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The Objective Scope of Article 7 and the Treaty Protection to Deemed Distributed Dividends

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The claim for the so-called "single taxation principle", in spite of its doubtful general acceptance, seems to have been acknowledged by the OECD, which has moved from a position whereby countries should explicitly state the limits of the application of tax treaties in case of abuse, to an opposite view ascertaining that tax treaty protection may not be invoked to protect a tax avoidance scheme. This is not an obvious construction, and its applicability for treaties signed prior to this change in OECD´s position is certainly arguable, even if both Contracting States belong to said organization. Should at least one of the countries be a non-member State, than the reluctance to follow this understanding will be stronger.

Irrespective of this general anti-avoidance principle, there is an issue which has also been addressed by the OECD based on the wording of the treaty itself: whether CFC legislation would be compatible with the wording of the treaties. There are certainly several manners to build CFC legislation, and in some cases, the very characterization of a piece of legislation as a CFC rule may be challenged. If one considers BEPS Action 3 ("Strengthen CFC rules"), it becomes clear that there are different approaches. In the Brazilian case, where profits earned by foreign subsidiaries are immediately included in the parent´s taxable base, irrespective of the location of the subsidiary or the nature of its activities, one will immediately conclude that the boundaries of a legitimate anti-avoidance CFC legislation are not clear. One can easily claim that such legislation avoids any base-company tax avoidance scheme, but it has also an effect of anticipating tax revenues on undistributed profits.

Since (i) the general anti-avoidance implicit rule in tax treaties is not generally accepted and (ii) in several cases the anti-avoidance function of legislation providing for taxation of undistributed profits is not clear, it seems relevant to ask whether tax treaties would contain a clause limiting such taxation.

The very first discussion would be based on Article 10, which would generally allow the residence State to tax dividends paid by foreign subsidiaries (in several cases, allowing a taxation at source, as well). Countries could claim that undistributed profits are dividends, allowing such taxation. There are several arguments against such construction, one of the most relevant being the wording of Article 10: how to claim that undistributed profits are dividends "paid" by a company? It is generally accepted that the word "paid" does not mean cash payment, and a disbursement may be substituted by another "payment". However, undistributed profits are not due to the shareholders.

In the absence of a shareholders´ decision, there is no credit. Moreover, the mere fact that a subsidiary earns a profit does not mean that dividends may be distributed (consider the case where subsidiary has had losses in previous years, which would imply the impossibility of distributing present earnings).

An alternative would be Article 21, which would allow taxation of "other income" by the State of residence. However, this would only be the case if there were no protection of such payments in a specific treaty disposition. Brazilian authorities tried, in the past, to claim that Article 21 would be applicable to items of income which could be included in Article 7, but this understanding was not only rejected in the literature, but also in the jurisprudence. Presently not even Brazilian tax authorities dare to claim that Article 21 would be applicable for business profits.

This brings us to a very relevant issue: is Article 7 applicable for undistributed profits earned by foreign subsidiaries? If one reads Paragraph 14 of the OECD´s commentary to Article 7, one will immediately see that their authors claim that CFC legislation would not be obstructed by said Article: *The paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents´ participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits.* This text was first introduced in the Commentaries as Paragraph 10.1 in 2003, as a reaction to the decision of the French *Conseil d'État* Schneider Electric Case (28 June 2002), together with several other amendments aiming at restricting the entitlement to treaty benefits.

Although it is correct to say that Article 7 does not aim at determining how one State shall compute the taxable profits of its own taxpayers, one should also recognize that Article 7 entails a clear limitation. There is something which may not be taxed by a Contracting State: profits attributable to an enterprise resident of the other Contracting State.

The OECD´s Commentary argue that taxes levied by a Contracting State may not be said to have been levied on profits of the company of the other Contracting State if said profits have not been reduced. As a matter of fact, taxes of the parent company are not reflected in the books of the subsidiary, what confirms that the latter is not a taxpayer in the first Contracting State. There is no doubt that the taxpayer (i.e.: who bornes the taxes) is the parent company.

However – and this is the issue disregarded by the Commentaries – Article 7 does not aim at protecting the foreign subsidiary. It does not have a subjective, but rather an objective scope. Article 7 does not say "foreign entities shall not be taxed", but rather protects "business profits" earned by said enterprises. It is therefore not the case of examining who suffers the burden of the tax: Article 7 simply declares that one State may not tax business profits earned by a company resident in the other Contracting State, irrespective of the taxpayer liable for its payment.

According to Article 7, business profits earned by an enterprise resident in one Contracting State are beyond the jurisdiction of the other Contracting State (unless a Permanent Establishment is present). This is an objective protection, which means that a State may not include in its own taxpayers' tax base an amount which has been excluded from its jurisdiction.

One should conclude, therefore, that whenever CFC legislation determines that a parent company

must add to its own profits those other profits earned by its subsidiary resident in another Contracting State, than Article 7 is being disrespected. Accordingly, if Article 7 has an objective scope, than said profits may never be included in the tax base of the first Contracting State.

In summary, one can conclude that in spite of the clear statement made by the OECD in its commentaries, Article 7 protects business profits earned by foreign companies, irrespective of the taxpayer who is burdened. CFC legislation may therefore be against tax treaties, when they aim at including in a parent company's tax base profits which, according to Article 7, are not subject to tax in that State.

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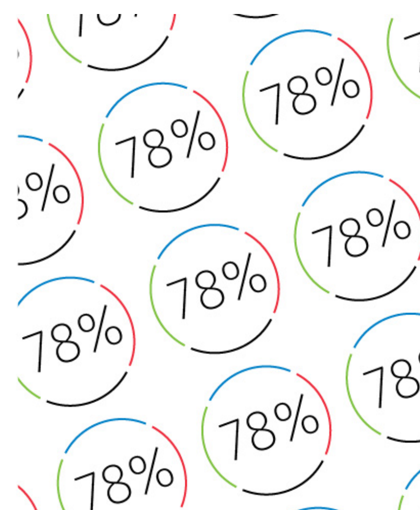

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