Taxes

Newsletter of the International Bar Association Legal Practice Division

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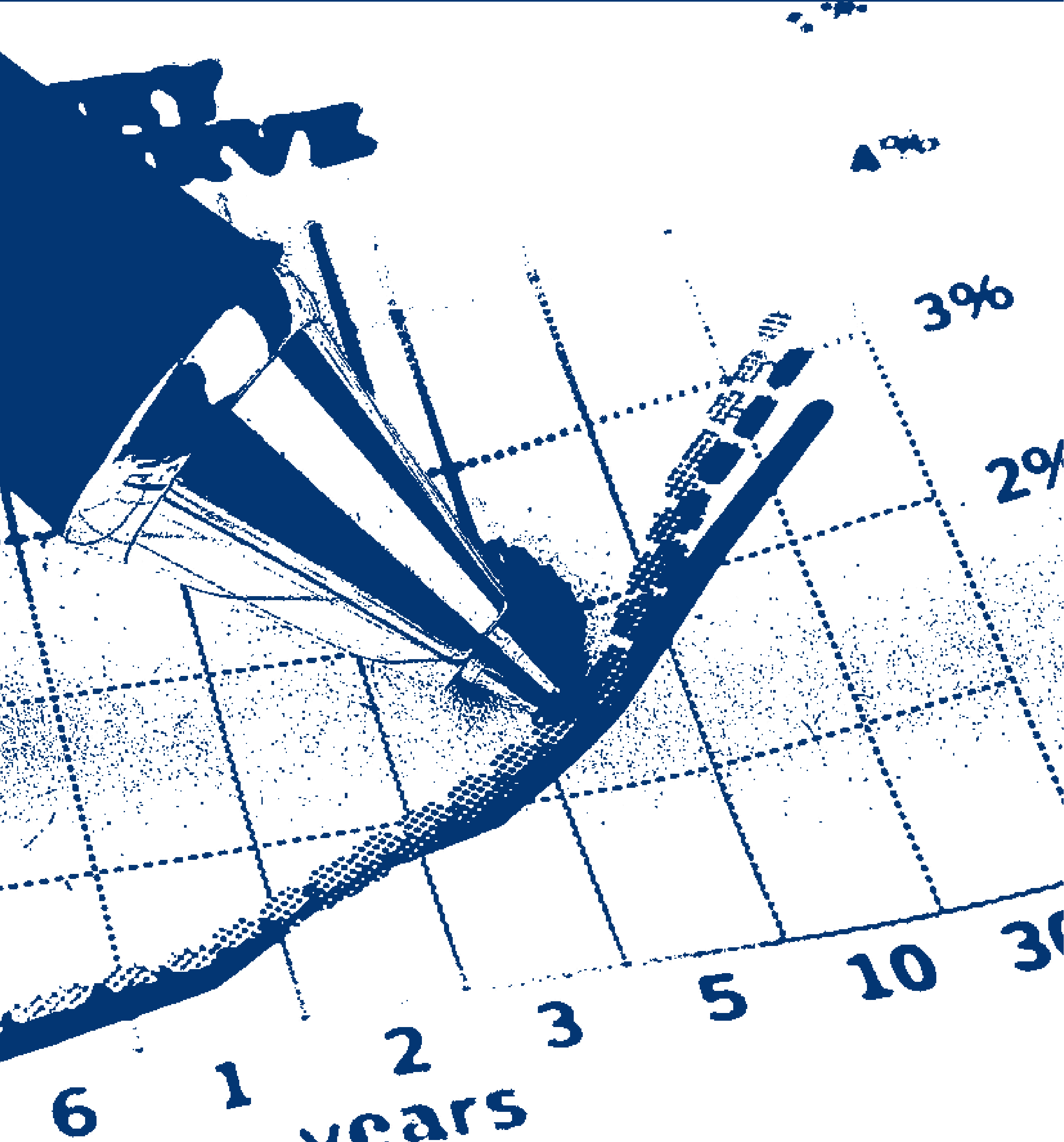
the global voice of the legal profession





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Rethinking international taxation as we know it

What senior practitioners should learn from younger ones

22 November 2013 | **OECD Conference Centre, Paris, France**

A conference presented by the IBA Taxes Committee, supported by the IBA European Regional Forum

As various nations, regulators and international bodies reassess a number of key parameters and guidelines relating to international and domestic corporate tax, this conference will examine what these changes might mean to practitioners from various jurisdictions involved in the field today, and how they may impact younger practitioners over the next 30 years.

