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FROM THE EDITOR

The sigh of relief heard when the new Switzerland/US tax treaty was finally concluded this year after some 17 years of sometimes contentious negotiations may have been premature, once tax planners feel the full impact of the new pact's Limitation on Benefits clause, which was one reason why the negotiations were so protracted. In the end, the US got its way and may well have achieved its objective of an effective barrier to treaty shopping — the treaty contains one of the most comprehensive LOB clauses of any treaty concluded in recent years. The leading article gives an in-depth analysis.

As readers will know, New Zealand has enacted an international tax reform implementing an extended foreign investor tax credit regime, new thin capitalization rules and more robust transfer pricing rules, all of which is designed to encourage and facilitate foreign investment in the country by providing a level playing field for New Zealand businesses in respect of both domestic and foreign sources of capital and to further the government's strategy of a broad-based, low-tax environment. This month's concluding article in the series focuses on the application of the new transfer pricing regime in practice. Overall, the new regime will have a few more teeth in its bite than the previous legislation — *eg*, there are severe noncompliance penalties. The Commissioner's guidelines are awaited, but in the meantime taxpayers are well advised now to maintain full documentation of their pricing methodology. See page 6 for details.

North American expatriates, particularly US citizens who decide they want to give up their citizenship, will find that expatriation has become much more expensive — at least from a tax standpoint. Side-by-side, Canada and the US both took steps in October - separately - that may make those considering expatriation or renouncing of citizenship think twice. Canada is proposing to extend its departure tax rules while the US will bar from ever re-entering the US any citizen who is found to have renounced citizenship for tax avoidance reasons. Details on page 9.

This being the Christmas season, treat yourself to a gift of one (or better yet, all) of the books featured in this month's Tax Bookshelf column. Each is the last word on their subject.

Best wishes for a prosperous New Year!

Richard Casna, Editor

TAX TREATIES

Swiss/US pact sets strict limitation on benefits

Following the pattern of other recently concluded US pacts, the new Swiss/US income tax treaty includes strict limitation on benefits provisions that set a number of tests taxpayers will have to meet in order to benefit from the treaty. Peter Reinarz of Bär & Karrer in Zurich, provides the details.

A new income tax convention and protocol between Switzerland and the United States (hereinafter the "New Treaty") was signed on 2 October 1996. Upon ratification, the New Treaty will replace the existing Swiss/US income tax treaty of 1951. It is expected that the New Treaty will come into effect on 1 January 1998. Taxpayers may, however, elect to be treated according to the provisions of the 1951 treaty for one year following the effective date of the New Treaty *[Article 29(3) New Treaty]*.

Limitation on benefits agreed — Similar to all recent international tax treaties concluded by the US since the revised US/German income tax treaty of 29

continued overleaf

THIS MONTH

Tax Treaties
New Swiss/US pact sets strict LOB clause 1

Transfer Pricing
New Zealand's new regime in practice 7

Expatriate Taxation 9
Canada and the US decide to get tough

Tax Bookshelf 10
Conference Calendar 11
World Summary 12
Next month in ITR 12

PROFESSIONAL INFORMATION PUBLISHING

August 1989, the New Treaty contains a comprehensive "Limitation on Benefits" ("LOB") clause *[Article 22]*. The LOB clause reflects the general policy of the US Congress and Treasury Department to combat the abuse of US international tax treaties (*ie* "treaty shopping") by the enactment of various "anti-conduit" provisions in US domestic tax law as well as the inclusion of LOB clauses in its international tax treaties.

Once the regime of the LOB clause of the New Treaty is fully applicable, Switzerland will in relation to the US no longer apply its unilateral anti-treaty shopping rules contained in the Federal Council's Decree of 14 December 1962 on Measures Against Improper Use of Tax Conventions Concluded by the Swiss Confederation.

Entitlement to treaty benefits

Residents — Generally, treaty benefits may be claimed by persons who are resident of one or both of the contracting states. "Resident" is principally any person (individuals, partnerships, companies, estates, trusts, other bodies of persons — see Article 3(1)(a) New Treaty) who, under the laws of the respective contracting state, is liable to tax there by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature *[Article 4(1)(a)]*.

For the purposes of the New Treaty, individuals are regarded to be resident in Switzerland only if they are subject to the generally imposed income taxes in Switzerland with respect to all income from US sources. Hence, those individuals who have elected for a general expense-based lump-sum taxation ("*Pauschalbesteuerung*") in Switzerland are for Swiss domestic tax purposes treated as residents, but not for the purposes of the New Treaty. Such individuals may, however, elect to be taxed under a "modified lump-sum" taxation regime with inclusion of all US source income in their tax base in order to obtain resident status and entitlement to the New Treaty.

