THE PROHIBITION OF EXTRATERRITORIAL TAXATION UNDER TREATY LAW AND ITS RELATION TO ANTI-TREATY SHOPPING RULES

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Abstract

This study has two objectives. First, the content and scope of the prohibition of extraterritorial taxation under Article 10 paragraph 5 of the 2017 Organisation for Economic Co-operation and Development Model Tax Convention (OECD MTC) are examined. It deals with dual resident corporations as distributing companies. The prohibition of extraterritorial taxation of dividends is included in all double taxation conventions (DTC). However, the exact conditions of application and the interpretation of the prohibition of extraterritorial taxation are disputed in research and literature and the regulation has only been examined cursorily to date. Second, the prohibition of extraterritorial taxation under treaty law is brought into the context of bilateral and unilateral anti-treaty shopping regulations for the first time. Here, it can be shown that, due to their specific structure, anti-treaty shopping rules generally do not apply to dividend payments from dual resident companies that fall under the prohibition of extraterritorial taxation under treaty law, according to Article 10 paragraph 5 of the 2017 OECD MTC. This leads to the tax planning conclusion that dual resident companies can generally be used to optimize withholding taxes on dividends. This is an important finding, as the strategy of interposing holding companies to avoid or reduce withholding tax on dividends has now become largely ineffective due to the introduction of the Principal Purpose Test (PPT) in double tax conventions (Article 29 paragraph 9 of the 2017 OECD MTC) and unilateral anti-treaty shopping rules. From a tax policy perspective, this article examines options for limiting withholding tax avoidance by dual resident companies.

Keywords: *treaty law, OECD MTC, international taxation, dividends, withholding tax, treaty shopping*

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This study explores the potential of dual resident companies as a strategy for shareholders seeking to optimize withholding taxes on dividends from foreign subsidiaries. The study provides a comprehensive answer to the burning question of how the legal structure of a group can be organized to address tax-related issues, with a focus on the tax-efficient repatriation of profits from foreign subsidiaries. It highlights the benefits of a dual resident foreign subsidiary compared to a traditional holding company strategy regarding the tax optimized repatriation of foreign profits. The key research question is whether the withholding tax on dividends in the country of residence of the distributing company can be avoided by the prohibition of extraterritorial taxation of dividends under treaty law (Article 10 paragraph 5 of the 2017 OECD MTC) if the distributing subsidiary is a dual resident. The study provides a comprehensive analysis of the prohibition of the extraterritorial taxation of dividends under treaty law, and how this relates to dual resident distributing companies and anti-treaty shopping rules.

1. Literature review and contribution of the study

The literature has not yet examined in detail whether the withholding tax of foreign subsidiaries on dividend distributions can be avoided by using a dual resident foreign subsidiary.[1] This study adds to the existing literature by examining the interplay between dual resident distributing subsidiaries, the prohibition of extraterritorial taxation of dividends by treaty law, and the relationship with anti-treaty shopping rules. The present study, therefore, makes a substantial contribution to the existing literature.

Fett (2013) deals with triangular situations, considering the withholding tax on dividends in the case of dual resident subsidiaries and the prohibition of extraterritorial taxation by treaty law.[2] However, the focus of his study is on treaty law. It does not deal with the possible use of dual resident companies in finance to optimise the repatriation of foreign profits. Furthermore, the study does not consider the relationship between the prohibition of extraterritorial taxation and anti-treaty shopping rules. Whether a dual resident foreign subsidiary can be used to optimise the repatriation of profits is not addressed in the study.

Hohmann et al. (2024) address the OECD's multilateral instrument (MLI) to combat tax avoidance.[3] However, the use of dual resident companies is not addressed by the authors, particularly in connection with the avoidance of withholding taxes on dividends.

1 Beer, S., de Mooij, R. and Liu, L. (2020). International corporate tax avoidance: A review of the channels, magnitudes, and blind spots. *Journal of Economic Surveys*, *34* (3), 660-688. https://doi.org/10.1111/joes.12305; Ftouhi, K. & Ghardallou, W. (2020). International tax planning techniques: A review of the literature. *Journal of Applied Accounting Research*, *21*(2), 329–343. https://doi.org/10.1108/JAAR-05-2019-0080; Petkova, K., Stasio, A. & Zagler, M. (2020). On the relevance of double tax treaties. *International Tax Public Finance*, *27*, 575–605. https://doi.org/10.1007/s10797-019-09570-9; Karjalainen, J., Kasanen, E., Kinnunen, J., & Niskanen, J. (2020). Dividends and tax avoidance as drivers of earnings management: Evidence from dividend-paying private SMEs in Finland. *Journal of Small Business Management*, *61*(2), 906–937. https://doi.org/10.1080/00472778.2020.1824526; Khan, A. (2021). Ownership structure, board characteristics and dividend policy: Evidence from Turkey. *Corporate Governance*, *22*(2), 340-363. https://doi.org/10.1108/CG-04-2021- 0129; Park, S. J., Lee, K-M, & Yang, J-S (2021). Navigating optimal treaty-shopping routes using a multiplex network model. *PLoS ONE, 16*(8). https://doi.org/10.1371/journal.pone.0256764; König, T., Schneider, D., & Artmeier, M. (2023). Asset managers and withholding tax: Problems, options and best practices for asset managers on withholding tax processing. *Journal of Securities Operations & Custody, 16*(1), 20-30. https://doi.org/10.69554/BAFV6473.

