jackson Plc. (as depicted in Figure 1). On July 2, 2002 a meeting of the Board of Directors of Tradehold was held in Luxembourg which decided that all further meetings would be held in Luxembourg. At this point in time and with effect from that date, Tradehold became effectively controlled and managed in Luxembourg. However, it still remained a 'resident' of South Africa by reason of the definition of 'resident' under Section 2 of the Income tax Act, 1962 ("**South African ITA**") and a non-application of any tie breaker provision. This status changed by virtue of an amendment brought about to the South African ITA, pursuant to which Tradehold ceased to be a resident of South Africa with effect from February 26, 2003.

A consequence of this change in residency status of Tradehold was the trigger of an exit tax provision under the South African ITA[4]. Under this provision, tax was levied on Tradehold, in respect of the appreciation on the South Africa based Tradehold Sub which was deemed to have been disposed so as to result in a capital gains tax, also known as exit tax.

4 12. Events treated as disposals and acquisitions – (1) Where an event described in sub-paragraph (2) occurs, a person will be treated for the purposes of this Schedule as having disposed of an asset described in that subparagraph for proceeds equal to the market value of the asset at the time of the event and to have immediately reacquired the asset at an expenditure equal to that market value, which expenditure must be treated as an amount of expenditure actually incurred and paid for the purposes of paragraph 20(1)(a).

(2) Sub-paragraph (1) applies, in the case of –

(a) a person who ceases to be a resident, or a resident who is as a result of the application of any agreement entered into by the Republic for the avoidance of double taxation treated as not being a resident, in respect of all assets of that person other than assets in the Republic listed in paragraphs 2(1)(b)(i) and (ii);

(b) an asset of a person who is not a resident, which asset –

(i) becomes an asset of that person's permanent establishment in the Republic otherwise than by way of acquisition; or

(ii) ceases to be an asset of that person's permanent establishment in the Republic otherwise than by way of a disposal contemplated in paragraph 11…'

[6] Paragraph 12 must be read with para 2 of the Eighth Schedule which provides:

'Application. – (1) Subject to paragraph 97, this Schedule applies to the disposal on or after valuation date of –

1. any asset of a resident; and

2. the following assets of a person who is not a resident, namely –

(i) immovable property situated in the Republic held by that person or any interest or right of whatsoever nature of that person to or in immovable property situated in the Republic; or

(ii) any asset which is attributable to a permanent establishment of that person in the Republic.'

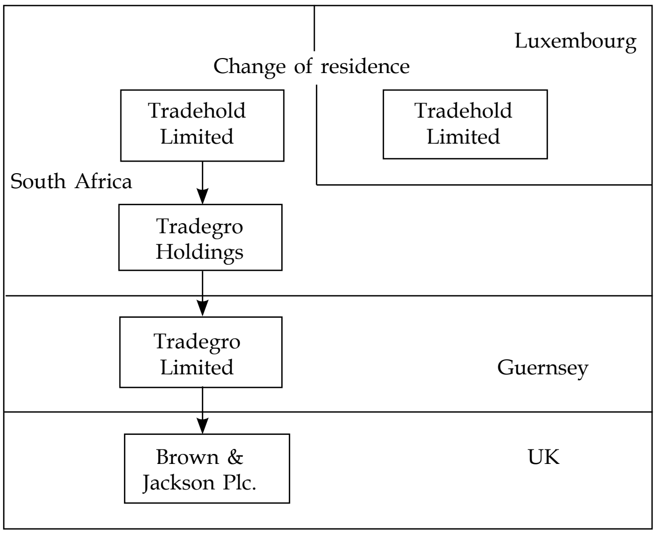

Figure 1

Primary Arguments: It was contended by Tradehold that pursuant to the Luxembourg-South Africa Tax Treaty, the capital gains arising out of the deemed disposal of the investment held by Tradehold during the year 2003 was not taxable in South Africa but in Luxembourg. This is because at the time the capital gains arose Tradehold was a resident of Luxembourg under Article 4(3) of the Luxembourg-South Africa Tax Treaty[5] which states that the place of residence of a company is the place where its effective management is situated. As regards the alienation of property, it was contended that Article 13(4) should be applicable to the present case. It was contended that the reference in Article 13(4) of the Luxembourg-South Africa Tax Treaty to gains from the alienation of property did not include a deemed disposal of property as contemplated in para 12(2)(a) of the Schedule. Rejecting his arguments, the Tax Commissioner held that as per para 2(1)(a) of the Schedule, capital gains tax becomes payable in respect of "the disposal of any asset of a resident". Subparagraphs 12(1) and (2) of the Schedule provide that upon an event occurring in terms of those provisions '*a person will be treated for the purposes of this Schedule as having disposed of an asset*'. Thus, the above provision encompasses both actual and deemed alienation of property.

5 The Treaty came into effect on January 1, 2003

The main issue under consideration in this case was **whether or not the term 'alienation' as used in the Luxembourg-South Africa Tax Treaty, includes within its scope gains arising from a deemed disposal of assets**.

It was contended by the South African tax authorities that a deemed disposal provided in para 12 of the Eighth Schedule is not 'alienation' as contemplated in Article 13(4) of the Luxembourg-South Africa Tax Treaty. It was submitted that both these terms are notionally different from each other as 'actual disposal' proposes something that has actually occurred, whereas deemed disposal refers to something that is deemed to have occurred but has not actually occurred. For this purpose, the South African tax authorities referred to various cases that have defined the expression 'deemed' to mean something that departs from reality. A reference was also made to the case of *Cronje NO vs. Paul Els Investments (Pty) Ltd.*[6] to contend that the term 'alienation' as used in the Luxembourg-South Africa Tax Treaty bears the same meaning as it does in the domestic law, namely the action of transferring ownership to another. For the following reasons it was submitted that Tradehold was not protected in terms of Article 13(4) from liability for capital gains tax arising out of deemed disposal of its assets. It was also submitted that such a reading of Article 13(4) would mean that exit tax would only be payable in the event of a South African tax payer emigrating to a country which has not entered into a treaty containing a provision similar to Article 13(4). This could never have been the intention of the legislature.