Additional conditions for companies — Much more significant conditions for the entitlement to the treaty benefits are set forth in the LOB clause of Article 22 of the New Treaty.Pursuant to that Article, an entitlement to treaty benefits *without any restrictions* is provided for:

- individuals residing in one of the contracting states (except for those Swiss taxpayers who elect for the general lump-sum taxation regime); and
- the contracting states themselves, including their political subdivisions, local authorities, agencies or instrumentalities.

Resident persons other than individuals and governmental bodies (*ie* companies and other private legal entities) must, however, meet *additional conditions* in order to qualify for benefits of the New Treaty under Article 22. They have to qualify under at least one of four different tests in order to be eligible for treaty benefits, namely:

— the predominant interest test;

— the stock exchange test;

— the headquarters company test; or

— the active trade or business test.

The rationale of the LOB clause is to deny treaty benefits to those companies which choose their registered office and tax residence in either contracting state primarily for tax reasons, ie in order to secure themselves treaty benefits, rather than for "genuine" (non-tax) business reasons. Therefore, companies resident in one of the contracting states claiming a relief from taxes imposed by the other contracting state under the New Treaty must show a sufficient economic connection with the contracting state in which they are resident.

Further limitation tests — In addition to these general tests, Article 22 provides for further limitation tests to be met by Swiss family foundations [*Article 22(1)(b)*] as well as pension funds and charities [*Article 22(2)*].

Furthermore, Article 22(3) provides for a limited entitlement to treaty relief in relation to withholding taxes on dividends, interest and royalties for certain private companies that do not meet any of the four general tests mentioned *above*.

Article 22(4) contains a special limitation clause for "triangular" situations where companies resident in one of the contracting states derive treaty-protected income from sources in the other contracting state through a permanent establishment located in a third country.

Discretionary relief — Article 22(6) of the New Treaty reserves the possibility to grant "discretionary" treaty relief even to those persons or companies which would otherwise be excluded from treaty entitlement under the various tests of the foregoing paragraphs, if in a specific case, the competent Swiss and US authorities reach a mutual agreement to that effect.

No overriding of US anti-conduit rules — Finally, it must be noted that the New Treaty — and specifically the LOB clause — do *not* override the US domestic "anti-conduit" rules as set forth in US Treasury Regulations 1.881-3 and 1.881-4. Under these rules, the Internal Revenue Service ("IRS") may, under certain conditions, collapse related "financing transactions" into one recharacterized financing transaction, which may result in a non-recognition of the existence of an interposed entity.

Thus, it is possible that a Swiss resident, although qualifying for the benefits under the New Treaty, is ignored as an interposed person or entity under the US anti-conduit regulations — with the result that the US may levy tax on a transaction without regard to the protection which the interposed Swiss resident would be entitled to under the NewTreaty.

Qualification tests for companies

As noted *above*, companies — any body corporate or any entity that is treated as a body corporate for tax purposes under the laws of the contracting state in which it is organized [*Article 3(1)(b)*] — that are resident in one of the contracting states may benefit from relief under the New Treaty if they meet *at least one* of the four tests discussed *below*.

1. Predominant interest test:

Companies that are resident of a contracting state may claim benefits under the New Treaty, unless they are *predominantly controlled or beneficially owned* by persons who are themselves not entitled to treaty benefits as individuals, a contracting state or political subdivision thereof, headquarters companies (see *below*), companies meeting the stock exchange test (see *below*), or qualifying Swiss family foundations (see *below*).

A shareholder who qualifies for treaty benefits only under the active trade or business test (see *below*) is not a "good" shareholder for the purposes of the predominant interest test.

A disqualifying predominant interest in a company, in the aggregate, by persons who are not themselves entitled to the New Treaty, essentially means a capital interest of such persons of *more than 50%*. Thus, if the capital interest in the company of persons who are not entitled to the New Treaty amounts, in the aggregate, to exactly 50%, this fact should not as such disqualify the company from treaty benefits. However, the predominant control over, or beneficial ownership in, a company does not necessarily have to result from the control over the capital, but may also be the result of any other contractual relationship which crystallize in payments to nonresidents that reduce the company's taxable net income (such as interest, royalties, salaries, management fees, etc) — excluding, however, payments under purchase and sale or services contracts that are: a) entered into in the course of the company's ordinary business; and b) made at fair market conditions.