Topics include:

- Transparency and enhanced mutual assistance in tax matters: will tax planning suffer?
- Will tax competition in the EU – and beyond – survive the 'base erosion and profit shifting' developments?
- Tax planning and abuse of tax treaties: navigating within tax uncertainty?
- Can Source States protect their tax base through the Permanent Establishment Concept?

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This newsletter is intended to provide general information regarding recent developments in taxes law. Views expressed are not necessarily those of the International Bar Association.

From the Co-Chairs

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This year is shaping up to be a year of tumult and, perhaps, of drastic change in the tax world. Such topics as 'base erosion', 'profit-shifting', transfer pricing, taxation of digital businesses, transparency and tax justice are receiving almost daily attention in the press and before the investigative committees of legislatures. The very concept of 'tax planning' has received massive publicity – usually negative and often uninformed. Obviously such traditional players as the EU, OECD and the taxing authorities themselves remain very active in these developments. Finally, some jurisdictions (eg, the United States) will be considering fundamental reform of their entire approach to taxing international transactions. 'International taxation' is no longer an affair just for us specialists but is now is in everybody's mouth – for good or for ill.

It has been also a busy year so far for the Taxes Committee. The second London Conference on Current International Tax Issues and Cross-Border Finance, sponsored in conjunction with the Chartered Institute of Taxation, held in February 2013, was extraordinarily well attended. The conference on European-US Tax Strategies held in London in April, jointly sponsored with the American Bar Association and the International Fiscal Association, was also a great success in terms of attendance and the quality of the panels.

Launched last year, the IBA Taxes Committee International Liaison initiative has continued to engage on international tax matters by preparing a submission to the OECD on the Commentary to Article 5 (Permanent Establishment) of the OECD Model Tax Convention and by the representation at the OECD International Tax Conference in Washington DC by a Committee officer.

The IBA Taxes Committee Scholarship Programme had another successful year in 2013 with 21 participants in the Scholarship Programme. In addition, the Scholarship Programme has expanded with the potential of a second scholarship being granted annually to a young lawyers programme.

Another appointment for which the IBA Taxes Committee worked hard is the annual Latin American-US Tax Strategies conference held in Miami on 12–14 June (including the 12 June pre-meeting programmes) – sponsored by the IBA, the ABA and the Tax Executives Institute.

We are now looking forward to our most important event of the year, the IBA Annual Conference in Boston which will be held from 6–11 October 2013. The programme has already been set and the panellists are preparing the sessions. The programme will address the hot topics in the international tax world, such as taxation of e-commerce, transfer pricing, basis erosion and profit shifting. Leading representatives of the OECD and the US Treasury will speak at our panels and give their perspective on these developments.

We extend a warm invitation to you to join us in Boston and attend our sessions and also take advantage of the unique opportunity to network with lawyers from almost every country in the world. The Committee officers have put together an outstanding programme which should keep you busy from Monday morning on 7 October until Friday morning on 11 October inclusive.

In addition to the technical programme, we want to point out the social and business events sponsored by the Committee. First, we will host a breakfast at the conference venue for the National Reporters on Monday, 7 October at 0800 – 0900. Immediately after the breakfast, Robert B Stack, Deputy Assistant Secretary, International Tax Affairs, of the US Treasury Department, will give an address to launch the first session of the week. Secondly, our traditional Taxes Committee dinner will take place on Tuesday 8 October at the Boston Harbor Hotel overlooking the harbour. Finally, our open business meeting will take place over lunch at the conference venue on Thursday 10 October. The agenda will include the presentation of the topics for next year's conference in Tokyo. Anyone interested in speaking on a panel next year or in participating more intensively in the activity of the Taxes Committee should take advantage of these opportunities to speak to the Committee officers. We look forward to seeing you in Boston!