<u>Judgment</u>: The Supreme Court of Appeal perused through section 108 of the South African ITA which provided the National Executive of South Africa the power to enter into Tax Treaties. The Supreme Court of Appeal stated that once brought into operation, such an agreement has the effect of law[7]. Thus, a double tax agreement modifies the domestic law and will apply in preference to the domestic law to the extent that there is any conflict. The Supreme Court of Appeal also referred to the OECD Model Tax Convention, which acts as a base on which most tax treaties as based on. Accordingly, it was observed that it may be difficult to find an exact correlation between the wordings of a domestic statute and the relevant tax treaty. The Supreme Court of Appeal observed that in case of a term not defined in the treaty or domestic legislation, the

6 1982 (2) SA 179 (T)

7 SIR vs. Downing 1975 (4) SA 518 (A)

first step should be to ascertain where in the scheme of the treaty, the relevant tax falls and then to consider whether the tax can be imposed in accordance with the other obligations[8]. Further, the term under consideration must be given a meaning that is congruent with the language of the treaty[9].

With regards to the issue in the present case, the Supreme Court of Appeal held that Article 13 of the Luxembourg-South Africa Tax Treaty is of a wide nature and included within its ambit capital gains derived from the alienation of all property. Further, it held that the parties to the Luxembourg-South Africa Tax Treaty would have been aware of the provisions of the ITA and must have intended its application to capital gains provided therein. It further held that there is no distinction between capital gains arising out of deemed or actual alienation of property. As regards to the term 'alienation', the Supreme Court of Appeal held that it has a broad meaning and includes both actual and deemed disposal of assets.

It was held that Article 13(4) of the Luxembourg-South Africa Tax Treaty applied to capital gains arising from both deemed and actual alienation of disposal of assets. Further, on relocating the seat of effective management, Tradehold became a 'resident' of Luxembourg and as per the provisions of the Luxembourg-South Africa Tax Treaty, Luxembourg had exclusive rights in respect of taxing Tradehold's capital gains. On this basis it was held that Luxembourg had the right to tax as per the terms of the relevant tax treaty.

Comments: South Africa follows a source based taxation system according to which all assets situated in South Africa are taxed in South Africa and based on this principle there capital gains tax was levied in case of deemed disposal of assets. This is particularly relevant from the Indian perspective, as well as the reliance placed by the Supreme Court of Appeal on the language of s. 108 (discussed above), which may be compared to the effect of s. 90 in the Indian context. The ruling also dealt with key issues of tax treaty interpretation which find parallels in the interpretive scheme, partly also on account of the reliance placed by South Africa upon common law. While India does not currently have a system

8 Ostime (Inspector of Taxes) vs. Australian Mutual Provident Society [1959] 3 All ER 245.

9 See Pan American World Airways Inc vs. SA Fire and Accident Insurance 1965 (3) SA 150 (A), Potgieter vs. British Airways plc. [2005] ZAWCHC 5; 2005 (3) SA 133 (C)

of exit taxes, the issue of deemed taxation (barring disposition of Indian assets) could be equally relevant to us, and what would be important to consider then would be whether there is an inherent inconsistency between the domestic law and the treaty provisions. For a further update, in South Africa, the Ministry of Finance issued a press release discussing the amendment to the South African ITA so as to not render the domestic laws ineffective. However, what impact this notification would have on cases such as this ruling is at this point unclear.

2.2. *Circumstances in which a Distributorship Arrangement should result in an Agency PE*

There have been several cases in the Indian context which have dealt with the constitution of agency PE, and situations where a person should be considered authorized to "conclude contracts" or secure orders as contemplated by tax treaties such as the India-US tax treaty. The recent case of ***Dell Products***[10] considered the contentious issue of when a distributorship arrangement should result in the constitution of an agency PE in the context of the Norway-Ireland Tax Treaty. This case may cast some light on the thresholds which would be applicable with respect to the act of securing orders and whether there should be a difference between the treatment of a distributor agency arrangement versus a distributor-repurchase arrangement.

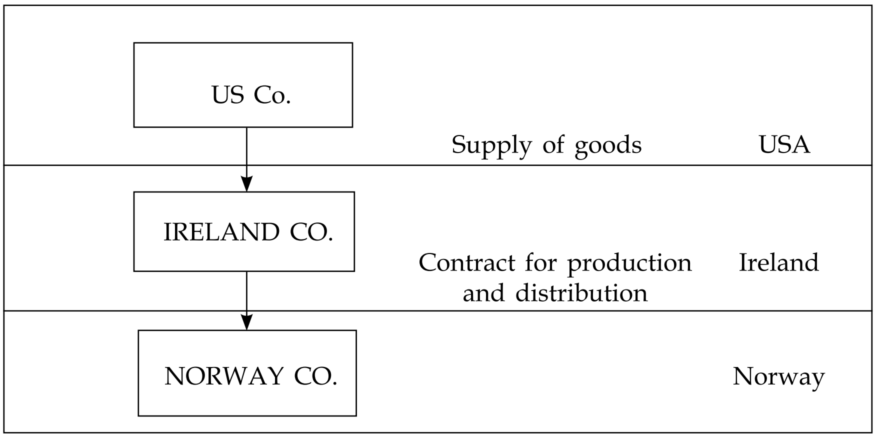

Figure 2

10 Case No. HR-2011-02245-A, (sak nr. 2011/755)

Facts: Dell Group was a US based multinational which was in the business of selling computers and computer products all over the world. Various group entities of this company carried out its production and distribution facilities. One Ireland based subsidiary, Dell AS ("**Dell Ireland**") carried out production and distribution facilities in Ireland and other parts of Europe and Africa. Further, Dell Ireland sold its computer and computer products through another Dell group entity located in Norway, ("**Dell Norway**") (As depicted in Figure 2 above). The moot question thus, in this case was whether Dell Norway should be considered to have a permanent establishment ("**PE**") in Norway keeping in mind the nature of activities carried on by it. As per the Ireland-Norway Tax Treaty, a foreign company would only be taxable on its business income in Norway if it has a PE in Norway. The case hinged on the issue of whether the distributorship activities of Dell Norway should result in a PE of Dell Ireland in Norway. The case was considered by the lower courts and this particular judgment was by the Norwegian Supreme Court. The main issue under consideration was whether the tax payer falls under the purview of 'dependent agent' under Article 5(5) of the Ireland-Norway Tax Treaty.

Primary Arguments: The Norwegian tax authorities argued that Dell Norway constituted a PE of Dell Ireland in terms of Article 5(5) of the Norway-Ireland Tax Treaty and, hence, in addition to the commission fee received by Dell Ireland, distribution profits earned by Dell Ireland should be liable to be taxed in Norway. The tax payer, on the other hand argued that in the absence of any legally binding authority exercised by Dell Ireland on Dell Norway, no PE existed.

