Analysis

Tax treaty briefing for July

SPEED READ **UK companies managing foreign subsidiaries from the UK and seeking group relief for their losses should oversee the foreign business from the UK at both executive and day to day levels. Potential exposure to Indian tax on consultancy fees requires careful scrutiny of domestic legislation, the exact terms of the treaty and the date when it takes effect. For airlines to be exempt from tax on revenues from destination countries, they must actually operate the aircraft, as opposed to merely arranging bookings. Maltese companies enjoying special tax treatment may be denied treaty benefits. Recent treaty highlights include provisions relating to MAP tiebreakers, MAP arbitration, stocks of goods as PEs, profit allocation under the authorised OECD approach, and anti-abuse.**

Allan Cinnamon provides tuition and online information on cross border tax structuring through his company, Cintax the Word Ltd. He is a visiting teacher at the University of London, Queen Mary School of Commercial Law Studies and the Institute of Advanced Legal Studies. Email: allancinnamon@gmail.com; tel: 07875 359 040.

Effective management and group relief

A Memorandum of Understanding (MOU) between the Mauritian Revenue Authority and the South African Revenue Service, signed on 22 May 2015, has established the factors to be considered in determining the dual residence of companies. In line with BEPS Action 6, art 4.3 of the Mauritius/South Africa treaty provides for a mutual agreement procedure (MAP) tiebreaker, rather than the traditional effective management test. The determining factors detailed in the MOU are in line with amendments to para 24 of the commentary on art 4 suggested at para 102 of the 22 May Action 6 discussion draft. The place of effective management is to take into account the location of the CEO and other senior executives and the senior day to day management. (The current para 24.3 refers to key management and commercial decisions for the business as a whole.)

Turning to the UK, one of the determining factors included in HMRC's *International Manual* (at INTM120085) for dealing with the MAP tiebreaker is the company's economic linkages to the state where its business is carried on. An earlier Statement of Practice (SP1/90) suggests that a company may be effectively managed by executives based abroad, rather than by non-executives at UK directors' meetings.

In line with this approach, INTM 120085 includes an example of a group in the UK that is trying to import losses from its foreign subsidiary. For example, a UK group's Germany subsidiary is currently suffering significant losses in its German business. As a result, two senior UK directors join the German board, conducting board meetings in the UK that are also attended by the German based directors. The company is centrally managed and controlled in the UK; and so claims that it is potentially entitled to surrender its German trading losses as group relief. Does CTA 2009 s 18 apply to deny UK residence, however, on the basis that the company is non-UK resident under the tiebreaker art 4.3 because it is effectively managed in Germany where its economic linkages are closest, its senior executives are based and its business is carried on?

Points to watch: UK groups managing foreign subsidiaries from the UK may assert that group relief applies to the foreign losses in view of central management and control from the UK. Depending on the facts, there could be a risk that CTA 2009 s 18 will determine the foreign subsidiary to be non-UK resident, in view of its effective management outside the UK.

Aside from the situations discussed above, a number of other treaties and regulations determine effective management to be where day to day business and senior executive decisions are made. Among other judgments on effective management (including that of the Special Commissioners in *Smallwood* SC/3144/2006*)*, a recent decision in the Federal Supreme Court of Switzerland *2C-1086/2012* and *2C-1087/2012* is relevant. A Swiss company's Guernsey finance subsidiary held board meetings in Guernsey, but the management of its daily business took place in Switzerland. The court distinguished the place of its effective management from that of its top level management and administration. Its effective management was where its economic and effective centre was located; namely, where key business decisions were taken, viz, in Switzerland.

In the light of these factors, and especially the HMRC and OECD guidance, UK companies seeking group relief for losses of foreign subsidiaries should consider the following action at UK board level. In addition to normal high level board decisions, such as raising funds, paying dividends and making acquisitions and disposals, the board should actively oversee its subsidiary's business activities at executive and senior day to day levels, such as staff hiring, supply and customer contracts and R&D activity.

Another case on Indian technical services

The February briefing reported on a case involving a Swedish company receiving management fees sourced in India. In its 18 February 2015 decision, *GVK Industries Ltd v ITO* 332 ITR 130, the Division Bench of India's Supreme Court came to a similar conclusion. It found that a Swiss consultancy company's contingent success fee for advising an Indian client on the financial package to be offered to potential lenders constituted foreign technical services within ITA 1961 s 9(1)(vii), defined as managerial, consulting or technical services.

It appears that the consultancy fee was received in March 1995, just before the India/Swiss treaty entered into effect on 1 April 1995 (the services having been rendered at an earlier date). That is presumably why the judgment does not refer to the treaty. However, there is an arguable case that the treaty should still apply, on the basis that it entered into force on 29 December 1994. In that case, the fee would have been exempt from Indian tax on the basis that the services were not 'made available' to the Indian client, as required by art 12.4(b)(ii), because the advice rendered did not enable the Indian client to apply it himself. (See the February briefing, *Tax Journal*, 6 February 2015, at 'Technical services', for a full discussion.)