2. Stock exchange test:

Companies whose principal class of shares is "primarily andregularly traded" on a recognized Swiss or US stock exchange (including any Swiss stock exchange on which registered dealings in shares take place, the NASDAQ System and any exchange registered with the US Securities and Exchange Commission), or on the stock exchanges of London, Tokyo, Frankfurt, Paris, Milan, Amsterdam, Madrid or Vienna, or on another stock exchange pursuant to mutual agreement between the competent authorities of the US and Switzerland, are entitled to benefits under the New Treaty.

The stock exchange test may also be met by a company the stock of which is not traded on a recognized stock exchange, if a predominant interest (see definition above) in such company is ultimately and beneficially owned by one or more companies that meet the stock exchange test described above (ie "indirect stock exchange test").

NB: It is at this point still uncertain whether the indirect stock exchange test must be interpreted to require that the listed company or companies owning a predominant interest in the company claiming treaty benefits must themselves be resident of the same contracting state and be entitled to the New Treaty.

3. Headquarters company test:

A company meets the headquarters company test set forth in Article 22(1)(d) and (7)(b) if it is a recognized headquarters company for a multinational corporate group. In order to be a recognized headquarters company, the following further conditions must be met:

i) The headquarters company provides in its residence state a substantial portion of the overall supervision and administration of a group of companies, which may nclude, but cannot be principally, group financing;

ii) The multinational corporate group consists of corporations resident in, and engaged in an active business in, at least five countries (or five groupings of countries);

iii) The business activities carried on in each of the five countries (or five groupings of countries) generate at least 10% of the gross income of the group;

iv) The business activities carried on in any one country other than the residence country of the headquarters company generates less than half of the gross income of the group; and

v) The headquarters company's gross income derived from sources in the other contracting state does not exceed 25% of its total gross income.

The income tests under iii) iv) and v) *above* must be met either in a given year or for the average of the preceding four years.

Furthermore, the headquarters company needs to have and exercise *discretionary authority* to carry out its functions. It has to be subject to *generally*

applicable taxation rules in the state of which it is a resident (ie it cannot enjoy a Swiss cantonal tax privilege). And finally, the income derived from sources within the other contracting state must be earned in connection with, or be incidental to, the active business of the group.

4. Active trade or business test:

Under the active trade or business test set forth in Article 22(1)(c) of the New Treaty, a company is entitled to treaty benefits if it performs an active trade or business activity in the contracting state of which it is a resident. Mere holding or capital investment activities (eg, making, managing or holding investments for the company's own account, including the administration and management of group loans) for the company's own account are not considered "active" business, even if they were considered "active" if they were performed for the account of third parties.

The exclusion of capital investments, however, does not apply to banks, insurance companies and registered securities dealers who make such investments in the ordinary course of their business. Furthermore, if a company does perform an "active" trade or business activity, such as an active licensing or leasing business in addition to the investment activities (which, taken alone, would be considered "passive"), it is entitled to the benefits of the New Treaty under the activity test with respect to those items of income that are *connected with*, or *incidental to*, such active business.

NB: Treaty entitlement under the "active trade or business test" is limited to those items of income that are either derived in connection with, or are incidental to, the active trade or business. Hence, the test is applied separately to each item of income for which tax relief under the New Treaty is sought.

The criterion of "active conduct of a trade or business" is determined on the basis of all facts and circumstances. Not only manufacturing or trading activities, but also services may be considered "active" business. Generally, a "trade or business" includes any activities that constitute, or could constitute, an independent economic enterprise carried on for profit. The active conduct generally includes all activities necessary for such conduct, in particular, the regular performance of "active and substantial management and operational functions through its own officers or staff of employees". Activities carried out by independent contractors under the control of the company are disregarded for the purpose of the activity test.

Income is considered derived in connection with an active trade or business in a contracting state if the income-generating activity in the other contracting state is a line of business which forms part of, or is complementary to, the trade or business in the first-mentioned contracting state. Such trade or business in the first-mentioned contracting state may be conducted directly by the company claiming treaty benefits or indirectly through controlled affiliates that are resident in the same contracting state.

The active trade or business test needs to be met only by those companies which do not meet any other qualification test (ie the predominant interest test, the headquarters company test or the stock exchange test). As mentioned above, however, if treaty entitlement must be based upon the activity test only, the test must be applied separately with respect to every item of income for which treaty relief is sought. Hence, depending upon the circumstances, the activity test may be met in respect of certain items of income but not in respect of other items.