Judgment: In order to constitute a PE in Norway under Article 5(5) of the Ireland-Norway Tax Treaty, the taxpayer should fulfil the following requirements:

i. Be a dependent agent and,

ii. Habitually exercise an authority to conclude contracts in the name of Dell Ireland

The Supreme Court based its decision on the interpretation of the phrase 'on behalf of' and 'have authority to conclude contracts on behalf of' within the meaning of Article 5(5) of the Ireland-Norway Tax Treaty. In this regard, the Supreme Court held that the lack of active involvement of the principal may be an indicator of grant of authority to the agent to conclude contracts. However, this was not the situation in the present case. The Supreme Court was of the opinion that Dell Norway cannot be said to be a dependent agent because all sales that were routed through the brand Dell had to be approved by Dell Ireland. This view was contrary to the view taken by the Norwegian tax authorities as they were of the opinion that the fact that contracts entered into by Dell Norway with the customers was binding on Dell Ireland. Further, the Supreme Court opined that a legal agency agreement had been entered into by the two parties under Norwegian domestic laws.

A reference was also made to the OECD Model Tax Convention as based on it similar treaties have been signed with over 15 countries. In this regard, the Supreme Court observed that no other jurisdiction has adopted such a narrow interpretation of Article 5(5). Reliance was also placed in Article 31 of the Vienna Convention which states that a purpose oriented understanding should be adopted i.e. rules should be interpreted in a manner such that a rational solution to the issue can be provided. Further, the *French Zimmer*[11] case was also referred to wherein was held that an agent cannot bind the principal in relation to contracts made with third parties.

In the instant case, the Dell Norway was acting solely on the instructions given to it by Dell Ireland within the ambit of the agency agreement between the two parties. It is not a situation where the principal was bound by the contracts entered into by the agent. Thus, the Supreme Court held that the Dell Ireland is not acting through a PE in Norway.

Comments: As a result of this case, it is expected that tax authorities in Norway will look into the tax audits of foreign companies having similar organization of sales and so on. Thus, tax payers must ensure that their agency agreements are properly documented so as to indicate a clear allocation of responsibilities and functions to the agent by the principal and also ensure the independence of the agent.

2.3. Outsourcing of primary business activities – whether a PE

DSM Nutritional Products vs. General State Administration[12] is another such case with deals with the issue of permanent establishment.

11 CE 31 Mars 2010 N° 304715 and 308525 10ème et 9ème sous sections réunies.

12 Case No. 1626/2008

Facts: A Swiss Company entered into two contracts with Roche Vitaminas S.A ("**Spanish Company**"), a member of the same multinational chain i.e. DSM Nutritional Products. The first contract i.e. the production contract related to the manufacture of products by the Spanish Company in its premises on behalf of the Swiss Company. The ownership of intellectual property rights like patents, technical know-how, etc. would remain with the Swiss Company. Under this production contract, the Swiss Company paid the Spanish Company the full cost of production plus a margin to provide for cost of capital on satisfying a specified quality and quantity. The second contract i.e. the marketing contract was in the nature of an agency contract that provided that the Swiss Company shall be represented by the Spanish Company and promote its products in Spain and Portugal. Under this contract, the Spanish Company received two per cent of all Spanish sales revenue. In addition, under this contract a warehouse was rented out to the Spanish Company for the storage of products prior to sending them to the customers.

Primary Arguments: On an examination of these two agreements, the Spanish tax authorities took the position that there was a permanent establishment in Spain as per Article 5 of the Spain-Switzerland Tax Treaty. The main reasoning behind this was that the Spanish Company carried out an activity that was primary in nature and such activity formed the corporate purpose for which the company was incorporated. A fixed place of business was another factor that was taken into account. Further, the Spanish Company carries out an economic activity and also assumes the manufacturing and production risks associated with such an activity.

Judgment of the National Court: The National Court perused through Article 5 of the Spain-Switzerland Tax Treaty and Article 11 of the Spanish Income Tax Act ("**Spanish ITA**"), both of which dealt with the concept of permanent establishment, and led to the conclusion that the domestic law provides a broader concept as compared to the Spain-Switzerland Tax Treaty. For e.g.: Article 5 of the said treaty left out purchasing centres, storage sites and information collection centres (para 3), such exclusion is not purported in the Spanish ITA. The National Court opined that in case of any inconsistency between the treaty and the domestic law, the treaty provisions should be given preference, leaving aside the domestic law for cases that are not covered by any treaty. Thus, the National Court stated that an entity is said to have a permanent establishment in Spain if it has a fixed place of business in Spain through which it carries out the business activities of the foreign enterprise, aside from the business activities which may be excluded by the auxiliary services article. As regards the determination of a fixed place of business, the National Court opined that in order to ascertain whether the tax payer had a fixed place of business in Spain, the direct actions of the company in Spain must be examined. The National Court concluded that the Spanish Company confined itself to storing and distributing resources to its customers and so, it cannot be said to constitute a fixed place of business of the Swiss company in Spain. Such a situation is covered by the exception under Article 5(3) of the Spain-Switzerland Tax Treaty.

The second issue addressed was whether the Spanish Company operated as a dependent agent of the Swiss Company in Spain under Article 5(4) of the Spain-Switzerland Tax Treaty. The National Court held that there need not be any employment or contractual relationship between the agent and the principal to constitute dependent agent PE. What is required to be evaluated is the **agent's capacity to effectively bind the principal enterprise to third parties**. In the instant case, the agency did not have the authority to conclude contracts in the name of the principal and its authority was confined to the management of purchase orders. However, the said contract gave the powers to the agent to promote the products purchased from the principal. Article 5(4) contemplates activities carried out through a fixed place of business, other than concluding contracts on behalf of the principal. Thus, the defendant agent clause operates not just when the agent has authority to contract in the name of the foreign principal but **also when given the nature of the activity the agent involves the principal in the activities of the domestic market**.

The National Court then looked into the negative perspective of Article 5 which is related to the absence of conditions as specified in Article 5(5). Article 5(5) referred to an independent agent in the form of a broker who constituted a separate and autonomous enterprise and stated that such an entity does not constitute a PE. In the present case, the activities carried out by the Spanish Company were subject to the detailed instructions or control of the taxpayer and did not satisfy the independent agent exclusion. This indicated that the Spanish Company was operating as a dependent agent of the taxpayer.