To conclude the year, we will be sponsoring, with the OECD in Paris, the Young Lawyers Conference on 22 November 2013. The theme of the conference will be 'Rethinking International Taxation as we know it: What Senior Practitioners should learn from Younger Ones.'

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Editor's note

As the Editor of the IBA Taxes Committee Newsletter, I am delighted to welcome all members to the second issue of 2013.

Further to the first issue at the beginning of this year, this mid-year edition intends to inform readers about the activities carried out by the Taxes Committee during the first half of the year and the plans for the future.

In the introductory article to this edition, the Co-Chairs of the IBA Taxes Committee, Stuart Chessman and Sonia Velasco, illustrate past activities and future initiatives.

The Newsletter contains the reports from the sessions of the successful conferences in London: the '2nd IBA/CIOT Conference: Current International Tax Issues in Cross-Border Corporate Finance and Capital Markets' and the '13th Annual Tax Planning Strategies Conference – US and Europe'. In total, 18 reports from the above-mentioned conferences have been collected and will guide readers throughout the most recent trends in international taxation and give a flavour of the current tax climate in the countries represented in the panels. Our appreciation goes to the volunteers who devoted their time and effort in preparing the reports in a short timeframe as well as to the co-chairs and panellists who reviewed the reports. Special thanks go to Margriet Lukkien for her precious work in sourcing and coordinating the session reporters.

Moreover, an insightful contribution from Simon Yates will take us into the recent debate on tax and morality which is ongoing in the UK as well as in other countries.

As a final remark, let me remind you that we are happy to receive contributions for the Newsletter from the members of the IBA Taxes Committee. Articles should not exceed 2,500 words and should cover subjects of broad interest. Anyone who is interested in writing an article for the Newsletter is welcome to contact me (details above) for further details.

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BOSTON 2013 6–11 OCTOBER

ANNUAL CONFERENCE OF THE INTERNATIONAL BAR ASSOCIATION

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Taxes Committee session

Monday 0830 – 0930

National rapporteurs breakfast and meeting

Presented by the Taxes Committee

All national rapporteurs are invited to attend a breakfast meeting on the Monday morning in order to meet each other, the Co-Chairs of their session and some of the Taxes Committee officers.

Monday 0930 – 1230

E-commerce: a modern approach to taxation

Presented by the Taxes Committee

Keynote address:
Robert B Stack *Deputy Assistant Secretary (International Tax Affairs) US Treasury Department, Washington DC, USA*, will open the session with a keynote address on 'US policy initiatives, interesting developments and international matters.'

The explosive development of e-commerce is creating challenges for tax practitioners in a wide range of disciplines. The panel will review recent developments in areas such as defining 'permanent establishment' (PE) and allocating income to a PE in the context of e-commerce. How is e-commerce taxed in various countries? What are the current international structures for owning IP, servers and websites? What are the new revenue protection measures and Google tax lookalikes adopted around the world? How do VAT, US state sales and use taxes and similar non-income taxes apply to sales made by the internet?

Monday 1430 – 1730

New challenges in obtaining interest deduction and in financing group activities

Presented by the Taxes Committee

Financing corporate groups in a tax-efficient manner is becoming more and more challenging in light of various initiatives adopted by several countries. The panel will review some of these new limits on interest deductions, repatriation of profits, depreciation of loans (eg, the so-called non-commercial loan doctrine in the Netherlands) and debt push-downs and will walk the audience through some of the pitfalls a corporate group needs to avoid when restructuring its finances.

