HOW NOT TO BORROW A TREATY: *SMITH V. COMMR.*

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Tags
B.E.P.S. Action 6
Limitation on Benefits
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BACKGROUND

On a fully distributed basis, profits of a corporation are taxed twice. First, profits are taxed at the corporate level.[1] They are taxed again as after-tax earnings & profits are paid out in the form of dividends. Double taxation applies whether the corporation distributing the dividend is a domestic corporation or a foreign corporation. To alleviate the problem, Code §1(h)(11) taxes "qualified dividend income" at the beneficial long-term capital gains rates of 20%. For a dividend from a domestic corporation, this results in overall Federal taxation of 36.8% on a fully distributed basis.[2] For earnings generated by a foreign corporation in a low-tax jurisdiction, this can be even more attractive if Code §1(h)(11) is applicable. If not applicable, the tax on dividends received from a foreign corporation can be quite high, as the top rate of tax on ordinary income is 37%. That rate also applies to income that is taxed under the all U.S. anti-deferral rules such as Subpart F, the Global Intangible Low-Taxed Income ("G.I.L.T.I."), and the Passive Foreign Investment Company ("P.F.I.C.") rules, all of which are beyond the scope of this article.

QUALIFIED FOREIGN CORPORATION

Code §1(h)(11)(C) provides qualified dividend income treatment to dividends received from a foreign corporation that is treated as a "qualified foreign corporation." A qualified foreign corporation ("Q.F.C.") is a foreign corporation that meets one of two tests:[3]

- The corporation is organized in a U.S. possession.
- The corporation is eligible for benefits of a comprehensive tax treaty with the U.S. that contains an exchange of information provision, and which the I.R.S. determines is satisfactory for these purposes.

A foreign corporation cannot be a Q.F.C. if it is, or was during the preceding taxable year, a P.F.I.C., unless the P.F.I.C. status is ignored because the corporation is also a controlled foreign corporation ("C.F.C.").

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[1] Current U.S. Federal corporate tax rate is 21%.

[2] Does not take into account 3.8% Net Investment Income Tax. Compare with the current maximum individual Federal income tax rate of 37%.

[3] A separate rule provides that dividend from a foreign corporation which is not treated as a Q.F.C. will equally benefit from the reduced rate of taxation if the shares of stock are regularly tradable on an established securities market in the U.S.

I.R.S. Notice 2011-64[4] provides a list of treaties that satisfy the exchange of information requirement, and provides that a foreign corporation is considered eligible for benefits of a U.S. income tax treaty listed in the notice if

- the foreign corporation is a resident of the treaty country, within the meaning of such term under the relevant treaty, and
- the foreign corporation satisfies any other requirements of that treaty, including the requirements under any applicable limitation on benefits ("L.O.B.") provision.

The determination of a foreign entity's status as a foreign corporation for purposes of Code §1(h)(11)(C) is made under U.S. rules.[5] Thus, a foreign entity that would be treated as a partnership under U.S. rules but that made an entity classification election to be taxed as a corporation under the rules of Treas. Reg. §301.7701-3 is treated as a foreign corporation for these purposes.[6]

TREATY RESIDENCE AND ELIGIBILTY FOR TREATY BENEFITS

The determination of whether a foreign corporation is a resident of the foreign country within the meaning of the treaty with such country is made under foreign law without regard to U.S. classification.[7] The determination of whether a foreign corporation meets the limitation on benefits provision of a treaty for purposes of Code §1(h)(11)(C) is made under the same standard that is applied for allowing treaty benefits to reduce withholding tax on U.S. source income under Code §894. In other words, a foreign corporation would be Q.F.C. only if it is treated as a taxable entity in its country of residence and is eligible for treaty benefits under the applicable L.O.B. provision.

L.O.B. provisions in U.S. income tax treaties generally provide foreign corporations with qualifying status based on meeting one of several alternative tests:

- The company issued shares that are publicly traded or is owned by a company that issued publicly traded shares.[8]
- The company meets an ownership and base erosion test.[9]

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[4] Notice 2011-64, 2011-37 IRB 231, 08/18/2011.

[5] P.L.R. 200752029 published 12/28/2007.

[6] *Id.*, where the I.R.S. concluded that a Fund that was an unincorporated, open-ended, limited purpose trust established under the laws of a foreign jurisdiction is treated as a foreign corporation for purposes of Code §1(h)(11)(C) because it was an "eligible entity" that made a proper entity classification election to be treated as an association for U.S. tax purposes.

