Changing Residence as Tax Planning

V Congresso Brasileiro de Direito Tributario Internacional
Instituto Brasileiro de Direito Tributario
Sao Paulo 3-4 Outubro 2013

Prof. Dr. Juan Zornoza
Universidad Carlos III de Madrid
zornoza@der-pu.uc3m.es

Outline

- Some remarks on residence as connecting factor for the allocation of taxing power.
- Arbitrages and tax planning through tax residence:
  - Asymmetries regarding the tax residence definition by domestic tax laws in different countries.
  - Case law and the debate about tax exile and transfer of residence.
- Defensive measures: tax residence enlargement and exit/expatriation taxes.
- Conclusions.

Residence as connecting factor

- Reasons to use residence as connecting factor: economic allegiance (benefit principle) and ability to pay.
- The different treatment of the basis of residence in domestic legislation:
  - Individuals: permanence test, CVI test, domicile or disposal of a habitual abode, etc.
  - Companies: place of incorporation, legal seat, place of effective management.
- Double tax residence as a consequence of the asymmetry in the definition of residence.

Residence as...

- Residence in tax treaties (Art. 4.1 OECD and UN MTC):
  - Is not defined by the circumstances which determines it, that should be established by the domestic law.
  - But by the effect it produces, i.e. the liability to tax on a worldwide basis.
- Residence definition in tax treaties does not avoid double tax residence, but gives criteria to solve it (tiebreaker rules).

Residence as…

- A valuation of residence as connecting factor: the concept of residence should be…
  - Equitable: it is necessary to consider circumstances that link the taxpayer with the state with which maintains the stronger attachment from the benefits principle perspective.
  - Administrable: residence for individuals is a relatively easy concept, but for companies is quite complicated to specify criteria that could be properly managed.
  - Difficult to manipulate, so that residence cannot be easily given up in one country and established in another: the problem of the formal criteria.

Tax planning throuh residence

- The interaction between independent sets of tax residence rules and the "electivity" of residence.
- Differences among:
  - Individuals: residence as a given fact and tax planning through the transfer of residence and reallocation of assets.
  - Companies: residence "electivity" as a tool for tax planning (election of the place of incorporation and legal seat, structure of the company and branch, etc.).

Tax planning… Individuals

- Transfer of residence should not be a sham, but a real one: tax authorities are very actives on that (B. Becker moves to Monaco).
  - If it is to a tax haven changes on the burden of the proof (Sánchez-Vicario transfer to Andorra).
  - To other low tax jurisdiction (and there are many): is legally indisputable, even if are strongly rejected by the public opinion (Frenchs tax exiled; Depardieu Case).
  - Due to non tax consequences and implications make sense only for some taxpayers: sportsman and artist.
  - Or for some kind of taxes: wealth and inheritance tax implications (even if normally follows the concept of residence for Income Tax purposes).

Tax planning… Individuals II

- Transfer of residence and the need for a proper restructuring on the individual assets.
  - The risk of double residence if an available permanent home and sources of income remain in the emigration country.
  - Uncertainty about the tiebreaker rules, because CVI is an open and vague concept.
- Other alternatives to minimize individuals tax burden:
  - Reallocation of assets in other jurisdiction.
  - Use of foreign entities if CFC rules do not affect individuals.

Tax planning… Individuals III

- Other alternatives…:
  - Special regimes designed to attract mobile skilled labour: taxation of internal sources of income, with foreign source income
    - Exempt during the firs years of residence if comes from a country with DTC in force and the income is taxable there.
    - Taxed on a remittance basis (non-doms regimes
    - But there are some concerns:
      - About potential conflicts of dual residence.
      - About his consideration as resident for tax treaty purposes

Tax planning… Companies

- Election of the place of incorporation and legal seat: a non-tax oriented decision that could be influenced for tax reasons.
  - A consequence of tax competition and the heterogeneous, asymmetric domestic law criteria to define the corporate residence.
  - Which has lead to well know schemes (special purpose entities like conduit or base companies, holding companies, etc.).
  - Incorporation or legal seat on a tax haven: an option far from optimal considering the existence of preferential regimes in many OECD countries

Tax planning… Companies II

➢Decentralized structure of MNEs and lost of relevance of the place of incorporation:

- ➢Detaching the place of incorporation or legal seats from financial centers, cash pooling centers, centers for R&D activities, etc. with different places of incorporation.
- ➢A company can be incorporated in a high tax jurisdiction, achieving a low effective tax rate on the income received from its branches.
- ➢The so-called “low taxed branches", as a central tool for tax planning (Amazon, Google and Starbuck cases).
- ➢The only requirement is to locate the parent company in a country with an exemption regime for foreing branches income.