Judgment of the Supreme Court: The Supreme Court reiterated the decision of the National Court and held that the Swiss Company acted in Spain through a permanent establishment (the Spanish Company) by way of Article 5(4) of the Spain-Switzerland Tax Treaty.

Comments: The Spanish Supreme Court has not delved into the issue of 'authority to conclude contracts' in great detail and has limited its analysis to the findings of the lower court and the concept of 'fixed place of business'. However, they seem to have adopted an expansive interpretation of agency PE which does not appear to have legal support. The treaty provisions are clear to the extent that a principal has a permanent establishment if a dependent agent habitually exercises the authority to conclude contracts in the name of the enterprise. This cannot be said to have taken place in the instant case.

3. The Many Facets of Tax Planning and Tax Avoidance

3.1. A cross continent perspective on beneficial ownership

This section examines three recent cases on beneficial ownership, from Canada, Europe and South-East Asia respectively.

In the recent judgment of ***Velcro Canada Inc. vs. R***[13], the Canadian Tax Court dealt with the issue of determining the beneficial owner of royalties. A diagrammatic depiction of the structure is contained below in Figure 3.

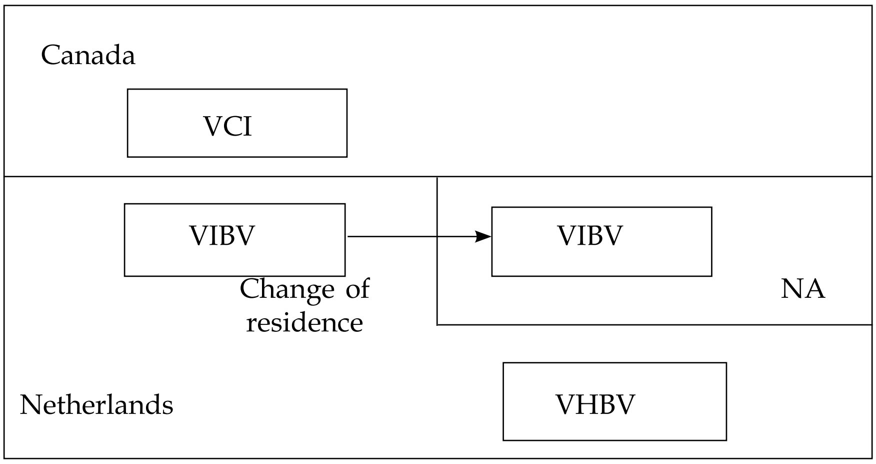

Figure 3

13 2012 TCC 57

Facts: Velcro Canada Inc. ("**VCI**"), a Canadian company was in the business of manufacturing and selling Velcro® fasteners mainly for the auto industry. In 1987, a license agreement was entered into by Velcro Industries BV ("**VIBV**"), a Dutch company which was the owner of the Velcro Brands, and VCI for the use of Velcro technology in Canada. During the years 1987 to 1995, VCI made royalty payments to VIBV and withheld tax at the rate of 25% which was the applicable rate at that time. From 1996 onwards, VIBV became a resident of Netherlands Antilles. A new arrangement was put into play wherein VIBV assigned the licence to its subsidiary, Velcro Holdings BV ("**VHBV**") which was a resident of Netherlands. Under this agreement, VHBV paid VIBV a sum equivalent to 90% of the royalties received from VCI. However, the ownership of the intellectual property, remained with VIBV, and VIBV was specified as the express third party beneficiary, which had the right to enforce the licensor's rights if VHBV failed to do so. Thus, as per the new arrangement VCI withheld tax at the rate of 10% which was the applicable withholding tax rate under the Canada-Netherlands Tax Treaty entered between the two countries. This rate became zero in 1998. The main issue dealt with by the Canadian Tax Court was whether or not VHBV the beneficial owner of the royalties from VCI from 1996 through to 2004 and if so, was it entitled to a reduced withholding rate under the convention.

Primary Arguments: The appellant contended that VHBV being the beneficial owner of the royalties for the years 1996 to 2004 should be entitled to the reduced withholding tax rate under the Canada-Netherlands Tax Treaty. For this purpose, reliance was placed on Article 3(2) of the Canada-Netherlands Tax Treaty and the case of *Prévost Car Inc. vs. R.*[14] wherein it was held that beneficial ownership was based on **possession, use and control over the property and the risks associated with it.**

On the other hand, the respondent contended that VIBV was the beneficial owner of the royalties during the contested assessment years and thus, reduced withholding tax rate should not be provided. The respondent argued that VHBV was not the beneficial owner of the royalties and was in fact, an agent or conduit. Further, the beneficial ownership test as laid down in the *Prévost* case was not fulfilled. Thus, the Canada-Netherlands Tax Treaty should be applicable and tax should be withheld at the rate of 25%.

14 2008 TCC 231

Judgment: The Canadian Tax Court relied heavily upon the decision of *Prévost,* to determine whether VHBV was the beneficial owner of the royalties.

i. **Possession**: As regards to the possession of royalty, the Canadian Tax Court held that the licence agreements and assignment agreements indicated that VHBV had the right to receive royalties. This was due to the fact that the royalties were deposited into accounts, in Canadian funds, owned, exclusively possessed and controlled by VHBV. The royalties were comingled with other monies flowing in and out of the accounts. These funds were converted from Canadian dollars to US dollars by VHBV after which they were moved into US accounts. Further, any interest earned on the funds was earned to the credit of VHBV alone.

ii. **Use:** As regards to the use of royalties, the main question was whether the royalty payments were used by VHBV to its own benefits. This was clear from the evidence that showed that the royalties were comingled with other funds and used for various purposes like to pay bills and fees, re-pay loans, earn interest income, invest in new enterprises, etc.

iii. **Risk:** The next question put forth was whether VHBV assumed any risk in relation to the royalties. As the funds were converted from Canadian dollars to US dollars or Dutch currency, it was clear that VHBV assumed some amount of currency risk. Moreover, the royalties were shown as assets in the financial statements, and thus they were at the risk of being seized or being available to the creditors.

iv. **Control**: As regards to control over the royalty payments, it was observed that the flow of royalties was at the discretion of VHBV. Further, VHBV exercised its control in using the funds for payment of outstanding obligations. Also, the decrease or increase of funds would affect interest payments and currency risk.

v. **Conduit**: The Canadian Tax Court rejected the contention of the respondent that VHBV could be treated as a conduit or agent of VIBV. In this regard, it was held that for there to be a principal-agent relationship, the agent must have the capacity to affect the legal position of the principal. This was not the case here as VHBV was bound by the said agreements and did exercise certain amount of discretion.