2 Fett, E. E. (2013). *Triangular cases: The application of bilateral tax treaties in multilateral situations* [Thesis, fully internal, Universiteit van Amsterdam]. University Amsterdam, pp. 322-354. https://pure.uva.nl/ws/files/1913382/123900_16.pdf

3 Hohmann, A., Merlo, V., Riedel, N. (2025, April). Multilateral tax treaty revision to combat tax avoidance: On the merits and limits of BEPS's multilateral instrument. *Economic Policy*, *40*(122), 427-480. https://doi.org/10.1093/epolic/eiae043

The study at hand adds significantly to the literature. It specifically addresses the use of dual resident companies as a legal form in the foreign investment state to optimize the withholding tax burden on dividends. This has not yet been done in the literature. Furthermore, the study examines the current limitations of dual resident companies (OECD BEPS and anti-avoidance rules) and their effective use. Overall, this study significantly expands the literature on legal sciences, as these issues have not yet been thoroughly examined and answered.

2. Methodology

Theoretical legal analysis and case study analysis are employed methodologically. Combining these two approaches is the best way to answer the research questions at hand. Quantitative or empirical legal research is not applicable here, as the focus is on analysing tax law and legal regulations. This requires legal analysis and the application of legal interpretation methods. An analysis of case law is also included.

3. Background and research question

In the case of cross-border participation in companies, dividends are generally taxed at sources in the foreign country of residence of the distributing company (Article 10 paragraph 2 of the 2017 OECD MTC). The level of dividend taxation in the source state is reduced to 15% of the gross dividend by the applicable double tax convention (DTC).[4] In the case of a qualifying holding in the distributing company, the withholding tax on dividends can be reduced to 5% of the gross dividend by Article 10 paragraph 2 lit. a) of the 2017 OECD MTC, or 0% under some bilateral DTCs.[5] However, the reduction in withholding taxes on dividends under treaty law is regularly subject to anti-avoidance provisions[6] and is also linked to restrictive participation requirements.[7] In particular, if holding companies are interposed for treaty shopping, the reduction in withholding tax under treaty law in the country of residence of the distributing company is denied (Article 29 paragraph 9 of the 2017 OECD MTC). If the withholding tax reduction under treaty law does not apply, the dividend is taxed unmitigated under national tax law in the country of residence of the

4 Paragraph 2(b) Article 10 of the 2017 OECD MTC.

5 See, for example, paragraph 3 Article 10 of the 2008 DTC USA-Germany.

6 Principal Purpose Test (PPT) according to paragraph 9 Article 29 of the OECD MTC or Limitation-on-Benefit regulations (LoB) as in Article 28 of the 2008 DTC USA-Germany.

7 Paragraph 3(a) Article 10 of the 2008 DTC USA-Germany requires a direct shareholding of at least 80% of the voting rights of a US corporation in a German corporation. These shares must have been held for 12 months when the dividend entitlement arises.

distributing company. In this case, it can be subject to withholding tax at a rate of 25%[8] to 35%[9] of the gross dividend.

Therefore, the question arises as to whether withholding tax on dividends in the country of residence of the distributing company can be avoided by prohibiting extraterritorial taxation of dividends under treaty law (Article 10 paragraph 5 of the 2017 OECD MTC). This provision is included in the dividend article of all DTCs, such as Article 10 paragraph 8 of the DTC USA-Germany 2008. It generally prohibits the under-treaty law nonresident state of the distributing company from taxing the dividend. The prohibition of extraterritorial taxation applies irrespective of a specific level of shareholding in the distributing company and is not based on the shareholder of the distributing company. It also does not require any holding periods. In addition, this provision should not be subject to anti-treaty shopping rules under treaty law, such as the Principal Purpose Test (PPT) and limitation-on-benefit rules or national law. It may be advantageous to reduce the withholding tax in the distributing company's country of residence by taking advantage of the prohibition of the extraterritorial taxation of dividends (Article 10 paragraph 5 of the 2017 OECD MTC).

In principle, access to the prohibition of the extraterritorial taxation of dividends could be achieved by using a dual-resident company. In this case, the registered office of the company is in a DTC state (investment state), whereas the management of the company is located in another DTC state that does not levy withholding taxes on dividends under national law. The dual resident company generates profits or income from the state where its registered office is located (state of incorporation). According to the tie-breaker rule of Article 4 paragraph 3 of the DTC, the company is only resident in the country of management for purposes of treaty law. An example is a German corporation (GmbH) with its place of management and exclusive residence under treaty law in Liechtenstein.[10]

According to Article 10 paragraph 5 of the DTC Germany-Liechtenstein 2012, the prohibition of extraterritorial taxation, the nonresident state of the company (in this case Germany) may not tax dividend payments from the company resident exclusively in Liechtenstein under treaty law to shareholders in third countries or

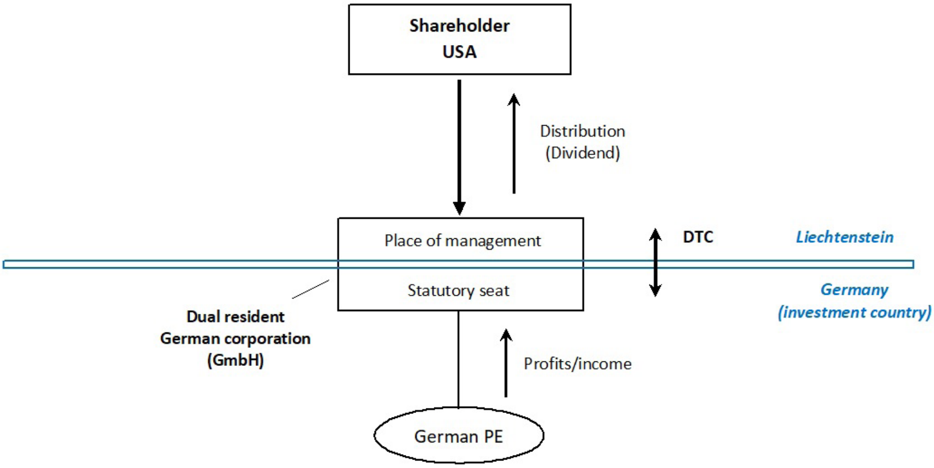
8 In Germany, for example, the withholding tax rate is 25% of the gross dividend.

