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IRS Denies Treaty Benefits Despite Lack of Treaty Shopping

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In *Starr International Company, Inc., v. United States*, the taxpayer ("Starr International Company, Inc." or "SICO") filed a complaint in the United States District Court for the District of Columbia seeking a tax refund from the IRS of approximately $38 million. The refund is allegedly due to an overpayment of U.S. withholding taxes on dividends SICO received from American International Group ("AIG") in 2007. A similar refund claim was filed relating to dividends SICO received from AIG in 2008 and the IRS allowed that refund in its entirety. The IRS is denying the 2007 refund claim on the grounds that SICO was "treaty shopping" when it moved its tax residence from Ireland to Switzerland in 2006, despite the fact that SICO would have been entitled to the same U.S. withholding tax rate under the U.S.-Ireland treaty as it would under the U.S.-Switzerland treaty (i.e., 15 percent in both cases) had it not re-located its tax residence. The IRS's position seems to be inconsistent with the technical explanation of the U.S.-Switzerland income treaty, as well as a recent Chief Counsel Advice Memorandum dealing with the U.S.-Cyprus income tax treaty.

Facts of SICO Case

SICO was incorporated in Panama in 1943 to own and operate insurance agencies outside of the United States. From 1943 until 2004, SICO's management and headquarters resided in Cuba and then Bermuda. From 1970 until the present, Maurice R. Greenberg had been the chairman of the board of directors of SICO. In the 1970s, SICO entered into a series of transactions that transferred all of SICO's insurance businesses to AIG. As a result of these transactions, by 1978 SICO was the largest shareholder of AIG. When AIG paid dividends on its common shares, AIG withheld and paid U.S. federal income tax to the IRS from the dividends paid to SICO.

In 2004, SICO moved its headquarters to Ireland. During the time that SICO was a tax resident of Ireland, SICO was entitled to benefits under the 1997 U.S.-Ireland Tax Treaty. In particular, the U.S. withholding tax rate on dividends from AIG to SICO was limited to a maximum rate of 15 percent, rather than the generally applicable 30 percent rate. In March 2005, Mr. Greenberg resigned from AIG after threats of criminal prosecution by Elliot Spitzer, the New York Attorney General at that time. In the wake of Mr. Spitzer's attack against Mr. Greenberg, animosity developed between AIG and SICO, and the two companies severed their previously close business relationship. Mr. Greenberg determined to reestablish SICO's insurance business and become a competitor of AIG. Contentious litigation between the two companies followed.

In 2005, SICO commenced an action against AIG for replevin and conversion, seeking to recover art and other property from AIG. Around the time SICO's assets came under attack by AIG, the Starr family of companies hired a new general counsel who was responsible in part for ensuring that SICO's assets were protected from AIG's claims. The new general counsel analyzed SICO's structure and its residency in Ireland. The general counsel researched several other jurisdictions, including Switzerland, the United Kingdom, and the Netherlands. The general counsel determined that Switzerland was the best jurisdiction to protect SICO's assets from AIG's claims. Accordingly, in December of 2006, SICO's board of directors moved the management of SICO to Switzerland causing it to become a Swiss tax resident for purposes of the U.S.-Switzerland income tax treaty.

LOB Provision of U.S.-Switzerland Income Tax Treaty

Similar to the U.S.-Ireland income tax treaty, the U.S. withholding tax rate on dividends was reduced from 30 percent to 15 percent under the U.S.-Switzerland income tax treaty. Unlike the U.S.-Ireland treaty, however, a Swiss resident corporation (such as SICO) that was owned by a resident charity and U.S. persons did not automatically qualify for treaty benefits under the limitation on benefits ("LOB") article of the U.S.-Switzerland income tax treaty. (While a charity was considered a "resident" for LOB purposes under Article 22(2), a charity was not a resident for purposes of the ownership/base ownership test under Article 22(1)(f) or the derivative benefits provision under Article 22(3)).

Instead, SICO sought to claim discretionary treaty benefits under Article 22(6) of the LOB provision. Under that provision, a corporation or other person that is not automatically entitled to benefits

> "may, nevertheless, be granted the benefits of the Convention if the competent authority of the State in which the income arises so determines after consultation with the competent authority of the other Contracting State."

The Technical Explanation to the U.S.-Switzerland income tax treat (the "Technical Explanation") states that the purpose of Article 22, paragraph 6 was to "identify investors whose residence in [Switzerland] can be explained by factors other than a purpose to derive treaty benefits." In other words, Article 22 paragraph 6 provides benefits to Swiss residents that do not meet one of the treaty's mechanical tests for automatic benefits but yet are not treaty shopping. The Technical Explanation further states that

> "[t]he competent authority of a State will base a determination under this paragraph on whether the establishment, acquisition, or maintenance of the person seeking benefits under the Convention, or the conduct of such person's operations has or had as one of its principal purposes the obtaining of benefit under the Convention."