Substantiality requirement — For the purpose of the active trade or business test, an additional substantiality requirement applies in regard to *payments between related parties*. For these purposes, the recipient of an item of income is deemed to be related to the payor of the income if it owns, directly or indirectly, 10% or more of the shares or other comparable rights in the payor. Payments between related parties are considered to be *derived in connection with* the active trade or business carried on in the residence state only if the trade or business carried on in the state is substantial as compared to the activity performed in the other contracting state that gives right to the income for which treaty protection is claimed. The substantiality is considered by taking into account all facts and circumstances, such as the comparative sizes of the businesses in each contracting state measured by reference to asset values, income and payroll expenses, the nature of the activities carried on in each state, and in cases where a trade or business is conducted in both contracting states, the relative contributions made to that trade or business in each contracting state. The Protocol states that in making each determination or comparison, due regard will be given to the relative sizes of the US and Swiss economies.

The substantiality requirement is aimed at avoiding treaty shopping within a limited scope only, namely in those cases where a company tries to "construct" the otherwise lacking treaty entitlement by taking up a minimal business activity connected with the income for which it seeks treaty relief, whereby the cost and importance of the activity in relation to the company's main business are remote. The purpose of the substantiality requirement is the avoidance of obvious treaty abuses in connection with transactions between related parties.

Dividend, interest and royalty income

Limited treaty entitlement — Article 22(3) of the New Treaty provides for a limited treaty entitlement in respect of dividends, interest and royalties derived by those companies resident in a contracting state which do not meet any of the four tests provided under

Article 22(1) (active trade or business, stock exchange test, predominant interest, headquarters companies), if such companies meet all of the following three conditions (*ie* "limited derivative benefits/base reduction test"):

1. The 30% test:

More than 30% of the aggregate vote and value of all the shares of the company are ultimately and beneficially owned by persons that are resident in the same contracting state as the company and are individuals, a contracting state or political subdivisions thereof, qualified headquarters companies, companies meeting the stock exchange test or the predominant interest test, or qualifying family foundations *[see below]*. Companies that only meet the active trade or business test are not "suitable" shareholders for this purpose.

2. The 70% test:

At least 70% of the value and votes of such shares are ultimately and beneficially held by persons described in the paragraph *above* re the 30% test, or persons resident in member states of the European Union or the European Economic Area, or parties to the North American Free Trade Agreement. For the purpose of this test, a shareholder resident in a member country of the EU, the EEA or the NAFTA is taken into account only if such person:

- is a resident of a country with which the other contracting state has a comprehensive income tax convention and that person is entitled to all of the benefits provided by the other contracting state;
- would qualify for benefits under Article 22(1) New Treaty if that person were a resident of the same contracting state as the company and if references in Article 22(1) to such contracting state were references to that person's state of residence; and
- would be subject to a tax rate in the other contracting state under the tax treaty between that person's residence country and the other contracting state in respect of the particular class of income for which benefits are claimed under the New Treaty, ie is at least as low as the rate applicable under the New Treaty.

3. Base reduction test:

The amount of expenses deductible from gross income that are paid by the company for its preceding fiscal period (or, in the case of its first fiscal period, that period) to persons that would not qualify for benefits under New Treaty Article 22(1)(a) [individuals], (b) [contracting state, political subdivision], (d) [headquarters company], (e) [stock exchange test], (f) [predominant interest test], or (g) [qualifying family foundation] is *less than 50%* of the gross income of the company for that period.

The objective of the base reduction test is to prevent "conduit" companies from benefiting from the New Treaty — a similar approach is taken under the Swiss unilateral anti-treaty shopping Decree of 1962, which in relation to the US is overridden by the New Treaty.

Partnerships

Position and treatment — For the purposes of the New Treaty, a partnership is a "person", but not a "company". As a person, a partnership may qualify for treaty benefits. The status of partnerships under the LOB clause of Article 22 depends upon whether or not the partnership is treated as a resident for treaty purposes.

For the purposes of the New Treaty, a partnership is treated as a resident of a contracting state if and only to the extent that the income derived by the partnership is subject to tax in that state in the same manner as the income of a resident of that state, either in its (the partnership's) hands or in the hands of its partners *[Article 4(1)(d)]*. If a partnership is a resident of a contracting state for treaty purposes, it *must* meet the conditions of the active trade or business test *(see above)* in order to be eligible for the benefits of the New Treaty — even if all of the beneficial ownership interests in the partnership are held by Swiss or US residents or Swiss or US stock exchange-listed companies.

If the partnership is not a resident of a contracting state for the purposes of the New Treaty, then the partnership itself cannot qualify for treaty benefits. In this case, the tests of Article 22 are exclusively applied to the partners (to the extent the partners are Swiss or US residents for treaty purposes).