Continued overleaf

Tuesday 1430 – 1730

Mind the 'tax' gap: a global reaction to base erosion and profit shifting

Presented by the Taxes Committee and the Organisation for Economic Co-operation and Development (OECD)

In a globalised economy, base erosion constitutes a major risk for tax revenues. The worldwide spread of MNEs and the crystallisation of new business models in the so-called digital economy make profit shifting one of the major sources of base erosion. Also, other challenges such as targeting effectively hybrid mismatches, re-assessing transfer pricing guidelines, the effectiveness of anti-avoidance measures, the need for increased transparency are being faced in the short run by policy makers in the area of international taxation. At the request of the G20, the OECD launched a comprehensive initiative to address base erosion and profit shifting (BEPS). Work in the area of aggressive tax planning is also being undertaken by the EU Commission. In this session, co-organised with the OECD Secretariat, a panel of experts will debate about these initiatives and the possible measures to tackle BEPS instances in an effective manner.

Wednesday 0930 – 1230

Tax residency: coming or going: do you know where you are?

Presented by the Taxes Committee

This panel will review where companies and other entities are treated as being resident for tax purposes, a question which has become more important due to globalisation, executive mobility and the growth of online business. Passing or failing the tests for corporate residence has significant implications for the tax position under both domestic law and international treaties. The panel will also consider the technical and practical aspects of corporate redomiciliation, migration and inversion transactions, intended to change the corporate seat and tax residence or domicile of a company or corporate group.

Wednesday 1430 – 1730

Family business: benefits of family trusts and their alternatives

Presented by the Taxation Section

Control without ownership, creditor proofing, reduction in total income taxes, succession planning – those are only few of the many benefits family trusts offer to family-owned businesses. This panel discusses how families with substantial businesses structure their corporate and personal affairs. We will focus on the issues of control of wealth planning vehicles, and on governance of the underlying corporate structures. The panel further investigates which vehicles, jurisdictions and governing laws are popular, and why. Recent changes in tax policies across the globe affect family-owned structures. The panel will suggest how to respond to these changes in the interest of your client.

Thursday 0930 – 1230

Cutting your losses: where did all my NOLs go?

Presented by the Taxes Committee

Most jurisdictions allow a company to set off tax losses against profits in other periods. In addition to limiting the period for loss carry forwards, many countries have restricted the use of tax losses and have established or tightened loss forfeiture rules upon change of ownership. This session will explore the situations in which a company or corporate group may be unable to claim relief for its tax losses and how to address this problem proactively.

Thursday 1230 – 1430

Open committee business meeting and lunch

Presented by the Taxes Committee

An open meeting and lunch of the Taxes Committee will be held to discuss matters of interest and future activities.

Thursday 1100 – 1230

Exchange of information and collection assistance: is transparency trumping taxpayer confidentiality?

Presented by the Taxes Committee

Revenue authorities are stepping up efforts to protect their tax bases. Pressured by some countries, with support from intergovernmental bodies such as the OECD and G20, many jurisdictions are being forced to exchange bank customer information, automatically or upon general request. In addition, countries that have traditionally resisted enforcing foreign tax claims have given way. This panel will discuss the current international trends, including automatic exchange of information, mutual assistance procedures, FATCA, use of money laundering tools, savings taxes, informer programmes and tax amnesties.

Thursday 1430 – 1730

Recent legislative developments and new case law in transfer pricing: is this the end of the arm's length principle?

Presented by the Taxes Committee

Protecting the tax base is becoming a key driver these days as some countries find that the arm's length methodology is not leading to satisfactory results. The panel will provide a transfer pricing update in several jurisdictions and will review the formulary apportionment approach that is now being considered (OECD draft report and EU consolidation approach).

Thursday 1430 – 1730

Tax fraud: causes and cures

Presented by the Business Crime Committee and the Taxation Section

The panel will first examine the underlying elements of tax fraud – is it pure greed or are there other reasons why avoidance steps over the line and becomes evasion? What parts do lack of resource on the part of investigators and widely different tax rates play and what perceptions surround the chances of being found out and prosecuted?

