IOTA PAPER

2022 NOVEMBER

ASSESSING A CASE OF DIVIDEND TAX AVOIDANCE AS GOOD PRACTICE

Martynas Endrijaitis

Deputy Head

State Tax Inspectorate
under the Ministry of Finance of the
Republic of Lithuania

IOTA
Intra-European Organisation
of Tax Administrations

Recent discussions have increasingly focused on the practicality of applying anti-avoidance provisions of corporate income tax to potential tax avoidance cases. This article follows a case of good practice in Lithuania.

Dividend tax anti-avoidance rule

Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (hereinafter referred to as “Council Directive 2011/96/EU”) establishes rules aimed at avoiding situations of double taxation of the profits of companies operating in more than one Member State under the objective to exempt dividends and other profit distributions paid by subsidiary companies to their parent companies from withholding taxes and to eliminate double taxation of such income at the level of the parent company.

Nevertheless, the international tax practice faced concerns about the potential exploitative use of the Council Directive 2011/96/EU benefits and the differences and loopholes in national tax systems to abuse the dividend exemption rules, leading to the adoption of Council Directive (EU) 2015/121 of 27 January 2015 amending Council Directive 2011/96/EU, aimed to ensure that the Council Directive 2011/96/EU provisions on dividend exemptions from corporation tax are not to be misused. This provision in the Directive derives from the recommendations of the Organization for Economic Co-operation and Development.

International discussions have repeatedly highlighted the lack of clarity on how the dividend anti-avoidance rule applies in practice in real-life circumstances. Therefore, the following article shares a case of good practice in Lithuania on how this rule has been applied in use. The dividend anti-avoidance rule states that the provisions on the exemption of dividends received from or paid to foreign companies do not apply to a derivative or multiple derivatives if the main purpose or one of the main purposes of their establishment was to obtain a tax advantage contrary to the Council Directive 2011/96/EU provisions on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, and are therefore fraudulent having regard to all the relevant facts and circumstances. A derivative transaction may involve more than one stage or part. A derivative or multiple derivatives are treated as fraudulent to the extent that they have not been established for valid commercial reasons reflective of economic realities.

Practical example

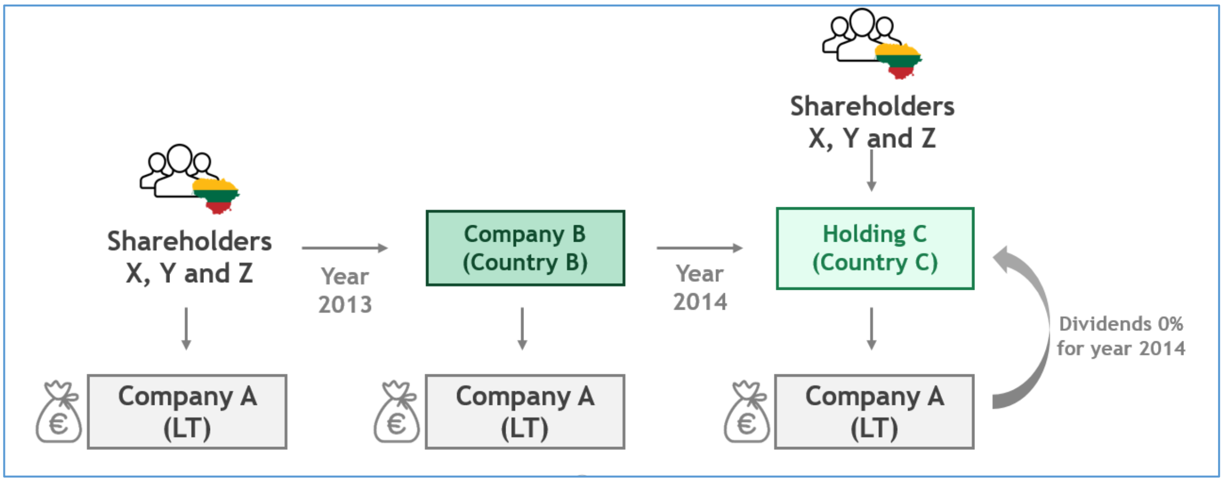
The facts of the situation were as follows: in 2013, by means of a share purchase agreement, the shareholders of Lithuanian company A (natural persons X, Y and Z) sold 55% of the shares of company A to a company B registered in the Country B for EUR 900,000. Subsequently, company B settled for the company's A shares by means of a bank wire transfer from the bank account of a credit institution established in another country which is known for its well-developed offshore financial services sector.

Company B was established in 2013 under an address where more than 350 other companies are registered, however, it has been in liquidation since autumn 2014. At the end of 2014, company B sold all its shares of company A to a holding C established in the Country C for the same amount of EUR 900,000 by means of a share purchase agreement. Holding C paid for the shares EUR 100,000, which were lent to it by one of the main shareholders, natural person X, by means of a loan agreement without interest. At the end of 2015, holding C owed company B EUR 800,000 for the purchase of company's A shares, and there have been no indications of any attempt to settle this debt.

Other relevant facts include evidence that holding C was established at the end of 2014 and its shareholders were the same natural persons X, Y and Z. Holding C was represented (managed) by the same natural person X, one of the shareholders.

Holding C did not have any actual (economic, business) activity during the period in question, and it had no human resources or other resources to operate and develop its activities. Company A did not deny these facts in principle, stating that holding C acted as a passive holding company, which did not need the resources in question. An important circumstance is that in 2016 company A paid dividends to holding C for year 2014 which have been used in holding's C investment activities: trading on the foreign exchange market.

Visual scheme of the mentioned transactions is shown below:



This situation therefore led to a tax dispute in which the decision of the tax administrator was upheld by the court of last instance.

The bottom line is that the court made the same assessment as the tax administrator, finding that holding C did not have any real activity, did not have human and other resources to operate and develop its activities, and that the sale of the shares of the company A to company B and subsequently to holding C were all relevant considerations. In other words, the circumstances and purposes of the 'movement' of the shares of company A were called into question, with the shares of company A at the end point being held again by the same natural persons, albeit through holding C rather than directly.

Moreover, the Lithuanian court of last instance upheld the position of the tax administrator and did not take into account the fact that the dividends received by holding C were not paid in any form to natural persons, nor did it take into account the fact that holding C invested the dividends received in trading on the foreign exchange market.

This case confirms that the tax administrator was correct to focus on the assessment of the substance of the activities of the holding C and to conclude that the substance was insufficient. As a result of this assessment, company A was taxed at a rate of 15% of the Lithuanian corporate income tax on the dividends paid to holding C. Initially, company A unjustifiably applied a corporate income tax benefit (0% rate) to the payment of dividends.

It is important to underline: the court noted that the tax status (fixated during the tax audit) of the passive holding company C holding shares of company A is not immutable, nor does it apply permanently. Depending on the 'behavior' of the passive holding in the future, its tax status may change from *completely artificial* to *passive holding that complies with economic logic*. Moreover, a passive holding company holding shares in another company cannot in itself be considered fraudulent. It is important to establish what purpose was served in transferring the management of the shares to a passive holding company; why, and for what purpose, this particular group management structure was chosen.

Arguably, this real-life practical example from Lithuania could serve as an example of good practice of how the special dividend tax anti-avoidance rule could be applied in tax audits in other countries.