9 Swiss withholding tax (Verrechnungssteuer) on dividends is generally 35% of the gross dividend paid.

10 Paragraph 3 Article 4 of the 2012 DTC Germany-Liechtenstein (tie-breaker rule): "If pursuant to paragraph 1, a person other than a natural person is resident in both contracting States, it shall be deemed to be resident only in the State in which the place of its effective management is situated."

Liechtenstein, irrespective of the amount of the participation of these shareholders. According to the national tax law of the state in which the company is managed (in this case, Liechtenstein), no withholding tax is levied on profit distributions by the company. Thus, by using such a dual resident company, withholding tax on dividends can in principle be completely avoided, also as an alternative to the no longer effective interposition of holding companies (PPT, LOB), if a corresponding dual resident company is used in the respective DTC investment state. The structure is illustrated in Figure 1:

Figure 1: Dual resident company (DRC) and avoidance of withholding tax on dividends through the prohibition of extraterritorial taxation under treaty law



Source: Author's own illustration

The prohibition of extraterritorial taxation under treaty law according to Article 10 paragraph 5 of the 2017 OECD MTC is examined. First, the general content and the specific requirements of the provision are analyzed. The applicability to dual resident companies is also discussed. The discussion further explores the objective of prohibiting the extraterritorial taxation of dividends. Here, it can be shown that the prohibition of extraterritorial taxation has nothing to do with the taxation of the shareholder of the distributing company but only concerns the taxation of the distributing company itself.

Therefore, the application of the prohibition of extraterritorial taxation (Article 10 paragraph 5 of the 2017 OECD MTC) has nothing to do with the residence of the shareholder of the distributing company and is completely independent of it. Only the DTC between the country of residence of the distributing company under treaty law and the source country under treaty law from which the income of this company originates is relevant. The latter is prohibited from taxing the distributed profits of this company or its dividends. Furthermore, the relationship of the prohibition of extraterritorial taxation under Article 10 paragraph 5 of the 2017 OECD MTC to other income articles, such as Article 21 paragraph 1 of the DTC, is shown.

The assessment is conducted to determine whether companies that are residents in two different countries can avoid paying withholding tax on dividends. This involves evaluating whether extraterritorial taxation is prohibited and assessing the stability of this tax planning option given the bilateral and unilateral anti-treaty shopping rules. Concerning this tax planning option, further limitations are discussed, such as the type of tiebreaker rule under treaty law for companies (Article 4 paragraph 3 of the DTC) and general anti-avoidance provisions. The structure's practicability for US shareholders and taxpayers is also discussed.

The prohibition of the extraterritorial taxation of dividends in tax treaties generally corresponds to the wording of Article 10 paragraph 5 of the 2017 OECD MTC. This provision is examined below.

4. Prohibition of the extraterritorial taxation of dividends

The prohibition of the extraterritorial taxation of dividends is stipulated by Article 10 paragraph 5 of the 2017 OECD MTC as follows:

"Where a company which is a resident of a contracting State derives profits or income from the other contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, […] even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State."

According to the wording of Article 10 paragraph 5 of the 2017 OECD MTC, the nonresident state of the company under treaty law (the other contracting State) in the bilateral relationship may generally not tax the dividends paid by this company if the company receives profits or income from the nonresident state and if the dividends are paid to a person who is not resident in the nonresident state of the distributing company. What are the requirements for applying this provision? If one imagines the basic case in which the company receives income from its nonresident state in the bilateral relationship and distributes dividends to a shareholder who is not resident in the nonresident state of the company, the question arises as to how the dividend article can be applied at all.

This is because the application of the dividend article generally requires that the dividends are paid by a company resident in a contracting State to a person (shareholder) resident in the other contracting state (Article 10 paragraph 1 of the 2017 OECD MTC).

However, this requirement is not met when the prohibition of extraterritorial taxation under Article 10 paragraph 5 of the 2017 OECD MTC, as the dividend is not paid to a resident of the other contracting State but to a shareholder who is resident in the State of residence of the company or a third State or a non-DTC contracting state concerning the specific DTC. Consequently, the question arises as to how the dividend article can be relevant at all. This implies that the prohibition of extraterritorial taxation does not concern the taxation of the shareholders of the distributing company. This is also supported by the requirement in Article 10, paragraph 5 of the 2017 OECD MTC, which states that the company must receive profits or income from its nonresident contracting State in the bilateral relationship.

It should also be mentioned that Article 10 paragraph 5 of the 2017 OECD MTC takes precedence over the application of Article 21 paragraph 1 of the 2017 OECD MTC (other income). This is because Article 21 paragraph 1 only applies to income not covered in the previous articles of the convention. It follows from this that the taxation of dividends that fall under Article 10 paragraph 5 of the 2017 OECD MTC is not covered by Article 21 paragraph 1. If we now imagine a company resident in a contracting State that distributes dividends to a person having his tax residence in the country of residence of the distributing company (income from the country of residence) or a third country, Article 21 paragraph 1 would apply to this income so that the extraterritorial taxation prohibition under Article 10 paragraph 5 of the 2017 OECD MTC would not be necessary. However, it should be noted that Article 21 paragraph 1 of the 2017 OECD MTC requires the income of a resident of a contracting State. However, this is not the issue with the prohibition of extraterritorial taxation of dividends by the nonresident state of the distributing company. Rather, the provision of Article 10 paragraph 5 of the 2017 OECD MTC, which takes precedence over Article 21 paragraph 1, generally prohibits the nonresident state of the company from taxing dividends or distributed profits in the bilateral relationship if the distributing company receives profits or income from its nonresident state and distributes dividends to shareholders who are not resident in the other source state or nonresident state of the company.