It will then look at the alternative attempts made in various jurisdictions to cure this widespread and international problem, from the imposition of severe custodial sentences at one extreme, to offering an amnesty from prosecution and fixed penalties at the other.

Friday 0930 – 1230

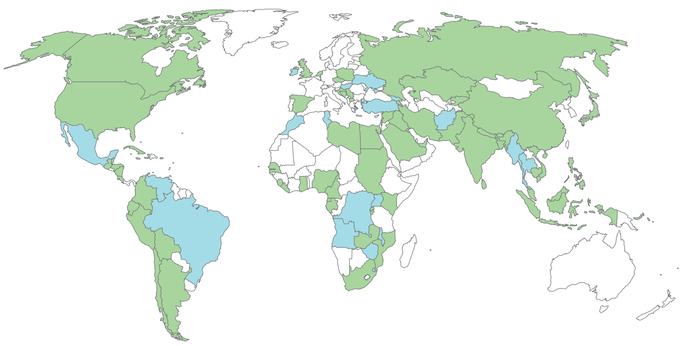
Acquisition, holding, restructuring and realisation of value assets

Presented by the Taxes Committee

Market liquidity is an asset's ability to be sold without causing a significant movement in the price and with minimum loss of value. Value buying generally involves buying securities at a discounted price so as to generate through restructuring and/or realisation higher returns to investors. The panel will explore the various international structures used by funds to invest in distressed assets (both equity and debt), including the use, where appropriate, of aggregators to reorganise the assets, and the ways (eg, securitisation) and the instruments (eg, participating loans) aimed at marketing the non-participating assets while at the same time trying to avoid international tax exposures (eg, establishment of PE by collecting agents).

INTERNATIONAL BAR ASSOCIATION'S HUMAN RIGHTS INSTITUTE (IBAHRI)

The International Bar Association's Human Rights Institute (IBAHRI), established in 1995, has become a leading global force in human rights, working to promote and protect the independence of the judiciary and the ability of lawyers to practice freely and without interference under a just rule of law. The IBAHRI runs training programmes and workshops, capacity building projects with bar associations, fact-finding missions, trial observations; issues regular reports and press releases disseminated widely to UN bodies, international governmental and non-governmental organisations and other stakeholders; and undertakes many other projects working towards its objectives.



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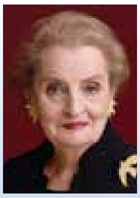

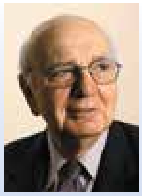

Madeleine K Albright *Former US Secretary of State, Opening Ceremony Keynote Speaker*

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Paul Volcker *American Economist and former Chairman of the Federal Reserve*

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Second IBA/CIOT Conference: Current International Tax Issues in Cross-Border Corporate Finance and Capital Markets

London, 11 February 2013

11 FEBRUARY 2013

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Interest deductibility – current state of play and direction of travel

Speakers
Michel Collet *CMS Bureau Francis Lefebvre, Neuilly sur Seine*
Fergus Harradence *HM Treasury, London*
Friedrich Hey *Debevoise & Plimpton, Frankfurt am Main*
Tom Scott *McDermott Will & Emery, London*
Jeffrey Trinklein *Gibson Dunn & Crutcher, New York*
Phil West *Steptoe & Johnson, Washington DC*

Introduction

This session focused on the phenomenon of debt bias and considered some of the ways in which it is currently addressed and discouraged by selected national tax systems (such as the UK, France, Germany and the US). The report includes a brief summary of the OECD's recently-released 'base-erosion and profit-shifting' report, which is presented contextually as a recent development at the international level in combating the debt bias, and concludes with a brief speculative consideration of some changes that could be made to the UK's corporate tax system in order to further combat debt bias in the supply chain planning of multinational corporations (MNCs).