Tax planning… Companies III

- The interplay between different circumstances to define residence and dual residence of companies.
  - Difficulties on the application of the place of effective management as tiebreaker rule.
  - Use of double residence schemes for tax planning purposes:
    - In order to benefit of dual consolidated loss transactions: the traditional DRC scheme in US-UK and its extension.
    - For the access to a (more beneficial) treaty network in the secondary residence country.

Tax planning… Companies IV

- The dual non residence of companies as the other side of the dual residence.
  - Dealing with different circumstances in order to obtain a dual non residence: the unexpected consequences of the interplay between residence definitions in Ireland an the US in the Apple Inc. case.
- Transfer of residence and tax-planning strategies:
  - Companies moving from one country to another and the measures to counteract this practices.
  - Business restructuring in order to change residence: access to a new residence through mergers (Fiat Industrial moving to UK after its merger with CNH Global N.V.).

Tackling tax planning throug residence

- Traditional methods to curb treaty shopping: the LOB rules and its extension through the commentary.
- Specific rules designed to curb tax oriented transfer of residence: extended tax liabilities and exit taxes.
- Extension of residence by emigration countries:
  - Differences among countries in its scope (tax haven or any country?) but always for citizens.
  - Deemed resident (*iruris et de iure* presumtion) or reversal of the burden of the proof.
  - The period for extended tax liability (Falcao case).

UNIVERSIDAD CARLOS III DE MADRID

Tackling tax planning… II

- Extension of residence deserves some criticism:
  - Which pieces of evidence should provide the taxpayer: the role of certificate of residence, and the risk of tax discrimination from DTC perspective.
  - Compatibility with DTC: a tax on nationality that will result in a dual residence conflict.
  - Even if the DTC permits the extension, it will give rise to double taxation: which state has to give relief (specially for income from thid countries)?
  - Administrative issues: the need for cooperation.

Tackling tax planning… III

- Expatriation or Exit taxes: a category with many different kind of taxes.
  - The pay as you go system: accelerating the payment of tax liabilities imposing an advance assessment and the obligation to pay all taxes due for the year of departure.
  - General and limited (on certain capital gains, normally derived from shares and securities) exit taxes.
- Exit taxes as a tool for taxation of income that could not be taxed after the change of residence, because of the domestic non-resident tax regimes or tax treaty provisions.

Tackling tax planning… IV

- The justification for exit taxes as a guidance for its design:
  - Should be aimed at taxing gains that accrued while the person was resident in the country of emigration.
  - Should not be apply for latent capital gains in assets which remain at the emigration country.
  - No immediate taxation of unrealized gains should be allowed if, in the domestic scenario, the country of emigration does not tax the gains.
  - It is doubtful whether or not the country of emigration should take into account decreases in the value of the assets after the emigration (as suggested by ECJ in *N)*.

Tackling tax planning… V

- The problems with exit taxes:
  - Valuation rules are critical because the non existence of a real transaction.
  - As are established on the grounds of a legislative fiction, exit taxes lay on non-realized capital gains.
    - The discussion about taxation on non-realized incomes and ability to pay principle:
      - Liquidity issues are not convincing (tax deferrals or payments plans)
      - The valuation problem: exit tax could result in the assessment of a capital gain that never exist.

Tackling tax planning… VI

- The problems …:
  - Its compatibility with tax treaties is controversial:
    - Neither the OECD MC, nor the UN MC contain a specific provision on exit or expatriation taxes.
    - Emigration countries believe that the introduction of exit taxes does not constitute a treaty override: but their argument are not convincing.
    - Exit taxes seems to be contrary to the tax treaties allocation of taxing rights on capital gains, even after considering Para. 7 on Art. 13 OECD MC, an the broad interpretation of "alienation”.
  - Exit taxes creates double taxation, or even triple when the relevant assets are located in a third country.

Conclusions

- The interplay between diverse criteria employed by domestic laws to define residence may generate arbitrage and tax planning possibilities encouraged by countries' tax competition practices.
- The use of SAARs or even GAARs to tackle this practice give rise to uncertainty and creates new possibilities for tax planning.
- Defensive measures in domestic law are controversial from tax treaties point of view.
- It's surprising that the awareness of these problems has not prompted a reflection on the concept of residence.

Conclusions II

- Residence should continue as a connecting factor, but the criteria for its determination do not seem appropriate: a reconsideration is needed.
- The frequency with which changes occur in the Commentaries to MC contrasts with the unvarying nature of their texts, which:
  - Reflect outdated income tax categories, typical of ancient impersonal taxes.
  - Are not useful for the treatment of international economic transactions such as hybrid financial products, hybrid entities, etc.
- More cooperation is needed, but one can wonder if it is an adequate solution or harmonization is required.