It therefore follows from the treaty provisions and context that Article 10 paragraph 5 of the 2017 OECD MTC, is not related to the taxation of the shareholders of the distributing company. Rather, it is about the taxation of the distributing company itself, that it is not repeatedly subject to "taxation" with the distributed profits (dividends) by the source state of the underlying income. Accordingly, the facts of Article 10 paragraph 5 2017 of the OECD MTC already stipulates that the distributing company must receive profits or income from the other contracting State, the nonresident state under treaty law. The distributing company has already been taxed on these profits or income in the source state (Article 7 paragraph 1 of the DTC for corporate profits or Article 10 paragraph 2 of the DTC for dividends received). If a company that is not a resident in the mentioned source state distributes dividends and if these distributed profits are taxed again by the nonresident state and the source state under treaty law, it would result in multiple taxations of the distributing company.

This becomes particularly clear in the case of a dual-resident company in a bilateral relationship that receives profits from its nonresident state under treaty law and pays dividends to a person who does not reside in the state where the income is generated. An example of this is the dual resident German corporation in Figure 1, which has its place of effective management in Liechtenstein and receives profits from a permanent establishment located in its nonresident state, Germany (source state), and pays dividends to a shareholder who is resident in a third state (USA). In this case, the permanent establishment profits are already taxed in the company's nonresident state and source state Germany at the time when they are generated (Article 7 paragraph 1 of the 2012 DTC Germany-Liechtenstein). If the nonresident state of the company under treaty law (Germany) is now allowed to tax dividends with withholding taxes when profits are distributed, this would result in multiple (economic) taxes on the distributing company. This is because the dividends are also correctly taxed by the distributing company's country of residence (Liechtenstein) vis-à-vis the shareholder, meaning that the distributing company must withhold a withholding tax in this respect and pay it to the Liechtenstein tax authorities. At the same time, it would have to withhold a further withholding tax concerning the same dividend and pay it to the nonresident state of Germany. As a result, the dual resident company must pay withholding taxes twice from the distributed profits. Compared with a situation in which only the country of residence under the treaty law of the distributing company is permitted to tax the dividend at source, the dual resident company is subject to multiple burdens. It has less net profit at its disposal than in a situation in which dividends or distributed profits may be taxed only by the company's country of residence under treaty law. In addition, the distributed profits were already taxed by the nonresident state and source state *vis-à-vis* the distributing company at the time the profits were realized.

The prohibition of the extraterritorial taxation of dividends under Article 10 paragraph 5 of the 2017 OECD MTC generally and correctly denies the nonresident state of the distributing company to tax dividends of this company. It therefore avoids multiple taxation of the (distributing) company by the nonresident state in the bilateral relationship. This prohibition avoids taxation of the distributed profits (dividends) by the nonresident state of the company, which, as shown in the example above, has a de facto effect on the distributing company and thus multiple taxes of the company by its nonresident state, as the latter has already taxed the profits as the source state with respect to this company. Article 10 paragraph 5 2017 OECD MTC is correctly included in the dividend article and concerns the (additional) taxation of distributed profits, which affects the distributing company, by the nonresident state of the company. According to the OECD commentary on Article 10, no 37, the provision of Article 10 paragraph 5 of the 2017 OECD MTC concerns only the taxation of the company and not that of the shareholder. Accordingly, Article 10 paragraph 5 of the 2017 OECD MTC is correct because a company resident in a contracting state receives profits or income from the other contracting State.

Therefore, the distributing company itself, which is resident in a contracting State under treaty law, is protected by Article 10 paragraph 5 of the OECD MTC,[11] and this company can invoke this provision against the nonresident state to prohibit the latter from taxing the distributed profits or dividends (prohibition of extraterritorial taxation of dividends). The nonresident state of the distributing company is

11 The 2017 Model Tax Convention on Income and on Capital: "The paragraph [Article 10 paragraph 5 of the 2017 OECD MTC] concerns only the taxation of the company and not that of the shareholder", see OECD (2019), *Model Tax Convention on Income and on Capital 2017*. (Full Version). OECD Publishing, Paris. https://doi.org/10.1787/g2g972ee-en; Thiessen, O. (2010). *Dreiecksverhältnisse im Internationalen Steuerrecht* [trans: Triangular relationships in international tax law involving dual-resident corporations] (doctoral thesis). Verlag Peter Lang, Frankfurt am Main, Berlin, p. 76 and 84. https://doi.org/10.3726/978-3-653-00452-6; BFH (German Supreme Tax Court), judgment of 20.01.1993, I R 54/92, BStBl II 1993, p. 483: "Only the paying corporation is protected" (on Article XIV paragraph 2 of the DTC USA- Germany 1954/66); Fett (2013), *supra* note 2, pp. 347-349.

therefore generally prohibited under treaty law from taxing dividends of the company if this company receives profits or income from its territory. The shareholders of the distributing company and its residence under treaty law are irrelevant (OECD commentary on Article 10, no. 37). This is completely irrelevant to the prohibition of extraterritorial taxation. This is because Article 10 paragraph 5 of the 2017 OECD MTC is about avoiding multiple taxation of the company and not the shareholder (OECD commentary on Article 10, no 37). Article 10 paragraph 5 of the 2017 OECD MTC has nothing to do with the taxation of the shareholders of the distributing company.

