Case study 2: GAAR and Tax Sparing

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http://www.un.org/esa/ffd/

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)

CASE STUDY: TAX SPARING

- Loosely based on Annex IV of the 1997 OECD Report "Tax Sparing: A Reconsideration"

Facts

- 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.

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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.

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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

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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.

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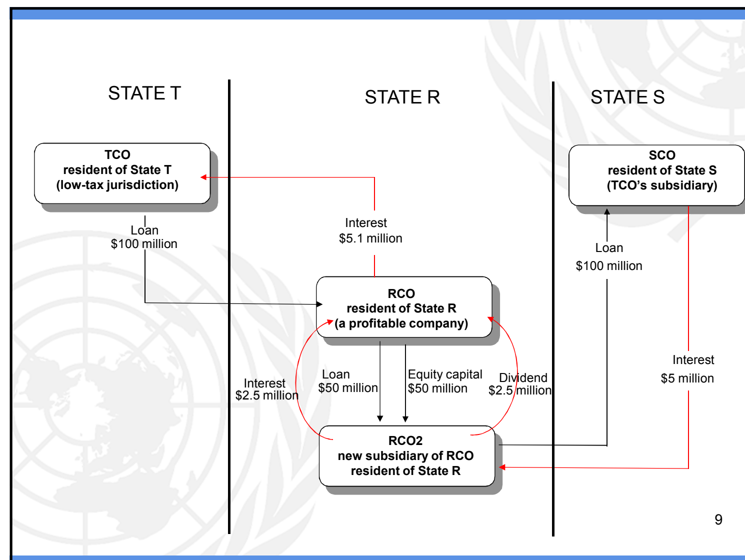

Facts

- 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

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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

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Thank you

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