Debt bias – consequences and remedial actions

As a general proposition, debt is typically more attractive to corporate taxpayers than equity. This is principally because interest payments on debt are usually tax-deductible and so are in theory an easy way in which to reduce a company's effective tax rate. But interest deductibility is only the beginning; debt is fundamentally more flexible and advantageous than equity in several respects. For example:

- debt can be repaid without the need for the company in question to have 'distributable reserves';
- it can be tranched, split, subordinated and traded;
- interest payments can be capitalised or rolled-up;
- it can incorporate certain features of equity (such as profit participation) whilst retaining certain features of debt (such as priority of repayment over shareholders in a winding-up); and
- it can carry rights of conversion and/or exchange in respect of the common stock of the borrower or another company.

Over time, these numerous benefits have contributed to the so-called 'debt bias' in the supply chain planning of MNCs, which typically tends to exhibit a strong preference for funding to be sourced in the form of debt rather than equity.

This debt bias is generally thought to have several negative potential ramifications. Most obviously, excessive leverage is generally accepted as having been one of the key causes of the 'credit crunch', which was damaging not only to domestic financial systems in their own right but also to the global economy as a whole. Furthermore, although it is not always easy to distinguish causation from correlation, it is a fact that a debt bias tends to go hand-in-hand with 'base erosion', that is, the tendency of MNCs to locate their debt financing in the same jurisdictions in which their profits are generated in order to shelter or wipeout any potential tax. Taken a step further, a debt bias can result in the location of a company in a given jurisdiction solely for the purposes of drawing-down debt, where that jurisdiction offers a favourable regime for interest deductibility and perhaps also the ability to surrender deductions into the wider group.

A debt bias can therefore fundamentally affect not only the way in which companies do business where they are already based, but can also encourage structures to be established solely for the purpose of exploiting favourable interest deductibility regimes and arbitraging differences between domestic regimes to the benefit of an MNC. This can in theory be just as undesirable as the basic phenomenon of over-leverage, which can itself present a systemic risk for national governments generally. Most developed taxing jurisdictions therefore have rules that are intended to reduce the attractiveness of debt finance to MNCs and to curb the tendency towards a debt bias in their supply chain structuring.

Selected national tax systems – combating the debt bias

Presently, the UK rules dealing with interest deductibility include:

- thin capitalisation and transfer pricing (which restrict interest deductibility where, for example, the ratio of debt to equity is too high, the level of debt is supported by a connected company guarantee that would not be available to an unconnected borrower or where the rate of interest charged is excessive);
- purpose-based rules (which tend to prevent interest deductions where either the interest or the related principal are connected with a tax evasion motive);
- anti-arbitrage rules (which restrict the UK deduction where there is an element of cross-border arbitrage involved, such as the ability of the taxpayer in question to claim deductions in more than one country in respect of the same interest payment);
- the 'worldwide debt cap' (which prevents 'debt dumping' in the UK by limiting a UK company's interest deductions by reference to the amount of third party debt in the consolidated accounts of the group); and
- the statutory general anti-abuse rule.

Other jurisdictions have rules that are similar, but have also added their own domestic twists. The US, for example, has long-standing anti-debt bias rules around late paid interest and earnings stripping. Germany applies two limits to interest deductibility known as the Trade Income Tax (which restricts 25 per cent of otherwise deductible interest in respect of certain modified income) and the interest barrier rule (which applies where companies have a net interest expense position in excess of €3m and effectively caps interest deductions at 30 per cent of the company's modified taxable EBITDA). In France, there are three cumulative layers of legislation that an interest payment must safely navigate through in order to achieve deductibility:

- thin capitalisation (which, in a similar fashion to the UK rules, looks both at the rate of interest and the ratio of debt to equity);
- anti-abuse rules relating to the French participation exemption (which aim to restrict the availability of the exemption where a French company is purchased in a leveraged acquisition); and
- the interest tax barrier (which applies in a similar way to the German interest barrier rule described above).

International action

Perhaps the clearest sign of the growing political desire to address the debt bias in supply chain structuring is the OECD's work on base-erosion and profit-shifting (BEPS). This has become a key focus for many countries that in recent years have seen a reduction in tax revenues which they feel cannot fully be attributed to the global recession.