Thus, the statements in the literature that the prohibition of extraterritorial taxation would not apply if the shareholder of the distributing company is resident in a third country or noncontracting State, i.e., is not resident in the country of residence of the distributing company under the treaty law and is therefore not entitled to the tax treaty, must be rejected incorrectly. This view also contradicts the case law. For the application of Article 10 paragraph 5 of the 2017 OECD MTC, the residence (under treaty law) of the shareholder of the distributing company is completely irrelevant. The provision refers to the distributing company that is resident under treaty law in one contracting State and receives income from the other contracting State (nonresident State). Multiple taxes of the distributing company are to be avoided. This is what the prohibition of extraterritorial taxation is all about. Therefore, statements in the literature are not convincing, that assume that the shareholder of the distributing company resides in a third country can invoke Article 10 paragraph 5 of the 2017 OECD MTC, although the lack of residence under treaty law in a contracting state is given, as the provisions of the DTC are generally implemented in domestic tax law. As already shown, Article 10 paragraph 5 of the 2017 OECD MTC, and its conditions of application are not based on the shareholder of the distributing company (OECD commentary on Article 10, no. 37). The same is confirmed by case law in situations where shareholders of the distributing company reside in third countries (the noncontracting State of the tax treaty).[12]

Article 10 paragraph 5 of the 2017 OECD MTC requires a company resident in a contracting state that receives profits or income from the other contracting state (nonresident state) in the bilateral relationship. Moreover, Article 4 paragraphs 1 and 3 of the Double Taxation

12 *Hunter Douglas Ltd. v. Her Majesty the Queen* (Canada), 1979 CarswellNat 270, [1979] C.T.C. 424, [1980] 1 F.C. 493, 79 D.T.C. 5340; *Hoge Raad* (Netherlands), Case 27 252, BNB 1992/379, September 2, 1992.

Convention are relevant for determining the company's residence in a contracting state considering the tie-breaker rule for companies there. Accordingly, dual resident companies also fall within the scope of Article 10 paragraph 5 of the 2017 OECD MTC. For example, a German corporation with its registered office in Germany and place of effective management in Liechtenstein (see Figure 1) is resident in Liechtenstein for this DTC following Article 4 paragraph 1 and 3 of the 2012 DTC Germany-Liechtenstein and is therefore resident in a contracting State. Consequently, the prohibition of extraterritorial taxation of dividends under Article 10 paragraph 5 of the DTC applies to the profit distributions of this dual resident company, and its dividends cannot be taxed in Germany. Importantly, the provision of Article 10 paragraph 5 of the 2017 OECD MTC does not impose any restrictions on the fact that dual resident companies with exclusive residence under treaty law in a contracting state do not fall within the scope of the regulation. As already shown above, there is also a risk of multiple taxations of the (distributed) profits in this case concerning the distributing dual resident company itself. Moreover, case law has already correctly applied the prohibition of extraterritorial taxation to the taxation of dividends paid by dual-resident companies.[13]

Finally, it should be noted that the prohibition of extraterritorial taxation of dividends under Article 10 paragraph 5 of the 2017 OECD MTC does not depend on how or according to which technique the domestic tax law of the company's nonresident state under the treaty establishes a right to tax the dividends of this company. The regulation generally prohibits the nonresident state of the company, under treaty law, from taxing distributed profits or dividends if the distributing company receives profits or income from the nonresident state. It does not matter which legal requirements of domestic tax law the nonresident State uses to tax dividends. Accordingly, it is irrelevant whether the nonresident State of the company under treaty law taxes dividends based on domestic regulation because dividends originate from profits from its territory or because the distributing company is subject to unlimited tax liability according to domestic tax law, which may be the case for a dual resident company due to its registered office or seat. The wording and teleology of the prohibition of extraterritorial taxation under Article 10 paragraph 5 of the 2017 OECD MTC does not contain any limitations concerning a specific domestic tax nexus of the nonresident state of the company with dividends.

13 *Ibid.*

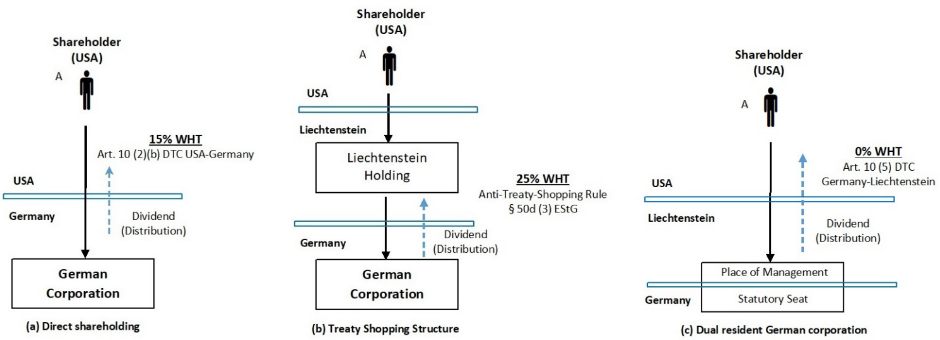
5. Withholding tax optimization and the potential of dual resident companies

5.1. Fundamentals of tax planning

As explained above, dual resident companies can be used to avoid withholding taxes on dividends in the foreign source state or investment state, considering Article 10 paragraph 5 of the 2017 OECD MTC (see Figure 1 as an example). Unlike an investment in a nondual resident company, the shareholder of the distributing company does not have to hold a certain minimum amount of shares or have a holding period. Concerning any withholding tax optimization in the foreign investment State, the use of a dual-resident company is therefore beneficial compared with participation in a non-dual-resident company in otherwise identical circumstances.

