LIUC – Università Carlo Cattaneo

International Tax Law

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Tax residence of companies

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Residence of Companies

- Contracting States may apply different criteria for the definition of residence of a company.
- The residence of a company is generally determined either by reference to its place of incorporation or its place of management or both.

Place of incorporation

- Using the place of incorporation as criterion to determine residence of companies provides simplicity and certainty to the tax authorities and the companies.
- Many countries use the place-of-incorporation test combined with other criteria.

Place of management and control

- Using the place of management and control as criterion to determine residence may be less certain than using the place of incorporation.
- For companies engaged in international operations, management activities may be conducted in several countries during any particular taxable year.
- In practice, many States using that criterion employ practical tests, such as the location of the company’s head office or the place where the board of directors meet.

Domestic Criteria for Residence of Companies

- Place of incorporation
- Place of management and control
- Statutory company seat
- Place of effective management
- Place of the main business purpose
- Other criteria

Country practices

UK

- Where the ‘real’ business of the company is carried on – designed to capture businesses which are incorporated overseas
  - Various tests applied by the UK authorities

- Also – if a company is incorporated in the UK, it will always be UK tax resident

Country practices

Italy

- Legal Seat – place indicated in the articles of incorporation
- Place of Effective Management – where the Directors manage the company (and “deemed” place of Effective Management for Companies controlling another Italian Company)
- Place of the Main Business Purpose – as indicated in the articles of incorporation

Country practices

Netherlands

- Companies incorporated under Dutch law are deemed to be residents of the Netherlands

- Companies are resident of the Netherlands for tax purposes if they are deemed to be "actually situated" there on the basis of "facts and circumstances“. Case law helps determination:
  - Place of effective management
  - Residence of Directors/Supervisory Board
  - Place of shareholder meetings
  - Location of company assets etc.

Country practices

Germany

- Legal seat in Germany
- Place of Management – the place where the persons who have final authority make their decisions concerning the management of the business
- Also, all entities organized under German commercial law must have their legal seat and their place of management (*Verwaltungssitz*) in Germany

Art. 4(3) OECD MC – Tiebreaker Rule for companies

- Why are tie-breaker rules needed?
- Due to differences in domestic residence legislation, dual residence is possible also for companies.
- When Art. 4(3) was first drafted, it was considered that it would not be an adequate solution to attach importance to a purely formal criterion like registration.
- Preference was given to a rule based on the place of effective management, which was intended to be based on the place where the company was actually managed.

Art. 4(3) OECD MC – Tiebreaker Rule for companies

Art. 4(3) OECD MC 2014: «*Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the State in which its* ***place of effective management*** *is situated*».

Art. 4(3) OECD MC – Tiebreaker Rule for companies

- According to the Commentary 2014 (as modified in 2000) «*The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management. <u>An entity may have more than one place of management, but it can have only one place of effective management at any one time</u>*».

Art. 4(3) OECD MC Tiebreaker Rule for Companies

- Observation of Italy to paragraphs 24 and 24.1 (place where the main and substantial activity of the entity is carried on)

Art. 4(3) OECD MC – Tiebreaker Rule for companies

- It is important to notice that Art. 4(3) has been recently amended in the last version of the OECD MC 2017.
- In 2017, the Committee on Fiscal Affairs recognised that although situations of double residence of entities other than individuals were relatively rare, there had been a number of tax-avoidance cases involving dual resident companies.
- It therefore concluded that a better solution to the issue of dual residence of entities other than individuals was to deal with such situations on a case-by-case basis.

Art. 4(3) OECD MC – Tiebreaker Rule for companies

Art. 4(3) OECD MC 2017: «*Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors*».

Art. 4(3) OECD MC – Tiebreaker Rule for companies

Competent authorities having to apply Art. 4(3) would be expected to take into account various factors, such as:

- Where the meetings of the person's board of directors or equivalent body are usually held
- Where the CEO and other senior executives carry on their activities
- Where the person's headquarters are located
- Which country's law govern the legal status of the person
- Where the accounting records of the company are kept

Art. 4(3) OECD MC – Tiebreaker Rule for companies

- Art. 4(3) OECD MC 2017 (last sentence): «*In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States*».
- The last sentence of paragraph 3 provides that in the absence of a determination by the competent authorities, the dual-resident entity shall not be entitled to any relief or exemption under the Convention except to the extent and in such manner as may be agreed upon by the competent authorities.