Comments: The issue of beneficial ownership is becoming more crucial by the day, in a world where capital moves across borders with remarkable ease. This judgment provides some relief to taxpayers as the Canadian Tax Court has taken a broad view in determining the beneficial ownership over royalties of the intermediary company which in turn makes payments to another entity. The case is significant as it discussed the use of an intermediate entity in another jurisdiction and the implications of treaty shopping. The Canadian Tax Court has reiterated and followed the principles laid down in the *Prévost* case. It may be noted that that this decision may be appealed in a higher court and that it may be important to wait for the final outcome.

Re Swiss Swaps Case I/A[15] In another case dealing with beneficial ownership in a European context, the Swiss Federal Administrative Tribunal dealt with the issue of who should be considered the beneficial ownership of specified assets.

Facts: The taxpayer in this case, A____AS, ("**Danish Company**") entered into total return swaps ("**TRSs"**) over equity issued by Swiss companies with counterparties located in France, Germany, UK and USA. The Danish Company was responsible for the decision to hedge the transactions by acquiring the underlying equities in the Swiss companies. As per the contract between the counterparties and the Danish Company, payment of the dividend amount was not dependent upon the receipt of the corresponding dividends. In fact, the dividends received could be disposed at the liberty of the taxpayer. Further, the duration of the swaps always exceeded three months.

Under Swiss domestic laws, withholding tax is levied on income generated by movable capital assets i.e. in this case, revenue from shares issues by domestic entities. The tax is payable by the debtor of the taxable payment, in this case the company distributing dividends. However, dividends paid by a Swiss company to a resident of Denmark can be taxed only in Denmark as per the Denmark-Switzerland Tax Treaty. Thus, although Switzerland may withhold taxes, such withholding taxes must be refunded.

Primary Arguments: It was contended by the Swiss tax authorities that concluding the swap agreement and simultaneously acquiring the shares meant that all the associated opportunities and risks have been transferred from the Danish company to the

15 A-6537/2010, ITLR- London. - Vol. 14 (2012), part 4 ; p. 638-702

counterparties. It was argued that through the swap agreement, the entire change in value, in particular the entire dividends had been transferred to the counterparties in a systematic manner. According to the Swiss tax authorities, these swap transactions were unusual and inappropriate and the sole purpose of the transactions was to avoid fiscal tax in particular the withholding tax at the Swiss level. Further, it was contended that the Danish Company was not the beneficial owner of the dividends and thus its actions constitute an abuse of the provisions of the Denmark-Switzerland Tax Treaty. As regards to beneficial ownership, it was submitted that determination of beneficial ownership must be based on economic assessment. Although in strict terms there were two transactions involved, in essence the two were linked by a causal connection. The dividend revenue did not remain with the Danish Company and thus, cannot be said to be the beneficial owner of the dividends.

The Danish Company argued that there was a substantial market for equity swaps. Further, it allowed a large amount of leverage, avoidance of stock market duties and disclosure obligations, etc. It was argued that the counterparties had made no tax savings from the said swap transactions. These were internationally and commercially accepted transactions that cannot be termed as unusual, inappropriate or abnormal.

Further, under the terms of the agreement between the Danish Company and the counterparties, payment of dividend was independent of whether the Danish Company received the corresponding dividend income from the Swiss Company. As regards to beneficial ownership, it was submitted that the relevant treaty did not stipulate beneficial ownership of dividends for entitlement of a tax exemption. Further, the duration of the swaps always exceeded three months. It was also argued that a causal connection between the two transactions would not determine the beneficial ownership. What must be looked into is whether the obligation to pay dividends to the counterparties was triggered by the receiving of dividends by the Danish Company from the Swiss Company.

Judgment: The Federal Administrative Tribunal opined that in case of foreign beneficiaries, the main purpose of a refund was not the reimbursement of the original withholding tax but a clear demarcation of the powers of taxation of the two countries. To determine whether any refund should be allowed in this case, the Federal Administrative Tribunal looked into the various provisions of the Denmark-Switzerland Tax Treaty. Since the transaction under question had taken place prior to 2005, the earlier treaty of 1973 was considered. On a reading of Article 10 of the Denmark-Switzerland Tax Treaty, the Federal Administrative Tribunal opined that it does not discuss the characteristics that the person receiving dividends must possess. The Federal Administrative Tribunal looked into the language used in the OECD Model Convention and observed that there is no mention on the concept of 'beneficial ownership' and it was only inserted in the 1977 version of the OECD Model tax convention. The Federal Administrative Tribunal took into regard that the OECD provisions regarding the attribution of dividends, interest income and royalties state that the criterion of beneficial ownership is implicit in every tax treaty. The Federal Administrative Tribunal held that beneficial ownership is substance over form principle, based on economic realities.

Further, it was held that the key issue while determining the beneficial ownership of incomes (dividends in this case) is to see the degree to which the generating income is dependent on the obligation to pass it on and vice versa. The main purpose of providing the concept of beneficial ownership in treaties is to avoid the use of intermediary structures set up only for the purpose of tax evasion.

Further, the power of the Danish Company to decide on the use of the dividends is indicative of determination of the beneficial ownership of the dividends. Under the agreements, there was no legal obligation to pass on those payments (dividend income received from the Swiss company) to the counterparties. Under the agreement, the Danish Company was obliged to pay the counterparties an amount equivalent to the gains on the underlying shares, over the duration of the swaps. The Federal Administrative Tribunal concluded that there was a no *de facto* obligation to pass on the same dividends and in the event that the dividends were not received by the Swiss Company, the Danish Company still had to make payments to the counterparty. Although the ultimate bearer of risk was the counterparty, the Federal Administrative Tribunal still concluded that the Danish Company was the beneficial owner of the dividends. This is because the underlyings were purchased by the Danish Company from the Swiss company. Finally, the Federal Administrative Tribunal held in favour of the Danish Company and concluded that he had beneficial ownership over the dividend income and was hence entitled to the withholding tax refund under the Article 10 of the Denmark-Switzerland Tax Treaty. However, please note that an appeal can be made to this judgment in the Federal Supreme Court.