In addition, the use of a dual resident company is likely to be favorable compared with the interposition of a foreign holding company, as in this constellation, owing to bilateral or unilateral anti-treaty shopping regulations, it is generally no longer possible to achieve a withholding tax reduction under treaty law (Principal Purpose Test, Article 29 paragraph 9 of the 2017 OECD-MTC). This relationship is illustrated in Figure 2.

Figure 2: Withholding tax on dividends depending on the shareholding structure



Source: Author's own illustration

By using a dual resident company (see case (c) in Figure 2), withholding tax on dividends in the country of the investment can be completely avoided. According to the prohibition of extraterritorial taxation of dividends under treaty law, the state of incorporation of the distributing company (Germany) may not tax dividends; in this case, according to Article 10 paragraph 5 of the 2012 DTC Germany-Liechtenstein. Liechtenstein is the country of the company's place of management, and the country of residence under treaty law[14] of the distributing company does not tax dividends to foreign shareholders according to its national law and does not levy any withholding tax on this basis.

14 Paragraph 3 and 1 Article 4 of the 2012 DTC Germany-Liechtenstein.

In comparison, participation in a nondual resident company in a foreign investment state (Germany) leads to a withholding tax burden of 15% of the gross dividend (see case (a) in Figure 2).

Finally, the interposition of a pure holding company and the intended use of the withholding tax exemption on dividends by Article 10 paragraph 2 lit. a) of the DTC Germany-Liechtenstein 2012 (see case (b) in Figure 2) does not reduce the withholding tax on dividends in the foreign investment country (here, Germany). This strategy of treaty shopping is ineffective because of the unilateral German anti-treaty shopping provision under Section 50d (3) of the EStG corresponding to the Principal Purpose Test under Article 29 paragraph 9 of the 2017 OECD MTC. Accordingly, in case (b), an unmitigated German withholding tax of 25% of the gross dividend is due. The use of a foreign holding company to minimize withholding taxes on dividends (known as treaty shopping) is not advisable.

5.2. Types of tiebreaker regulation and multilateral instrument (limitations)

The prohibition of extraterritorial taxation of dividends requires the distributing company to be resident in one of the two contracting States of the relevant DTC (see Article 10 paragraph 5 of the OECD MTC 2014/2017). The tie-breaker rule for legal entities in the DTC may therefore be relevant. A tiebreaker rule such as in the 2012 DTC Germany-Liechtenstein, according to which a company is only resident in the contracting state in which the place of its effective management is located, is not problematic (Article 4 paragraph 3 2012 DTC Germany-Liechtenstein; Article 4 paragraph 3 of the 2014 OECD MTC). Such a tiebreaker provision for legal entities is included in many bilateral DTC.

However, a different tiebreaker provision may be included in a bilateral DTC, for example, following Article 4 paragraph 3 of the 2017 OECD MTC. This provision is initially based on the fact that the competent tax authorities of the contracting States try to agree in which of the two contracting States a dual resident company is exclusively resident for the DTC if it has its registered office in one contracting State and its place of effective management in the other contracting State.[15] If no such agreement is reached, the company is not entitled to any tax exemptions under the DTC, except to the extent and manner agreed upon by the competent tax authorities of the contracting States.[16]

This means that the prohibition of the extraterritorial taxation of dividends under Article 10 paragraph 5 of the 2014 OECD MTC or 2017 MTC cannot apply if the company is not exclusively allocated to the contracting State where its place of effective management is located concerning its residence for purposes of the tax treaty.

15 Paragraph 3(1) Article 4 of the 2017 OECD MTC.
16 Paragraph 3(2) Article 4 of the 2017 OECD MTC.

Moreover, if Article 4 of the Multilateral Instrument (MLI) applies to the respective bilateral tax treaty (DTC), the dual resident company may lose the withholding tax exemption on dividends under Article 10, paragraph 5 of the 2017 OECD MTC (prohibition of extraterritorial taxation). However, some states have opted not to apply Article 4 MLI to their bilateral DTC; for example, Germany and Liechtenstein.

6. Relationship of Article 10 paragraph 5 of the 2017 Organisation for Economic Co-operation and Development Model Tax Convention to anti-treaty shopping regulations

Finally, whether a withholding tax exemption for distributing dual resident companies (according to Figure 1) under Article 10 paragraph 5 of the 2017 OECD MTC, the prohibition of extraterritorial taxation, may be precluded by anti-treaty shopping rules and general rules on tax abuse will be reviewed.

First, there is no tax abuse at hand if the management of a company is located (not only temporarily) in the other contracting State and not in the contracting State of the registered office or seat. As the provisions of the DTCs show, they explicitly recognize dual resident companies (Article 4 paragraph 1, 3 of the 2014 and 2017 OECD MTC). Such a company is entitled to the tax treaty under the DTC provisions. Within the European Union (EU) and the European Economic Area (EEA), a corporation protected by the freedom of establishment under Article 49 and 54 of the TFEU – can shift its place of effective management in isolation across borders and in a way that preserves its legal identity. This is confirmed by the established case law of the Court of Justice of the European Union (CJEU). Therefore, the isolated transfer of the place of effective management of the company to another Member State does not constitute abuse.[17] Accordingly, the use of a dual resident company is not itself an abuse of law and is recognized for tax purposes.

The question now arises as to whether bilateral or unilateral anti-treaty shopping regulations can prevent exemption from withholding taxes under treaty law by Article 10 paragraph 5 of the 2017 OECD MTC in the case of a distribution by a dual resident company in the contracting State of its registered office.