Art. 4(3) OECD MC – Tiebreaker Rule for companies

- The last sentence will not, however, prevent the taxpayer from being considered a resident of each Contracting State for purposes other than granting reliefs or exemptions to that person.
- This will mean, for example, that the condition in Art. 15(2)(b) will not be met with respect to an employee of that person who is a resident of either Contracting State exercising employment activities in the other State.
- Similarly, a company will be considered to be a resident of each State for the purposes of the application of Article 10 to dividends that it pays.

Art. 4(3) OECD MC – Tiebreaker Rule for companies

- Some States, however, as in some of the most recent double tax treaties, consider that it is preferable to deal with cases of dual residence of entities through the rule based on the “place of effective management” that was included in the OECD MC before 2017.
- Example: Convention between Italy and Barbados (2017).

OECD Multilateral Convention (MLI)

- Approved in November 2016
- Aimed at providing States a multilateral instrument to implement treaty related BEPS measures and amend bilateral tax treaties
- Article 4(1) of the MLI is almost identical to the new version of Art. 4(3) OECD MC and it is aimed to replace the former tie-breaker rule which is still present in most of the double tax treaties.

Art. 4(1) MLI – Dual Resident Entities

«*Where by reason of the provisions of a Covered Tax Agreement a person other than an individual is a resident of more than one Contracting Jurisdiction, the competent authorities of the Contracting Jurisdictions shall endeavour to determine by mutual agreement the Contracting Jurisdiction of which such person shall be deemed to be a resident for the purposes of the Covered Tax Agreement, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by the Covered Tax Agreement except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting Jurisdictions*».

Case Study

- Company A:
  - Established under Dutch law in the Netherlands
  - A subsidiary of a US company
  - 6 directors: 4 resident in the US, 2 in Ireland
  - One of the Irish directors is the MD for day to day decisions and has the power to act on behalf of the company
  - Board meetings are in Ireland

- Where is company A resident for treaty purposes?

Case Study Solution

- For domestic law purposes, Company A is resident in
  - Ireland, due to the location of management and control
  - Netherlands, since the company was established under Dutch law

- The Ireland/Netherlands treaty is needed to solve this issue

Case Study Solution

Art. 2(1) Ireland/Netherlands treaty

(f) the terms "resident of one of the States" and "resident of the other State" mean a resident of the Netherlands or a resident of Ireland, as the context requires; and the term

"resident of the Netherlands" means:

(1) any company whose business is managed and controlled in the Netherlands;

(2) any other person who is resident in the Netherlands for the purposes of Netherlands tax and not resident in Ireland for the purposes of Irish tax

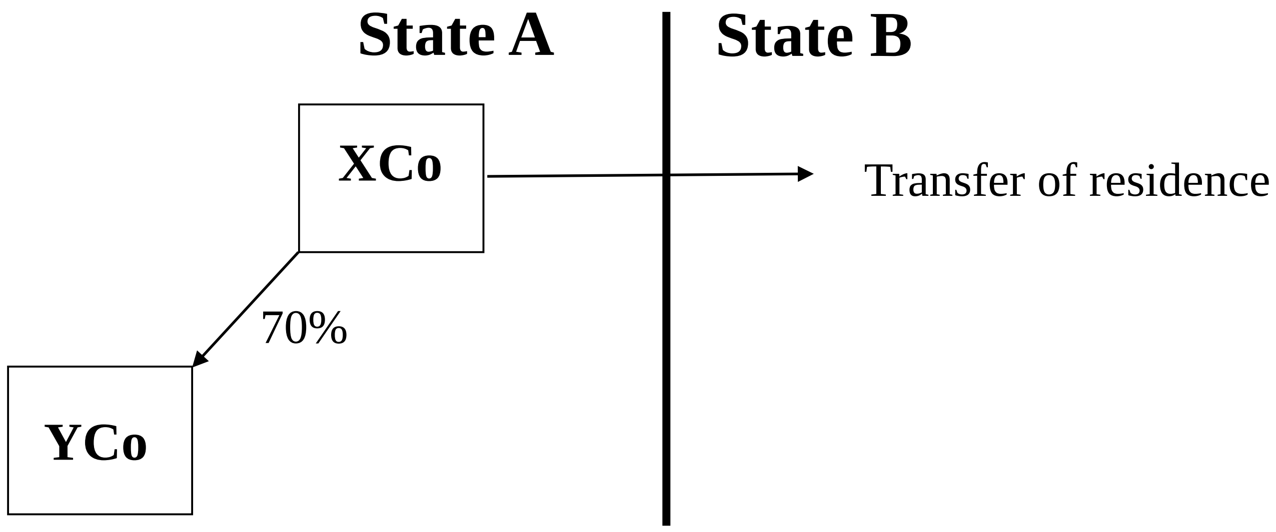
SOLUTION: Company A is tax resident in Ireland.