Comments: The Denmark-Switzerland Tax Treaty did not stipulate a requirement of beneficial ownership of dividends while claiming treaty benefits. Further, the Federal Administrative Tribunal held that even if this were to be the case, the Danish Company was still the beneficial owner of the dividends. The Federal Administrative Tribunal's decision in this case was primarily based upon the view that a certain amount of flexibility was available to the Danish Company for payment of dividends to the counterparties and there he was under no legal obligation to pass on the dividends received from the Swiss company. The Federal Administrative Tribunal held that there were two distinct transactions that were not interdependent on each other. Although, there was a clear tax benefit to the tax payer in case of application of the treaty, yet the Federal Administrative Tribunal held in favour of the taxpayer. The Federal Administrative Tribunal looked into the fact that the underlying assets were purchased by the tax payer from international brokers. However, whether they were indirectly purchased by the brokers from the counterparties was not looked into by the Federal Administrative Tribunal.

In a third case dealing with beneficial ownership, namely, of ***Lone Star Fund III (Bermuda) LP vs. Director of Yeok-sam Department of Revenue***[16]**,** the Korean Supreme Court has discussed the issue of beneficial ownership of shares in a company by foreign investors. This judgment has examined the use of holding companies in tax efficient jurisdictions as a tax saving mechanism.

Facts: Acquisition of Korean companies by foreign investors was often through intermediary holding jurisdictions having favourable treaties with Korea. Commonly used jurisdictions were Netherlands and Belgium for lack of beneficial ownership provisions and lack of source country taxation in case of disposition of shares respectively, in the relevant treaties. In the instant case, Lone Star Fund III, a Belgian company used a tax-efficient structure in order to invest in Korea and gain treaty benefits under the Korea-Belgium Tax Treaty. The structure was such that investments made by a US Limited Partnership ("**US LP**") and Bermuda limited partnership routed through an intermediary holding company ("**Star Holdings**") located in Belgium into Korea in the company Star Tower Co. Ltd. ("**Star Tower**") The main question posed before the Court was whether the US LP and Bermuda limited partnership would be treated as the beneficial owners and secondly, whether a US LP had

16 ITLR-London. - Vol. 14 (2012), part 5 ; Ps. 953-966

legal personality. A diagrammatic representation of the structure is contained below in Figure 4.

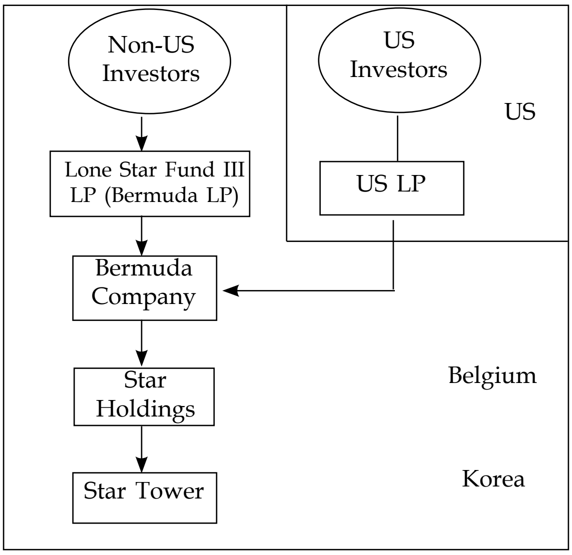

Figure 4

Judgment: The Court applied the principle of 'substance over form'; taking the view that such principle is derived from the 'principle of equal taxation' as laid down in the Constitution. Applying the provisions of the Korea-Belgium Tax Treaty, the Court concluded that Star Holdings did not engage in any business activities in Belgium and thus cannot be said to be the seller, as it just acted as a nominee for the foreign investors situated in USA. Thus, the original investors should be taxed for capital gains and no benefit can be taken under the Korea-Belgium Tax Treaty. As regards to the legal personality of the US LP, the Korean Supreme Court was of the opinion that under US law such an entity is treated as a separate legal entity from its partners as its investments, assets and liabilities are all separate and distinguished from its owners. Thus, such an entity should be taxed as a corporate entity under Korean law.

The Korean Supreme Court took the view that the entity must be taxed as per the domestic laws of Korea. Under the domestic laws, if profit is distributed by a particular entity then it will have been deemed to be part of same group. In case of joint members holding real property, each member has to pay tax based on the extent to which he holds property. in that entity i.e. his share. Organisations deemed to have a legal personality have to pay corporate taxes. The Korean Supreme Court held that the entity is a for-profit organisation that has the characteristics of an independent entity that was separate from its members in terms of rights and responsibilities.

Comments: The Korean Supreme Court took note of the fact that the US LP is the beneficial owner of the shares in the Korean company by disregarding the existence of the intermediary entities completely. This may potentially affect foreign investment into Korea through intermediary jurisdictions, which has been a well-recognized and popular method of investment structuring in various jurisdictions

3.2. Application of the step transaction doctrine under Canadian GAAR

The Supreme Court of Canada in the case of ***Copthorne Holdings Ltd. vs. Canada***[17] examined the applicability of GAAR in a series of transactions that constituted a tax evasive arrangement. This judgment is particularly important from an Indian perspective due to the absence of Indian jurisprudence in this regard, although it may be relevant to wait and watch as to the outcome of the Indian GAAR pursuant to the recommendations of the Shome Committee.

Facts: Copthorne Holdings Ltd. ("**Copthorne I**") was a wholly owned subsidiary of Big City Project Corporation B.V. ("**Big City**"), a Netherlands company and a member of the Li Group (two individuals controlling a group of Canadian and non-resident companies). VHHC I was another company owned by the Li Group. VHHC I invested in the share capital of VHHC II which in turn invested in the shares of Husky Oil Ltd. directly and through a subsidiary corporation, VHSUB Holdings Inc. Further, VHHC I transferred its shareholding in VHHC II to Copthorne I and Copthorne I sold its shares of VHHC II to Big City. Thus, pursuant to a series of transactions, VHHC I and Copthorne I, originally parent and subsidiary became sister corporations. They became owned directly by the same non-resident shareholder Big City. The sister corporations were then amalgamated by way of a "horizontal" amalgamation. Pursuant to this amalgamation, the paid-up capital ("**PUC**") of their respective shares was aggregated to form the PUC of the shares of the amalgamated corporation. The amalgamated corporation then redeemed a large portion of its shares and paid out the aggregate PUC attributable to the redeemed shares to its

17 [2011] 3 S.C.R. 721

non-resident share holder. Since the redemption amount was no more than the PUC of the Class D shares, the redemption did not give rise to a deemed dividend under the Canadian Income Tax Act (**"Canadian ITA"**). The main issue here is whether the horizontal merger can be said to a tax avoidance scheme under the GAAR provisions.