Points to watch: Most of India's tax treaties, including its treaty with the UK, empower it to tax fees for technical services arising there. However, the exact terms of both the treaty and Indian domestic legislation require careful scrutiny, as well as the date when the treaty takes effect.

Source of US airline's Indian income

The Mumbai Income Tax Appellate Tribunal published its ruling of 29 April 2015 in the case of *Delta Air Lines Inc v ADIT* (ITA 1256/Mum/2014). Delta was party to a code sharing arrangement with a third party airline under which space was booked, but Delta did not operate the flights. It argued that this was tantamount to chartering the third party aircraft, so that the income derived should be exempt from Indian tax and exclusively taxed by the US under art 8 of the India/US treaty as income from the operation of aircraft in international traffic. Article 8(4) includes profits from pooling arrangements. However, the tribunal held that the code sharing arrangement did not involve Delta in the operation, ownership or charter of the aircraft. The income was akin to a booking agent fee and was therefore taxable as part of the profits of Delta's Indian branch.

Points to watch: Article 8 of the OECD Model reserves to the state of residence the taxing rights from the operation of aircraft (and ships) in international traffic. Operation is therefore key. A number of other Indian cases dealing with charter, feeder and slot arrangements have also considered this issue, including *Hapag Lloyd Container Line Gmbh v ADIT* (2012) 51 SOT 299, *Balaji Shipping UK Ltd* (3024 and 3215 of 2009) and *MISC Berhad v ADIT* ITA6499/Mum/2012.

Malta/Netherlands treaty judged inoperative

The Netherlands Supreme Court recently gave its judgment in the case *of X1 BV, X2 BV and X3 BV v The Tax Administration* 13/05185. The three dually resident Dutch companies were resident in Malta, where they carried on a business of borrowing and lending money. They were owned by a Swiss resident company, to which they paid dividends. They claimed that the Malta/Netherlands treaty exempted the dividend payments from Dutch withholding tax. (Art 9.1 of the 1951 Netherlands/Switzerland treaty did not provide any relief in this regard.) Since the Dutch companies were effectively managed in Malta, they were in principle resident there for treaty purposes under the art 4.1 tie breaker of the Malta/Netherlands treaty. The main point at issue, though, was whether art 30 of the treaty disqualified them from treaty benefits.

It is fairly well known that Malta operates a unique tax credit system, under which a foreign shareholder may receive a significant refund of the Malta corporate tax underlying the dividend it receives from a Malta resident company, effectively reducing the approximate overall Maltese corporate tax rate at anything between 0% and 6%. This system originated under the Malta International Business Activities Act (MIBA). It was subsequently replaced by the flat rate foreign tax credit (FTRC) and Income Tax Management Act (ITMA). Article 30 of the treaty provides that the treaty is inapplicable to companies wholly or partly exempted from tax by a special regime. The predecessor MIBA regime fell under this heading and the court held that the combination of the FTRC and ITMA regimes was comparable to it. It followed that the treaty was inapplicable. As a result, the Maltese treaty residence of the three Dutch companies was irrelevant and their dividend payments therefore became liable to Dutch withholding tax under Netherlands domestic law.

Points to watch: Apart from the Netherlands, a significant number of treaties deny benefits to Maltese companies qualifying for the FTRC regime. These include the treaties with France, Germany, India, Luxembourg, Spain and the UK; therefore, for example, a Maltese company receiving UK source interest or royalties could suffer a 20% UK withholding tax. (However, ITTOIA 2005 s 758 would exempt the payments following the EU Interest and Royalties Directive, but subject to anti-avoidance under s 765.)

Recent treaty highlights

MAP tie breaker: Continuing the trend in recent UK treaties, the new UK/Kosovo treaty includes a dual residence tiebreaker to be settled by a MAP process between the two states, rather than by the effective management test.

Stock of goods as PE: The new Oman/Portugal treaty deems there to be a PE when a dependent agent habitually maintains a stock of goods delivered on behalf of a non-resident principal.

PE profit allocation – the AOA approach: Continuing a trend in recent UK treaties, the UK's new treaty with Kosovo attributes profits to a PE based on its functions, assets and risks, in accordance with the authorised OECD approach (AOA).

MAP arbitration: The new Belgium/Russia protocol, Germany's new treaties with France and Germany, and the UK's treaty with Kosovo all include an arbitration provision designed to speed up the MAP process.

Anti-abuse: The Dutch government intends to renegotiate treaties with developing countries to include an anti-abuse clause. Countries named so far are Ethiopia, Ghana, Kenya, Malawi and Zambia. The Vietnam Ministry of Finance has released a draft circular providing that its GAAR will apply to deny treaty benefits. (Australia has protected its own version of the diverted profits tax from treaty exemption in the same way.)

The new Argentina/Chile treaty contains an extensive limitation on benefits (LOB) article modelled on the BEPS Action 6 Report on treaty abuse. This follows a similar provision in the China/Russia treaty. ■

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Treaty briefing for May (Allan Cinnamon, 7.5.15)

Treaty briefing for February (Allan Cinnamon, 5.2.15)