Exit or departure taxes

- When a person ceases to be resident in a country that taxes residents o their world-wide income, the person will no longer be subject to tax on world-wide income in that country.
- States usually introduce law provisions to avoid that transfers of residence are performed for tax avoidance or abusive purposes.

Exit or departure taxes

- Example:



XCo owns the majority of the shares in YCo.

XCo decides to transfer its residence from State A to State B.

Exit or departure taxes

- At the time of the transfer of residence, the shares of YCo are worth significantly more than when they were acquired.
- Under A-B double tax treaty, capital gains derived by a taxpayer resident in one State from the disposal of the shares of a company resident in the other contracting State are taxable only in the State where the taxpayer is resident.
- Therefore, lacking an exit tax in State A, if XCo moves to State B the shares of YCo can be sold without any tax imposed in State A.

Exit or departure taxes

- To prevent the avoidance of domestic tax by the country of departure (State A), many States have adopted special rules called **exit** or **departure tax**.
- Typically, these taxes operate by requiring the departing resident to pay tax not only on the income and gain realized up to the date when the taxpayer ceases to be resident, but also on any accrued but unrealized income or gains.

Exit or departure taxes

- OECD MC Commentary on Article 1: "*exit or departure tax rules may prevent the avoidance of capital gains tax through a change of residence before the realisation of a treaty-exempt capital gain*".
- BEPS Action 6 Final Report: "*To the extent that such exit tax is levied when a person is still a resident of the State that applies the tax and does not extend to income accruing after the cessation of residence, nothing in the Convention, and in particular in Article 13, prevents the application of that form of taxation*".

Exit or departure taxes

- The imposition of an exit or departure tax is a restriction of the freedom of establishment.
- However, CJEU Case Law confirms that such restriction is necessary to correctly preserve the power of taxation of the States involved in the transfer of residence.
- Case *National Grid Indus*, C-371/10: "*the restriction of freedom of establishment is justified by the objective of ensuring the balanced allocation of powers of taxation between the Member States, in accordance with the principle of territoriality linked to a temporal component*".

Definition of residence as anti-abuse rule

- Some companies might be fictitiously located in a low tax jurisdiction, while actually resident in a jurisdiction where they are actually resident.
- This practice is used to gain the benefit of a low tax jurisdiction and it is considered an abusive scheme.
- In Italian: "*esterovestizione*" (concept created by case law)