Judgment: It was observed by the Supreme Court of Canada that under the Canadian ITA, the return of PUC is treated as a taxable payment. However, the transaction by which the parent and subsidiary became sister corporations was considered in the light of section 245 of the Canadian ITA, which has incorporated the General Anti-avoidance Rules. The three questions to be decided in a GAAR Analysis are as follows[18]:

i. Was there a tax benefit?

ii. Was the transaction giving rise to the tax benefit an avoidance transaction?

iii. Was the avoidance transaction giving rise to the tax benefit abusive?

i. Was there a tax benefit?

Copthorne I argued that a vertical amalgamation between Copthorne I and VHHC I was never a reasonable option because it would have resulted in the cancellation of the PUC of VHHC I shares and thus the redemption would have been taxed as deemed dividend. Thus, the Supreme Court of Canada held that Copthorne I has not fulfilled its onus of showing that there was no tax benefit, so this question is answered in the affirmative.

ii. Was the transaction giving rise to the tax benefit an avoidance transaction?

For this purpose, the Supreme Court of Canada looked into the provisions of the Canadian ITA. Under s. 245(3) of the Canadian ITA, a transaction can be categorised as an avoidance transaction if it results in a tax benefit, and the primary purpose behind it is a *bona fide* non-tax purpose. An avoidance transaction may also operate as a series of transactions to produce a tax benefit. As regards to the existence of a series of transactions that resulted in a tax benefit, in the present case what became necessary to decide was whether the

18 Canada Trustco Mortgage Co. vs. Canada, 2005 SCC 54, [2005] 2 S.C.R. 601

redemption transaction formed a part of the series of transactions which included the sale and subsequent horizontal merger. The Supreme Court of Canada upheld the view of the lower courts that there was a 'strong nexus' between the redemption transaction and the others as the redemption transaction was the kind of transaction that was "*necessary to make a tax benefit a reality based on the preservation of PUC*". The Supreme Court of Canada held that the sale of the VHHC II shares from Copthorne I to Big City was not primarily undertaken for a *bona fide* non-tax purpose, and Copthorne I had failed to prove the existence of a *bona fide* non-tax purpose.

iii. Was the avoidance transaction giving rise to the tax benefit abusive?

For this purpose, the Supreme Court of Canada first determined the object and purpose of the provisions that were relied upon for the tax benefit, as under the relevant legislation. The Supreme Court of Canada looked into the object and purpose of the parenthetical section 87(3). The Supreme Court of Canada considered the "implied exclusion" argument, i.e. whether the fact that a particular transaction was not caught by these provisions should lead to the conclusion that the transaction was not inconsistent with the purpose of these provisions. While it did not rule out the possibility that in some cases the underlying rationale of a provision would not be broader than the words of the statute, it rejected that argument in this case. Section 87(3) was interpreted on the basis that a return of capital from an amalgamated company to its shareholders should only be possible to the extent that such payment reflects the investment made with tax-paid funds.

It was concluded that the object of the provision was to preclude the preservation of PUC upon amalgamation, where it would result in a return of PUC in excess of the amounts invested in the amalgamating corporations with tax-paid funds. Thus, the sale of VHHC II by Copthone I to Big City defeated and frustrated the purpose of section 87(3) of the Canadian ITA because the non-resident share holder of Copthorne was paid amounts that were greater than the tax-paid funds that were invested in Copthorne. However, it is pertinent to note that the Supreme Court of Canada also observed that under the Act, there is no general policy against surplus stripping.

Comments: This case dealt with taxation on transactions resulting in restructuring or reorganisation that is primarily carried out to avoid tax. The Supreme Court of Canada has applied the

GAAR in this case, holding such a transaction to be 'impermissible' and carried out only for the purposes of avoiding tax. The case law brings about clarity and some thought on what kind of transactions may be hit by GAAR, since there is lack of jurisprudence on this subject While respecting the principle laid down in Duke *of Westminster* that every taxpayer is entitled to plan their affairs so as to minimise the incidence of tax on him, the Supreme Court of Canada held that any transaction that results in the abuse of the provisions of the Act shall be hit by the GAAR provisions. The judgment relied heavily on the principles laid down in the *Canada TrustCo.* case[19] to determine the applicability of GAAR to a particular transaction.

3.3. Entity characterisation mismatch and availability of treaty benefits

In the very interesting case of ***Revenue and Customs Commissioner vs. Anson***[20]**,** the Upper Tribunal primarily dealt with the issue of double taxation due to the treatment of limited liability companies as pass through entities in one jurisdiction and opaque entities in another. An interesting aspect of this judgment is that the taxpayer uses an anti-avoidance provision to claim treaty benefits.

Facts: Mr. Anson, the taxpayer was a member of a Delaware limited liability company called HarbourVest Partners LLC (**"LLC")**. As a member, he was entitled to a share of the profits of the LLC and was thus taxed on these profits in USA. This was because a LLC was treated as a tax transparent entity in USA and thus the members were taxed on the profits derived by the LLC. At this time, he was non-domiciled in USA and was thus taxed on the remittances made from USA to UK. The UK tax authorities treated this remitted income as a dividend and treated the LLC as an 'opaque' entity. No credit was given for the tax paid in USA. As a result, the taxpayer paid US tax at the rate of 45% on income distributions from the Delaware entity and further UK tax at 40% on the balance amount that was remitted back to UK. The lower court held against the taxpayer stating that the income was not the same. In this present case, the taxpayer has invoked the provisions of section 739 of the Income and Corporations Act, 1938 to reduce his tax liability.

19 Ibid

20 2012 UKUT 59 (TCC)

Contents of the relevant provisions: Section 739 is an anti-avoidance rule that seeks to provide a means for charging individuals with tax which they would have otherwise not have paid because of anti-avoidance steps taken by them. Section 741 gives an opportunity to the taxpayer to convince the relevant authorities that the purpose of the transaction is not to avoid tax. In case the authorities are not satisfied with the reasons provided, the taxpayer shall be charged to payment of tax and may take the advantage of the relevant tax treaty.