[7] *Id.*, where the I.R.S. ruled that the residence and limitation on benefits articles of the Treaty are applied to the Fund, a Country A entity, without regard to the Fund's entity classification for U.S. tax purposes.

[8] 2016 U.S. Model Treaty, Article 22(2)(c) and (d).

[9] 2016 U.S. Model Treaty, Article 22(2)(f).

- The company conducts an active business in the country of residence.[10]
- The company meets a derivative benefits test.[11]

The L.O.B. provision in the income tax treaty between Cyprus and the U.S. (the "Cyprus Treaty") differs from its counterparts in most other treaties. The L.O.B. Article of the Cyprus Treaty provides for two alternative tests, of which one must be met for a Cypriot company to be eligible for treaty benefits.[12] Under the first, more than 75% of the number of shares of each class of the corporation's shares must be owned, directly or indirectly, by one or more individual residents of Cyprus and certain base erosion tests must be met at the same time.[13] Under the second test, the establishment, acquisition and maintenance of the corporation and the conduct of its operations do not have as a principal purpose obtaining benefits under the Cyprus Treaty.[14]

In an I.R.S. legal memorandum ("I.L.M.") issued in 2013, the I.R.S. determined that a Cypriot company was a Q.F.C.[15] In the facts of the 2013 I.L.M., the Cypriot company was a holding company that never earned U.S. source income or claimed treaty benefits under the Cyprus Treaty. The I.R.S. did not challenge the status of the company as a resident. Rather, it focused on the principal purpose test in the L.O.B. of the Cyprus Treaty. The I.R.S. concluded that the company was a Q.F.C. because it was not set up for the purpose of obtaining tax treaty benefits. In support of that conclusion, the I.R.S. looked to the Treasury Department Technical Explanation ("T.E.") for the L.O.B. provision in the Cyprus Treaty and concluded that the company was established in Cyprus, and was being maintained there, for reasons unrelated to the Treaty. Hence, obtaining benefits under the Treaty was not a principal purpose of its formation and existence. Consequently, it was eligible for benefits under the L.O.B. provision of the Cyprus Treaty. A similar conclusion was reached in a C.C.A. issued shortly after the I.L.M.[16] Again, the I.R.S. did not address the residence issue, only the principal purpose issue.

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Notwithstanding the I.L.M. and the C.C.A., the I.R.S. challenged a taxpayer's assertion that a Cypriot company was Q.F.C. because the company was considered to be a resident of Cyprus under Cypriot tax law and the principal purpose test was met. In *Smith v. Commr.*,[17] the Court ruled that the residency certificate issued by the Cyprus Ministry of Finance was not sufficient to establish residence and that the facts and circumstances did not support the taxpayer's assertion of residence. Having determined that the Cypriot company was not a resident of Cyprus, the Court did not address the application of the L.O.B. test.

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[10] 2016 U.S. Model Treaty, Article 22(3).

[11] 2016 U.S. Model Treaty, Article 22(4).

[12] Income Tax Treaty between the U.S. and Cyprus, Article 26.

[13] Article 26(1) of the U.S. – Cyprus Treaty.

[14] Article 26(2) of the U.S. – Cyprus Treaty.

[15] I.R.S. Legal Memorandum Number 201343019 dated 09/10/2013.

[16] Chief Counsel Advice 201343019, 11/01/2013.

[17] *Smith v. Commr.*, 151 T.C. 41, 09/18/2018.

In the facts of the case, a U.S. married couple owned and operated a group of domestic and foreign corporations that manufactured and sold consumer electronic products. Through grantor trusts and an S-corporation ("Hopper U.S."), they owned the issued and outstanding shares of stock of a corporation in Hong Kong ("Memcorp H.K."). Memcorp H.K. was an operating company from its inception in 1995. In 2007, the taxpayers began winding down their active business operations, and sold the operating assets of Hopper U.S. and Memcorp H.K. to a third party for $47.5 million. The U.S. and Hong Kong have no income tax treaty in effect. Consequently, the taxpayers adopted a plan in 2008 to move Memcorp H.K. to Cyprus. Upon completion of that step, a newly formed Cypriot company held all the assets and liabilities of Memcorp H.K. and a dividend was paid to its shareholders in the U.S. The dividend was paid in 2009, shortly after a residency certificate was issued by the Cypriot tax authority, although it is not clear from the pleadings that the certificate was actually issued at that time or seven years later. The shareholders were U.S. citizens and they reported the dividend on the tax return as a qualified dividend.