Regarding their structure and facts, anti-treaty shopping regulations do not relate to exemptions under the tax treaty law of the distributing company itself but rather to persons who have a stake in this company. Anti-treaty shopping rules prohibit the direct shareholder of the distributing company from being exempt from withholding tax under treaty law (Article

17 CJEU, Judgment of 25 October 2017, C-106/16, *Polbud*, paragraph 40, 62 and 63, ECLI:EU:C:2017:804; CJEU, judgment of 29 November 2011, *National Grid Indus BV*, paragraph 84, ECLI:EU:C:2011:785; CJEU, Judgment of 27 February 2020, C-405/18, *Aures Holdings*, paragraph 25, 26, 28 and 45, ECLI:EU:C:2020:127.

10 paragraph 2 of the 2017 OECD MTC) if this is a (holding) company and persons are involved in this intermediary company who would not benefit from a corresponding withholding tax exemption under the DTC in question if they were directly involved in the distributing company. Anti-treaty shopping rules therefore do not deny exemptions under treaty law that the distributing company itself receives. However, Article 10 paragraph 5 of the 2017 OECD MTC applies to the distributing company and is independent of the shareholders of the distributing company.

However, bilateral measures to restrict treaty shopping, i.e., Article 29 paragraph 9 of the 2017 OECD MTC (principal purpose test) concerns the interposition of a company in a country with a favorable DTC to achieve a withholding tax reduction (treaty shopping). This is the required transaction, and one of the main purposes of this transaction is tax avoidance. The person holding an interest in the intermediary company cannot benefit from a DTC reduction of withholding tax on dividends in the same amount as the intermediary company, even assuming a direct interest in the distributing company, because the country of residence of this person has not concluded a DTC with the country of residence of the distributing company or has not concluded a favorable DTC as the country of residence of the intermediary company.

However, such a tax-motivated transaction is a prerequisite for the application of Article 29 paragraph 9 of the 2017 OECD MTC does not exist in the case of a profit distribution by a dual resident company. In this case, there is no transaction through which a tax benefit not provided under treaty law becomes accessible in the first place, through which a tax advantage not provided under treaty law can be claimed. This is because Article 10 paragraph 5 of the 2017 OECD MTC originally prohibits the nonresident contracting State of the company from taxing the company's dividends, without any transactions being relevant and irrespective of the existence or nonexistence of any withholding tax exemptions under treaty law or the residence of its shareholders. Article 29 paragraph 9 of the 2017 OECD MTC or an application of DTCs based thereon concerning combating treaty shopping does not preclude the exemption from withholding tax on dividends of a dual resident company under Article 10 paragraph 5 of the 2017 OECD MTC in the nonresident contracting State of the company (country of incorporation/statutory seat).

Unilateral anti-treaty shopping regulations do not prevent the nontaxation of dividends of a dual resident company by Article 10 paragraph 5 of the 2017 OECD MTC in the nonresident State (country of incorporation). Thus, unilateral anti-treaty shopping regulations are also structurally based on the shareholder of the distributing company being entitled to a preferential withholding tax reduction under treaty law. They deny the shareholder of the distributing company a withholding tax reduction under treaty law, which the shareholder can receive based on Article 10 paragraph 2 of the 2017 OECD MTC.

The unilateral German anti-treaty shopping provision of section 50d paragraph 3 of the EStG can be seen as an example here. This provision stipulates that an intermediary company that holds an interest in the distributing company (shareholder) is not entitled to a reduction in withholding tax under treaty law if persons hold an interest in the intermediary company who would not be entitled to the same reduction in withholding tax under treaty law if they held a direct interest in the distributing company and the interest in the distributing company held by the intermediary company has no significant connection with its original economic activity. As a legal consequence, section 50d paragraph 3 of the EStG only denies the shareholder of the distributing company a claim to relieve from withholding tax on dividends under treaty law. Importantly, section 50d paragraph 3 of the EStG does not deny any claims under treaty law to which the distributing company itself is entitled. However, since Article 10 paragraph 5 of the OECD MTC refers to the distributing company itself and already stipulates at this level that its dividend payments may be taxed only by the company's state of residence under treaty law, a unilateral anti-treaty shopping provision, in this case, section 50d paragraph 3 of the EStG, cannot prevent this exemption of the dividend from (withholding) taxation in the company's nonresident country under treaty law.

7. Tax policy implications

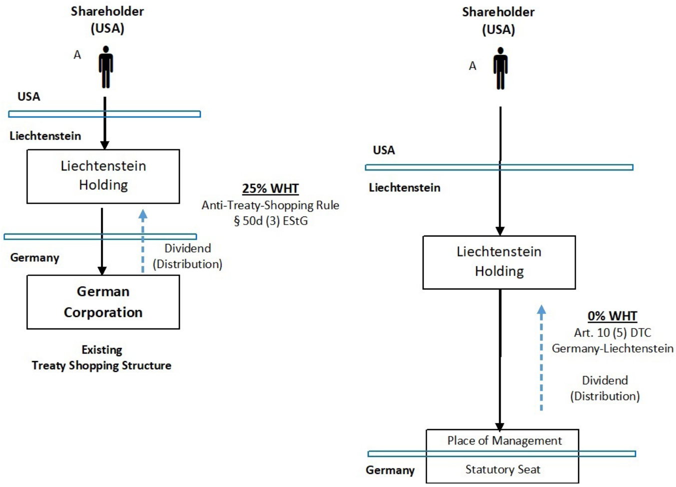
Dual resident companies may be used in connection with the prohibition of extraterritorial taxation of dividends under Article 10 paragraph 5 of the 2014/2017 OECD MTC to avoid (withholding) taxation of dividends in the DTC investment state and the company's nonresident state under treaty law. Bilateral and unilateral anti-treaty shopping regulations cannot cover this case for structural reasons, as they are based on a withholding tax reduction claim of the shareholder of the distributing company under treaty law and not on claims of the distributing company itself under treaty law. However, the prohibition of extraterritorial taxation under Article 10 paragraph 5 of the 2014/2017 OECD MTC is an original claim under the treaty law of the distributing company itself. DTC contracting States that wish to restrict the use of dual resident companies to reduce withholding taxes should implement Article 4 of the multilateral instrument (MLI) in their bilateral DTCs.