The BEPS report was released on 13 February 2013. Whilst in general terms it presents nothing new (as it substantively simply restates previous work such as the Report on Harmful Tax Competition and the Harmful Tax Project), the report clearly demonstrates that BEPS has now become a political issue and there is a real momentum behind the OECD's work on this issue.

The report concludes that the current rules on international tax are outmoded because they have failed to keep pace with the way in which MNCs do business nowadays. In particular, there is a recurrent focus in the report on what have become 'the usual suspects' in any discussion about the efficacy of the current principles on international tax; namely, transfers of intellectual property, e-sales/digital business and the tendency towards a debt bias in supply-chain structures founded on the principle of separate legal personality.

The report also touches on the impact of state-sponsored tax incentives. It notes that these may lead to an MNC having a low effective tax rate in an entirely uncontroversial manner (eg, where a government policy to encourage investment in a particular sector gives rise to a tax-break), but also flags the potential for distortion in a global economy where sovereign states compete with each other to attract inward investment by offering competitive tax systems.

The report recommends that an action plan be drawn up by June 2013, with concerted international action to take place as soon as possible thereafter in order to implement the plan. As debt bias is one of the aspects of BEPS (arguably one of the principal aspects), the OECD's work in this sphere will be of great relevance to MNCs going forward.

Possible tax law changes to combat debt bias

Aside from the work of the OECD on BEPS, it is likely that individual countries may wish to take unilateral action to combat debt bias. Although multilateral action at the international level will be more effective in combating debt bias globally, unilateral action taken by a given country changing its domestic tax rules is likely to yield results more quickly (albeit on a smaller level).

By way of example, the UK offers what is in general terms still a relatively generous interest deductibility regime for corporate taxpayers. Although a taxpayer seeking an interest deduction must navigate its way through an extensive battery of rules that can restrict or deny in full the deduction being sought, the starting proposition that an interest payment will be tax-deductible in line with the recognition of the interest expense in the borrower company's accounts is not easily disturbed in normal structuring. This has caused some commentators to query whether the UK's corporate tax rules are actually now too competitive (for example, there is a generous participation exemption, no withholding tax on outbound dividends, an exemption for foreign branches and no tax is levied on foreign or UK source dividends received by a UK company).

The UK Government has until now ruled-out any changes to the deductibility of interest. In general, this was because it was believed that changes would have been disruptive for business, would undermine stability and certainty, and could have damaged the UK's competitiveness. It was also thought that it would be difficult to design a workable rule that operates fairly for all businesses without creating complexity or uncertainty.

However, given the generally favourable and competitive corporate tax regime the UK now has, it is possible that the rules on interest deductibility are now ideal candidates for unilateral action by the UK; they could be amended at a purely domestic level, would be unlikely to place the UK in breach of any of its double tax treaty obligations and should be compliant with the UK's EU law obligations. We can only speculate as to the form of any such changes, but these would in theory be likely to borrow certain features from some of the regimes outlined above. For example, the UK could introduce an interest barrier rule or could restrict the availability of its participation exemption in a similar fashion to the French equivalent (at present, debt financing has no effect per se on the availability or operation of the UK's participation exemption). Such changes may be limited to certain sectors, with carve-outs for particular industries. The UK might also look to overhaul its generous rules on the carry-forward of losses (perhaps introducing a time limit to replace the current position of indefinite carry-forward) and possibly also review its rules on the availability of losses when a change of ownership takes place (perhaps seeking to narrow the scope of these rules in line with the equivalent regime in Germany). Alternatively, the UK could focus on levelling the playing field between debt and equity by introducing an allowance for corporate equity. Any such changes would need to be looked at holistically in the context of the UK's corporate tax system as a whole.