Income from third-country branches

"Triangular" situations — Article 22(4) New Treaty deals with so-called "triangular" situations in which a resident of a contracting state derives income from sources in the other contracting state through a *permanent establishment* (*eg*, a branch) in a third country. In such triangular situations, no treaty relief is granted by the source state of an income payment, unless the combined tax that is actually paid on such income by the recipient in its residence state and in the third country corresponds to *at least 60%* of the tax that would have been payable in the residence state if the income were earned in that state and were not attributable to the permanent establishment in the third country.

The limitation on treaty benefits with respect to income that is attributable to a permanent establishment in a third country, however, *does not* apply in respect to:

- royalties that are received as compensation for the use of, or the right to use, intangible property

produced or developed by the permanent establishment itself; or

- any other income derived from sources in the other contracting state in connection with, or incidental to, the active conduct of a trade or business (excluding mere investment holding activities, unless carried on by banks, insurance companies or registered securities dealers) carried on by the permanent establishment in the third country.

To the extent that the limitation on treaty benefits is effective in respect of income attributable to a permanent establishment in a third country, the source state may levy taxes with respect to such income in accordance with its domestic tax laws.

Limited treaty relief — A limited treaty relief, however, is granted in triangular cases in respect of dividends, interest and royalties. The New Treaty provides for a rate of tax in the source state not exceeding 15%. Note, however, that to the extent the US may impose such a 15% tax on US-source dividends, interest or royalties attributable to a permanent establishment maintained by the Swiss-resident recipient in a third country, Switzerland does not grant any credit for such US tax to the Swiss income tax (if any) payable with respect to such income. The amount of US tax paid is only deductible from the Swiss tax base.

Family foundations

Treaty entitlement — According to the provisions contained in Article 22(1)(g) New Treaty, Swiss resident family foundations may claim treaty benefits in respect to US-source income if the following two conditions are cumulatively met:

1. The founder, as well as *at least half* of the beneficiaries, are individuals resident in the US or Switzerland (excluding Swiss resident individuals who elect for general lump-sum taxation); and

2. *less than 50%* of the income of the family foundation is used to benefit persons who are not individuals resident in the US or in Switzerland.

Trusts and estates

Treaty entitlement — As with partnerships, trusts and estates are *persons* but not companies for the purposes of the New Treaty. By definition under Article 4(1)(d), a trust or estate is a *resident* of a contracting state to the extent that the income derived by such trust or estate is subject to tax in that state in the same manner as the income of a resident of that state, either in the hands of the trust or estate or in the hands of beneficiaries.

A trust or estate which is regarded as a resident of a contracting state must meet the *predominant interest test* set forth in Article 22(1)(f) New Treaty *[see above]* in order to qualify for treaty benefits.

Charities, pension funds, exempt organizations

Treaty entitlement — Certain tax-exempt pension funds and pension trusts, as well as certain tax-exempt non-profit organizations established and maintained in either contracting state for religious, charitable, educational, scientific, cultural or other purposes are treated as residents for the purposes of the New Treaty *[Article 4(1)(c)]*. These organizations may claim treaty benefits under the condition set forth in Article 22(2) New Treaty that *at least half* of the beneficiaries, members or participants, if any, in such organization are persons entitled to treaty benefits under Article 22.

Discretionary treaty relief

US expected to restrict — Article 22(6) New Treaty provides for the possibility that, based upon a mutual agreement procedure between the competent authorities of the two contracting states, a person who does not qualify for treaty benefits under the various tests of the LOB clause may, nevertheless, be granted the benefits of the New Treaty. It is expected, however, that the US will take a rather restrictive approach in agreeing to discretionary treaty benefits.

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TRANSFER PRICING

New Zealand joins the club with a new regime

*This is the final article in a 3-part series examining recent changes to New Zealand's international tax regime. Articles in the two previous issues discussed the foreign investor tax credit regime and the new thin capitalization rules. Here in this concluding article in the series, **Colin DeFreyne**, a Tax Principal in **Ernst & Young's Auckland office**, looks at the third major regime to be introduced in the package of international tax reforms — the transfer pricing regime.*

As readers of the previous articles in this series will be aware, New Zealand has recently enacted a raft of international tax reforms. The three pillars on which the reforms have been built are 1) the extended foreign investor tax credit ("FITC") regime *[see ITR October 1996, p5]*, 2) a comprehensive thin capitalization regime *[see ITR November 1996, p6]*,