The I.R.S. examined the tax return for 2009 and challenged the taxpayer's treatment of the dividend as a qualified dividend. The Tax Court agreed. The Court explained that for Cyprus company to be a Q.F.C. two tests must be met. First, it must have been a resident of Cyprus under the Cyprus Treaty at the time the dividend was distributed to the taxpayer. Second, its establishment and operation must not have had, "as a principal purpose," the obtaining of benefits under the Cyprus Treaty.

For purpose of the residency test, the taxpayers obtained a certificate of residency from Cyprus and argued that this certificate, should be viewed as binding under the act of state doctrine. The I.R.S. challenged residency status. To that end, it initiated exchange of information proceedings with the Cypriot tax authority to learn the facts surrounding the issuance of the certificate of residency. The information received from the Cypriot tax authority indicated that the certificate was issued five days after the application was filed. It consisted of a series of unsubstantiated representations by the company's director, who checked "yes" boxes on the application form. There was no evidence that the Cypriot tax authority verified any of the applicant's factual representations.

In the circumstances, the Court agreed that a residency certificate is relevant, and to the extent it is based on sound reasoning and accurate factual representations, it will be accorded appropriate weight. In view of all facts and inferences presented by the I.R.S., not much weight was given to the certificate. Its ultimate conclusion was that the Cypriot company was not a resident of Cyprus for purposes of the Cyprus Treaty because, under local law, this requires management and control to be exercised in Cyprus, and this company did not provide any evidence of having any connections with Cyprus. Because the first requirement for Q.F.C. status was not met, the Tax Court did not address the principal purpose test.

B.E.P.S.? AND SUMMARY

Several questions are raised by the *Smith v. Commr.* How does borrowing a U.S. treaty sit with B.E.P.S.? Is it simply a holding that is proper for its time? Does *Smith v. Commr.* represent a changing point in the I.R.S. position with respect to borrowing a treaty for purposes of the qualified dividend provision?

Action 6 of the O.E.C.D. B.E.P.S. Action Plan published in 2013 has been widely implemented in Europe. Action 6 deals with prevention of treaty shopping and the granting of treaty benefits in inappropriate circumstances. It introduced the principal purpose test ("P.P.T.") as an add-on to the L.O.B. provisions that were not included in most income tax treaties then in effect. The P.P.T. prevents treaty benefits from applying if one of the principal purposes of any arrangement is obtaining benefits under a treaty. The U.S. generally meets the Action 6 standards as U.S. treaties include an L.O.B. provision, which was used as a model when B.E.P.S. policies were formulated. The U.S. has not otherwise adopted Action 6 and has not imposed a separate P.P.T. rule. Additionally, as mentioned above, in the absence of claiming treaty benefits, borrowing a treaty for purposes of qualified dividend income should not be viewed as treaty shopping and thus does not contradict B.E.P.S. as a matter of law.

In addition, while *Smith* represents a case where qualified dividend treatment was not granted, the facts involved were blatantly bad. The Cypriot company was incorporated until the business operations in Hong Kong ceased and the assets were sold. The company never filed Cypriot tax returns until it applied for the certificate of residency seven years after incorporation after it sought confirmation that it was a resident of Cyprus in 2016. At some point between 2009 and 2016, it was stricken from the Cypriot registry of companies for failure to file tax returns and submit annual reports to the Cypriot Registrar of Companies.

Even in this fact pattern, the I.R.S. never argued that the borrowing of a treaty for purposes of Code §1(h)(11) was a tainted purpose which fails the "principal purpose" test. The Court decided that a residency certificate is not granted a dispositive effect as an "act of state." No other credible evidence was introduced to substantiate the status of the company as a resident of Cyprus under Cypriot law, which requires showing that the management and control of the company were exercised in Cyprus. Consequently, it agreed with the I.R.S. that the company was not a Q.F.C.

"Following Smith, one can expect an I.R.S. examination to demand more than a residency certificate as a proof of residence in a treaty country for purposes of obtaining benefits under Code §1(h)(11)(C)."

Following *Smith*, one can expect an I.R.S. examination to demand more than a residency certificate as a proof of residence in a treaty country for purposes of obtaining benefits under Code §1(h)(11)(C). Also, one can expect the I.R.S. to engage in consultation and information exchanges between the U.S. competent authority and the competent authority of the treaty country to learn the facts surrounding a request for, and the country's issuance of, certificates of residency in that country. However, *Smith* should not be read more broadly. Interestingly, in a post-B.E.P.S. world, Cypriot corporate and professional advisers are acutely aware that more than a piece of paper from a tax office will suffice for a company to be treated as a resident for income tax purposes. Indeed, it is not likely that reputable Cypriot advisers or the Cypriot tax authority would allow the facts in the case to exist today.

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