CASE STUDY: TAX SPARING

- What is “tax sparing” (“matching credits”)
- Many treaties extend tax sparing to passive income such as dividends, interest and royalties
- Many tax avoidance transactions seek to take advantage of tax sparing provisions (see, for example, the decision of the Dutch Supreme Court (Hoge Raad) in X BV. v. The Tax Administration [Case No. 10/0076] on whether currency losses must be taken into account for the calculation of a tax credit on interest under the Netherlands-Brazil Treaty)

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- The State R-State S tax convention includes a tax sparing provision applicable to interest
- Under that provision, withholding tax of 15 per cent is deemed to have been paid on interest paid by a resident of State S to a company resident of State R even if no withholding tax is levied by State S by reason of a certain tax incentive
Art. 23 (Elimination of double taxation) of the R-S treaty

1. In the case of State R, double taxation shall be avoided as follows: subject to the existing provisions of the law of State R regarding the deduction from tax payable in State R of tax paid in a territory outside State R and to any subsequent modification of those provisions – which shall not affect the general principle hereof – and unless a greater deduction or relief is provided under the laws of State R, tax payable in State S on profits, income or gains arising in State S shall be deducted from any State R tax payable in respect of such profits, income or gains.

Facts

• TCo, a company resident in State T (a no-tax jurisdiction that does not have a treaty network), wants to provide a loan of 100 million to its subsidiary SCo in State S
• Withholding tax in State S is eliminated by reason of tax incentive
• TCo enters into the following arrangement with RCo, a profitable operating company resident of State R

Art. 23 (Elimination of double taxation) of the R-S treaty

2. For the purposes of paragraph 1, tax payable in State S by a company which is a resident of State R shall be deemed to include any amount which would have been payable as State S tax for any year but for an exemption from, or reduction of, tax granted for that year or any part thereof under any of the following provisions of State S law:
(a) to (d) [references to specific tax incentives in State S tax]
For the application of this paragraph, the amount of State S tax shall be deemed to be:
(I) in the case of dividends
   (i) 10 per cent if the recipient of the dividends is the beneficial owner of at least 10 per cent of the voting stock of the company paying the dividends,
   (ii) 15 per cent in all other cases, and
(II) in the case of interest and royalties, 15 per cent.

Facts

• TCo makes a loan of 100 million to RCo at 5.1% interest.
• RCo contributes that money to a new subsidiary RCo2 (also resident of State R) in the form of 50 million for preference shares carrying an annual dividend of 5% and 50 million debt at 5% interest rate.
• RCo2 makes a loan of 100 million at 5% interest to SCo.
Facts

- Inter-corporate dividends are exempt from tax in State R
- These transactions have therefore generated a net extra interest deduction of 2.6 million for RCo, which it can use to offset other taxable income arising in State R
- The difference between the 5.1% interest paid to TCo and the 5% paid by SCo effectively means that TCo receives a commission of 100 000 for its role

• As a result of these transactions, RCo2 receives 5 million of interest each year and gets a deduction of 2.5 million for interest paid to RCo

• RCo2’s taxable income is therefore 2.5 million. At a tax rate of 30%, RCo2 would therefore pay 750,000 of tax but that tax is completely eliminated by the tax sparing credit of 15% x 5 000 000 = 750 000

• RCo receives 2.5 million of interest and 2.5 million of dividends from RCo2. It is entitled to an interest deduction of 5.1 million for the interest paid to TCo

Thank you

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