Was SICO Treaty Shopping?

The Technical Explanation defines "treaty shopping" as "the use, by residents of third States, of legal entities established in a Contracting State with a principal purpose to obtain the benefits of a tax treaty between the United States and the other Contracting State." Notably, the Technical Explanation goes on to provide that

> "this definition of treaty shopping does not encompass every case in which a third state resident establishes an entity in a U.S. treaty partner, and that entity enjoys treaty benefits to which the third state resident would not itself be entitled. If the third country resident had substantial reasons for establishing the structure that were unrelated to obtaining treaty benefits, the structure would not fall within the definition of treaty shopping set forth above."

In the case of SICO, it is clear that it would have been entitled to a 15 percent U.S. withholding tax rate on dividends had it remained a resident of Ireland for income tax purposes. SICO moved its corporate tax residence to Switzerland solely to protect its asset from AIG's claims. Therefore, it is difficult to comprehend the IRS's position that SICO was "established, acquired, or maintained" to claim treaty benefits, or that SICO's conduct of its operations has or had as one of its principal purposes of obtaining benefits under the U.S.-Switzerland income tax treaty.

The IRS's position in the SICO case also appears to be inconsistent with a position the IRS National Office recently advocated in Chief Counsel Advice Memorandum 201343019 ("CCA"). In that ruling, the IRS concluded that a U.S. individual was entitled to treat dividends received from a Cypriot holding company with no Cypriot ownership as qualified dividend income, and thereby eligible for reduced U.S. federal income tax rates.

Under the facts of the CCA, a U.S. individual (the "taxpayer") owned an interest in an operating company located in a jurisdiction that had a comprehensive income tax treaty with the United States (e.g., the Czech Republic). The operating company's jurisdiction, however, imposed a withholding tax on dividends paid to non-residents of that jurisdiction. In order to eliminate the foreign country withholding taxes, the shareholders (including the U.S. taxpayer) transferred the shares of the foreign operating company to a Cypriot holding company ("HoldCo") in exchange for HoldCo shares. The remaining shares of HoldCo were owned by persons who were not residents of the United States or Cyprus. Dividends were then paid from the operating company to HoldCo, and then from HoldCo to the United States. The taxpayer claimed that dividends received from HoldCo should be eligible for qualified dividend income rates.

In order for the dividends to be eligible for qualified dividend rates under Section 1(h)(11), HoldCo had to a resident of Cyprus and the taxpayer had to satisfy the LOB provision of the U.S.-Cyprus income tax treaty. The LOB provision of that treaty provides that a Cypriot corporation is not eligible for the treaty benefits unless more than 75 percent of the number of shares of each class of the corporation's shares is owned, directly or indirectly, by one or more individual residents of Cyprus, and certain other requirements are met. The U.S.-Cyprus treaty also provides, however, that the first LOB provision test will not apply to a Cypriot corporation if the "establishment, acquisition and maintenance of the Cypriot corporation and the conduct of its operations does not have as a principal purpose obtaining benefits under the treaty."

Without much analysis, the IRS concluded that HoldCo was established in Cyprus, and was being maintained, for reasons unrelated to the U.S.-Cyprus treaty. Therefore, HoldCo qualified for benefits under Article 26(2) of the U.S.-Cyprus treaty because there was "no principal purpose of obtaining treaty benefits." While it was not specifically mentioned in the CCA, it is apparent that HoldCo was established simply to reduce foreign country withholding taxes, and it was not established to allow the taxpayer to obtain qualified dividend income under Section 1(h)(11) (which technically is a statutory benefit rather than a treaty benefit anyway). Therefore, because the taxpayer in the CCA would have been entitled to a qualified dividend had it received a dividend directly from the operating company, the taxpayer clearly was not using HoldCo to obtain benefits under the U.S.-Cyprus income tax treaty (i.e., the ability to obtain a qualified dividend, which, as a pre-requisite, requires that the dividend be received from a jurisdiction that has a comprehensive income tax treaty with the United States).

This argument is analogous to SICO's claim that it would have been entitled to a 15 percent withholding tax rate on U.S.-source dividends under the U.S.-Ireland treaty had it remained a tax resident of Ireland. SICO should not be considered as treaty shopping simply because it moved its tax residence to Switzerland for reasons unrelated to the treaty, because both the U.S.-Ireland and U.S.-Switzerland treaties had the same withholding tax rates on dividends.

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