Information Sheet No. 16

Important principles affecting International Structures

Introduction

Investors engaged in international investments and transactions often use foreign entities through which they conduct operations. Overall tax optimization is not the only drive of using foreign entities. It is equally important to establish a structure that addresses practical, legal and business aspects.

International structures are perfectly legal. However, they often fall under the scrutiny of the jurisdiction in which the investor resides as well as the jurisdictions of the actual operations.

In brief, the investor's jurisdiction shall try to ensure that resulting incomes are not structured in a way that it cannot tax something that in accordance with its domestic laws it should. At the same time, the jurisdictions in which the operations are conducted shall, amongst other, try to ensure that the structures are not artificial schemes simply trying to obtain double tax treaty, EU Directive or other related benefits that would otherwise have not been available.

The tax authorities of most jurisdictions have become more educated and mature with these concepts, thus understanding these principles way better than before; and now scrutinising or challenging structures more often. Furthermore, jurisdictions pass anti-abuse related laws of one sort or another and demand certain related provisions on the double tax treaties they conclude or renegotiate with other countries. These provisions are either initiated domestically by each country, or embedded in their legislation as part of an international (e.g. EU) guideline / directive.

To a great extent, international structures can be safeguarded from such domestic and foreign challenges or laws by considering certain principles at all stages of their life; starting from the planning phase. In essence, one should be in a position to demonstrate that the structure at hand has solid business reasons for its existence other than pure tax reasons. There is no 'golden workable' formula. Each case is usually examined on its own specific merits. Still, the main principles of the surrounding issues are the same and are outlined below.

Main issues and principles to consider

- Controlled Foreign Company ("CFC") provisions
- Substance
- Effective Place of Management and Control
- Beneficial Ownership

Note: These principles are connected and overlapping

1. Controlled Foreign Company ("CFC") provisions

Many countries have CFC provisions of various sorts within their domestic legislation. They mainly apply on the use of foreign entities. Depending on the type of CFC rules, if certain conditions are met, a foreign entity becomes a CFC. For tax purposes, a CFC will be treated as transparent ('see-through'). In effect, the incomes earned on that CFC entity will be considered as incomes directly earned by the investor /

shareholder. Thus, investors engaged in international structures are prompted to separately examine from their own country of residence any local CFC rules that may apply, how they apply and how these can be legally circumvented.

2. Substance

Foreign companies and other types of vehicles are used for holding or operational purposes in an intermediary jurisdiction between the investor and the target jurisdiction / end-client. It is generally expected that companies in such intermediary jurisdictions have business and commercial reasons for their existence, other than pure tax reasons. One of the needed elements in this respect is to have relevant substance.

By substance it is meant to have some real presence, operations and business purpose in that intermediary jurisdiction. This substance can be a combination of various elements such as office facilities (owned or rented), owning necessary fixed assets (e.g. computers, telephones, furniture etc), having full or part time own staff, related local expenses and key personnel (including competent directors) residing and working locally. The extent of these elements to be justified and be relevant to the activities and purpose of the company.

The real business reasons for using that foreign company can then be demonstrated and justified when the substance elements are combined with the need to use that intermediary jurisdiction's infrastructure, business, corporate and legal framework as well as its proximity to the target market.

Usually, such international business centres demand little to zero substance from their own accord. So, the need for relevant substance is not so much to satisfy the intermediary jurisdiction BUT rather to demonstrate a solid business case to satisfy the jurisdictions of the investor and of the target market.

It is therefore suggested to establish such needed substance accordingly, dependent on the nature of activities at the level of an intermediary jurisdiction and in combination with what substance elements are expected to be found by way of common business practice.

3. Effective place of management and control

Most countries and most double tax treaties apply the test of 'tax residency' by way of the place of the management and control of the company. It is generally accepted that there can only be one place of 'effective' (real) management and control of a company. For example, it may be the case that there is a sole resident director at the level of the intermediary jurisdiction BUT in fact to be clear that the real effective management is exercised by the beneficial owner or another person in another jurisdiction.

If it can be demonstrated that the effective place of management and control of a company is in some other country, then the tax residency that the company claims to have in the intermediary jurisdiction is compromised and may be challenged. Such successful foreign challenge would result in treating the company also as tax resident in the country of residence of the persons who effectively manage the company OR to deny benefits that the company claims under double tax treaties or EU Directives applicable to the intermediary jurisdiction.

It is therefore imperative to ensure that the effective place of management and control actually takes place at the level of the intermediary jurisdiction. Simple steps would be to avoid issuing general powers of attorney, the local directors to exercise (and be competent to do so) real judgment and decision

making on the type of the business at hand and if needed to move own key personnel making such decisions at the level of the intermediary jurisdiction.

4. Beneficial Ownership

The concept of 'Beneficial Ownership' of incomes is becoming more and more important. In order for treaty benefits to apply (e.g. reduced withholding tax on a payment from one jurisdiction to another), the recipient needs to be considered as the beneficial owner of the income. There is a controversial debate as well as court cases and official (sometimes conflicting) guidelines as to who is considered to be the beneficial owner of a dividend, interest or royalty payment.

For example, consider an intermediary company engaged in a back-to-back financing or royalty arrangement, and the moment it receives interest (or royalty) it further on-pays almost all of it to its lender / licensor. Also consider the case of a holding company which distributes the entire dividend the moment it receives it. In these cases would the intermediary company be considered the beneficial owner of the gross dividend, interest or royalty that it received? – This is very debatable and much depends on how each jurisdiction, that will for example grant treaty benefits, treats this concept in practice.

In light of these inherent uncertainties that are not treated in a uniform manner across various jurisdictions, there are certain ways to minimise the related tax risk. For example, it is generally advisable that the company in the intermediary jurisdiction clearly undertakes some risk and is entitled to benefits related to that risk and to the extent of its involvement; also that there is actual decision making made at the level of this company before any on-payments (as opposed to simple flow-through fund movements). Furthermore, where possible, certain transactions could be made using own money or own assets as opposed to pure back-to-back transactions.

Conclusions

The evolution and application of these principles in international structures is becoming increasingly important and demands serious consideration by investors and international tax advisors. New structures need to take them into account from the planning stage and existing structures may need to be re-visited and re-structured accordingly.

These issues and principles apply on the use of any intermediary jurisdiction, EU or non-EU, and it is of paramount importance that each case is looked at on its own merits and always dependent on the laws and practices of the jurisdictions involved at the level of the investors as well as at the level of the target markets.

NOTES:

The above is intended to provide a brief guide only. It is essential that appropriate professional advice is obtained. P.G. Economides & Co Ltd will be glad to assist you in this respect. Please do not hesitate to contact us.

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