8. Tax planning options for the United States taxpayers

US shareholders of foreign corporations may use dual resident companies to avoid withholding taxes on dividends in the foreign country of investment. This applies both to the direct use of a dual resident company (direct participation of the US shareholder in such a foreign company)[18] and to indirect use.

The foreign dual resident company can be established from the outset or in an existing shareholding structure by transferring the place of effective management of the foreign company to a corresponding DTC state. In addition, dual-resident companies may be a solution to eliminate an existing treaty shopping structure that has been rendered ineffective by bilateral or unilateral anti-treaty shopping rules. For example, the foreign target company can transfer its place of management to the DTC country of residence of the intermediate holding company. An example of this is the constellation shown in Figure 2, case (b). In this case, the German target company can transfer its place of effective management to Liechtenstein, the country of residence of the intermediate holding company, while maintaining its legal identity. Distributions by the German corporation following the transfer of its place of management to Liechtenstein fall under the prohibition of extraterritorial taxation under Article 10 paragraph 5 of the 2012 DTC Liechtenstein-Germany and therefore cannot be taxed in Germany under treaty law. Anti-treaty shopping rules do not apply in this constellation either, as Article 10 paragraph 5 of the 2012 DTC Liechtenstein-Germany refers to the distributing company and not its shareholders. This tax planning option is illustrated in Figure 3:

Figure 3: Use of a dual resident company to streamline an existing treaty shopping structure



Source: Author's own illustration

18 Figure 2, case (c).

The isolated transfer of the place of management of the foreign corporation abroad is irrelevant for US tax purposes. The place of management of a corporation does not give rise to the unlimited tax liability of the company for US tax purposes. It results from the incorporation of the company or the registered office, which remains unchanged in the present case. Whether the foreign corporation becomes subject to limited or unlimited tax liability in another foreign country is irrelevant for US tax purposes. Moreover, the theory of incorporation applies so that the foreign company retains its identity under civil and tax law, even from the perspective of US law. Therefore, the isolated transfer of the place of management of the foreign company abroad does not change its tax shielding effect for US tax purposes.

The dual residence of the foreign company and its establishment do not affect any capital gains taxation concerning the shares held directly or indirectly by US shareholders in this foreign company (Article 13 paragraph 5 of the 2014/2017 OECD MTC).

Thus, US shareholders of foreign corporations can use dual resident foreign corporations in a variety of ways to avoid withholding taxes on dividends in the foreign country of investment. In this context, dual-resident foreign corporations can be an important tool in the international tax planning of US taxpayers and US foreign direct investment.

9. Results and conclusion

The prohibition of the extraterritorial taxation of dividends under Article 10 paragraph 5 of the 2014/2017 OECD MTC is included in all bilateral DTCs. It generally prohibits the company's nonresident contracting State under treaty law from taxing the dividends or distributed profits of this company.

The prohibition of extraterritorial taxation also applies in principle to companies that are dual residents in a bilateral relationship. Only the country of residence of the company under treaty law is authorized to tax the dividend at the source. This is generally the company's state in which its place of management is located following the tie breaker rule (Article 4 paragraph 3, Article 10 paragraph 5 of the 2014/2017 OECD MTC).

The prohibition of the extraterritorial taxation of dividends relates to the distributing company itself. The residences of the shareholders of the distributing company are irrelevant to the application of Article 10 paragraph 5 of the 2014/2017 OECD MTC. The objective of the prohibition of extraterritorial taxation is to avoid multiple taxation of the distributing company by its nonresident contracting State.

Dual resident companies can generally be used in combination with the prohibition of extraterritorial taxation of dividends under Article 10 paragraph 5 of the 2014/2017 OECD MTC to avoid (withholding) taxation of dividends in the DTC investment state. This tax structuring option is not covered by bilateral and unilateral anti-treaty shopping provisions such as Article 29 paragraph 9 of the 2017 OECD MTC.

Within their scope of application, anti-treaty shopping rules are based on a claim under treaty law of the shareholder of the distributing company to a reduction in withholding tax. Structurally, these tax rules can therefore not intervene in the case of a claim under treaty law of the (dual resident) distributing company itself under Article 10 paragraph 5 of the 2014/2017 OECD MTC to refrain from taxing dividends against its nonresident contracting State under treaty law.

With respect to tax policy, the implementation of Article 4 MLI to restrict treaty benefits for dual resident companies is therefore an option for countries. This regulation can limit the avoidance of withholding taxes by dual resident companies on dividends in the company's nonresident state under treaty law.

Domestic shareholders of foreign corporations can use companies with dual residence abroad to avoid withholding taxes on dividends. One option is direct participation in such a foreign company. Furthermore, foreign dual-resident companies can be used to eliminate an adverse anti-treaty shopping structure involving a foreign holding company. Due to the widespread introduction of anti-treaty shopping regulations, both bilateral and unilateral, the use of holding companies to optimize withholding taxes on dividends in the country of residence of the foreign subsidiary has largely become ineffective. Foreign dual-resident companies can therefore be an important tool for domestic taxpayers in their international tax planning, particularly about optimizing foreign withholding taxes. ●

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Author Contribution

The author solely contributed to the study conception and design. The author read and approved the final manuscript.

Declarations

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