Definition of residence as anti-abuse rule

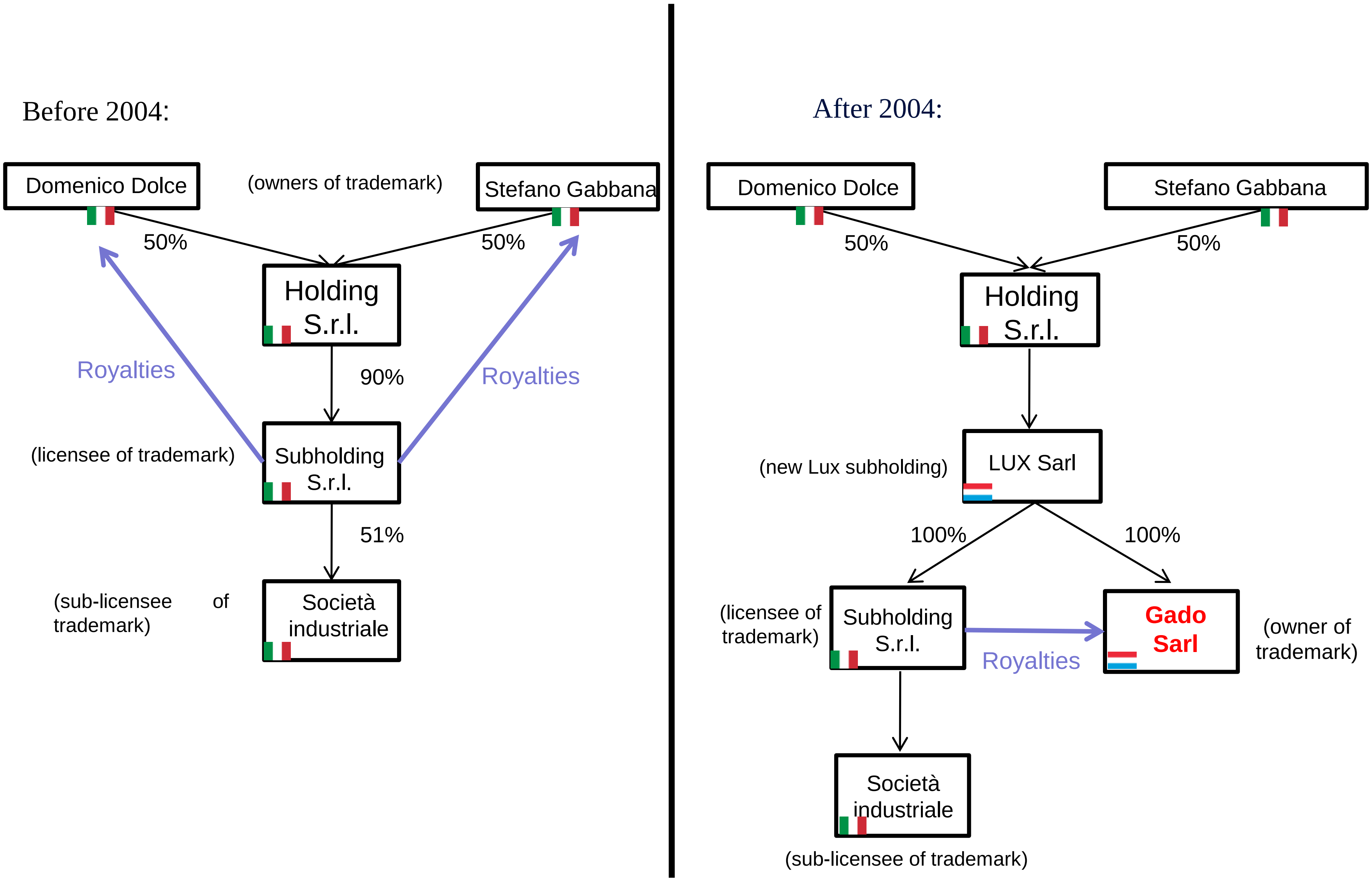
- In order to avoid this practice, some States introduced in their law some assumptions on the basis of which a company is deemed to be resident in their territory if certain circumstances occur.
- Example: Italy - Art. 73(5-*bis*) ITC: unless proven otherwise, the place of management of an entity is deemed to be located in the Italian territory if the entity, alternatively:
  - is controlled, even indirectly, by entities who are resident in Italy;
  - is administrated by a board of director (or another similar body) mostly composed by members who are resident in Italy.

Case law: "*Dolce&Gabbana*" Case: (Provincial tax court of Milan, 4 January 2012, No. 1/16/12; Regional tax court of Milan, 20 March 2013, No. 43; Criminal Supreme Court, 30 October 2015, No. 43809)

FACTS:

- Project of group corporate restructuring program and re-allocation of trademarks
- Sale of the trademark in 2004 from the two designers to a newly incorporated Luxembourg group company (Gado Sarl)
- Gado Sarl confers to Subholding srl the rights to use the trademarks.
- State of taxation of royalties:
  - Before 2004: Italy
  - After 2004: Luxembourg

Case law: “*Dolce&Gabbana*” Case: (Provincial tax court of Milan, 4 January 2012, No. 1/16/12; Regional tax court of Milan, 20 March 2013, No. 43; Criminal Supreme Court, 30 October 2015, No. 43809)



Case law: "*Dolce&Gabbana*" Case: (Provincial tax court of Milan, 4 January 2012, No. 1/16/12; Regional tax court of Milan, 20 March 2013, No. 43; Criminal Supreme Court, 30 October 2015, No. 43809)

- The Italian tax authorities claimed that Gado Sarl was effectively an Italian resident company that has been set up in Luxembourg to benefit of a more favorable tax regime for the transfer of royalties. In fact, it was controlled by Italian resident entities.
- The whole group corporate restructuring program was seen as an abusive aimed to obtain an undue tax advantage.
- The Italian tax authorities also claimed that Gado Sarl was not carrying out any economic business activity and that it was managed mostly by Italian resident individuals

Case law: "*Dolce&Gabbana*" Case: (Provincial tax court of Milan, 4 January 2012, No. 1/16/12; Regional tax court of Milan, 20 March 2013, No. 43; Criminal Supreme Court, 30 October 2015, No. 43809)

In the end, Dolce & Gabbana managed to prove that:

- The group corporate restructuring program was carried out for reasons going beyond the tax advantage
- Gado Sarl was carrying out an effective business activity in Luxembourg

Hence, the abovementioned scheme was not considered abusive from the Italian Supreme Court.