Primary Arguments: It was contended by the taxpayer that the factual underpinnings of section 739 were present in this case as Mr. Anson had entered into transactions that sent assets out of UK as result of which income had become payable to a person outside the UK i.e. the Delaware entity. Thus, such income was deemed to be the income of the taxpayer and he was liable to pay tax in both the jurisdictions. It was contended that on the material and evidence available, it could not have been satisfied that it was no part of Mr. Anson's purpose to avoid tax. Thus, section 741 has not been fulfilled so it was contended that as per this reasoning, tax should be charged but the relief under double taxation must be available to the taxpayer.

On the other hand, the UK tax authorities did not argue on the chargeability under section 739 and accepted that the factual basis of the application of section 739. The present application was thus, not avoided on the grounds of its anti-avoidance mechanism. The UK tax authorities argued on the grounds that section 741 has been fulfilled as the purpose of the transaction under question was not to avoid tax and thus, no relief of double taxation should be granted.

Judgment: The Upper Tribunal first looked into the decision given by the lower courts wherein it was held that a LLC is not a transparent entity and thus, the members i.e. the taxpayer in the present case does not have an interest in the profits of the LLC. Thus, the profits on which tax has been paid in USA are different to his distributions from the LLC agreement. These are two different sources and thus, no double taxation relief can be obtained.

As regards the applicability of section 739, the Upper Tribunal did not find any merit in this argument and held that this section, being an anti-avoidance provision can only be invoked by the UK tax authorities. The Upper Tribunal held that the decision of the Tribunal is correct in respect of determination of the taxpayer's liability. The

Upper Tribunal held that the conditions laid down in section 741 had been satisfied i.e. (1) the purpose of the transaction was not avoidance of tax, and (2) the transfer and any associated operations were *bona fide* commercial transactions. In this event, section 739 shall not be applicable and thus, no double taxation relief under section 743 (2) would be available.

Comments: The route adopted by the taxpayer to get advantage of double taxation relief was highly innovative. However, the Judge could not see how an anti-avoidance provision could be used to the benefit of the taxpayer. Thus, although this is a clear case of double taxation, the Tribunal has classified the income in the two jurisdictions as being distinct from each other. The decision of the Tribunal in the present matter may proceed for appeal in the Court of Appeals.

3.4. Yet another mismatch between domestic and treaty law

***Cassa di Risparmio di Carrara SpA vs. Tuscany Regional Tax Directorate*[21],** is another such case dealing with the issue of double taxation and conflict between domestic and treaty law.

Facts: Cassa di Risparmio di Carrara SpA, a company incorporated in Italy (**"Italian Company"**) entered into a financial investment transaction that aimed at purchasing bonds issued by Deutsche Finance Ltd (UK) ("**UK Company**"). An interest was payable on quarterly coupons and was received by the Italian Company and taxed at the gross of the 10% withholding tax paid in UK. The 10% withholding tax was levied as per the provisions of the UK-Italy Tax Treaty. Further, the Italian company deducted the withholding tax from the tax due in Italy as per Italian domestic laws and the UK-Italy Tax Treaty.

Primary Arguments: The primary argument of the tax authorities was based on the fact that the UK Company was granted a unilateral tax credit in the UK of an amount equal to the withholding taxes paid on the bonds. It was contended by the Italian authorities that, on the exercise of the right to deduction by the Italian Company, the UK Company benefited from a unilateral tax credit in the UK of an amount equal to the withholding tax, thus resulting in the abuse of the treaty provisions.

21 Case No. 153 of 2011, ITLR-London-Vol. 14 (2012), part 4; P. 574-580

Judgment: The Provincial Tax Court held that the withholding tax paid by the Italian Company was of a final character and well within the scope of Italian domestic laws and the UK-Italy Tax Treaty. According to the Provincial Tax Court, a tax credit was available for the purpose of elimination of international juridical double taxation that occurred when the same item was taxed twice in two jurisdictions in the hands of the same taxpayer. This was the situation in the instant case as tax was deducted through a final withholding tax payable in UK and then again in Italy. However, the Provincial Tax Court noted that the fact that the UK Company benefited from a tax credit that was unilaterally granted by UK under its domestic laws cannot invalidate the deduction claimed by the Italian Company. Further, it was held that the tax credit granted to the UK Company did not eliminate the foreign tax suffered by the Italian company in relation to taxable income in Italy.

Comments: This case reiterates important principles that have been laid down in Indian cases such as *Azadi Bachao Andolan,* namely, that a tax treaty is an agreement between two contracting states and a country cannot determine its actions on the basis of the taxability in the other country if the treaty language specifies otherwise. This position is important to keep in mind in an increasingly globalising world in order to preserve the sanctity of the principle of fiscal sovereignty and taxing rights of states.

4. Conclusion

Indian courts have always had an ear open to developments in other countries, as is clearly indicated by landmark cases like *Azadi Bachao Andolan vs. UOI*[22]. The uncertainty and ever-changing jurisprudence and policies in the area of taxation have made it all the more important to take into account judicial interpretation of various taxation principles and laws.

What constitutes a 'permanent establishment' has always been a problematic issue depending upon the facts and circumstances of each case. In fact, Indian courts have often referred to foreign judgments like *Philip Morris*, to gain clarity on the concept of PE. The various cases discussed on PE will provide much needed clarity on this ambiguous issue. Similarly, the concept of 'beneficial ownership' is fairly new in the Indian context. It is true that Indian courts,

22 [2003] 263 ITR 707 (SC)

in cases like *Vodafone*, *Moody's Analytics Inc.*[23] have reiterated the principle of 'form over substance'. However, unlike many countries, where the concept of beneficial ownership is recognised to ensure that tax benefits are availed by the person to whom such income is attributed, there is no significant jurisprudence in India on this issue, which is further complicated by the fact that India does not generally recognize the duality of ownership. The above-mentioned cases also throw light on the issues that may arise on account of a mismatch in treaty law and domestic law of the countries concerned. The various cases discussed above have reiterated the need to preserve the sanctity of the principle of fiscal sovereignty and taxing rights of states while respecting the right of a taxpayer to manage affairs in such a manner so as to achieve optimal tax efficiency by using benefits as conferred upon it by the relevant Tax Treaty.

23 AAR No. 1186 of 2011, AAR No. 1187 of 2011, AAR No. 1188 of 2011 decision dated June 7, 2012.