Conclusions

The debt bias is a prevalent feature of MNC supply chain structuring and results from the inherent tax and non-tax advantages of debt over equity. Whilst many countries already have their own domestic rules in place to combat debt bias, it is likely that multilateral action at the international level will take place over the coming years (principally in the wider context of BEPS) that will impact upon debt bias. In the meantime, MNCs should be aware that individual countries may move to address debt bias through changes in their domestic legislation in an attempt to block base-erosion unilaterally; MNCs will need to monitor any such developments carefully and factor them into the ongoing maintenance and development of their supply chain planning.

Financing transactions in this environment including conduits, hybrid entities and hybrid instruments

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Speakers
Paul Carman *Chapman and Cutler, Chicago*
Carlos Ferrer *Cuatrecasas Goncalves Pereira, Madrid*
James Somerville *A&L Goodbody, Dublin*
Gerald Rokoff *DLA Piper, New York*

The purpose of the session was to discuss recent tax developments affecting international financing transactions, including the treatment of conduit and fiscally transparent entities, hybrid entities and hybrid instruments.

Ireland

James Somerville began by discussing hybrid instruments and noted that it was a topical issue at OECD and EU level during 2012, evidenced by the publication by the EU of a consultation document on the subject in December 2012. Ireland anticipated these moves and took steps in 2011 to limit opportunities for double non-taxation through the enactment of domestic legislation. Pre-2011, it was possible to have an Irish company issue a hybrid instrument which would give rise to an interest deduction without taxation of the corresponding income in the recipient country.

The Irish changes focussed on the issue of profit participating notes by Irish section 110 companies. An Irish section 110 company is a 'normal' Irish company which is subject to Irish corporation tax and resident in Ireland for Irish domestic tax and treaty purposes. The legislation provides for it to be treated as 'trading' allowing it a full deduction for expenses incurred including 'profit dependant' interest (overriding normal rules). It is typically financed by way of profit participating loan notes, the return on which leaves only nominal profit within the vehicle taxable at 25 per cent. Irish section 110 companies are typically used for financing transactions and must meet certain conditions.

It was not immediately clear what triggered the 2011 changes; however, the recent focus on hybrid instruments and double non-taxation suggest that the Irish government's aim was to combat such arrangements. The Irish Revenue Commissioners engaged in consultation with industry representatives with a view to ensuring that only offensive transactions would be affected by the new legislation. Irish section 110 companies are typically used in a wide range of legitimate financing transactions and there were concerns that the changes, if not carefully considered, could affect Ireland's standing as an international financial services centre.

Interest deductibility is now denied in the case of certain offensive structures which result in either:

- double non-taxation; or
- a deduction in Ireland with no taxation in the recipient jurisdiction.

In broad terms, following the 2011 changes, interest deductibility is now dependant on the profit dependant interest element being taxable in the recipient country without a participation exemption or a notional/ deemed deduction.

Interest deductibility is not, however, restricted by the new anti-avoidance provisions where:

- interest is paid to a person within the charge to Irish corporation tax;
- interest is taxable in an EU/double tax treaty (DTT) country without a deemed or notional deduction calculated by reference to the amount of interest received;
- interest is paid to a pension fund, government body or equivalent in an EU/ DTT country in which that entity is exempt from tax;
- interest is paid on a 'quoted Eurobond' or a 'wholesale debt instrument' provided that it is not paid to a 'specified person' (which broadly means a person who controls the section 110 company or from whom the section 110 company has acquired 75 per cent of its assets).

Whilst the legislative changes were relatively brief, they resulted from a long consultation process and gave rise to long guidance notes issued by the Revenue Commissioners clarifying Revenue's approach to the changes and the treatment of certain foreign entities receiving interest.

A number of practical issues arise for advisors, for example, the requirement that the recipient of profit dependant interest is subject to tax in an EU/DTT country can necessitate a complex analysis where there are many recipients in different jurisdictions. The treatment of partnerships was also initially unclear. However, the Irish Revenue Commissioners have clarified that the interest will be considered subject to tax if it is taxed on an arising basis on receipt by a partner in an EU/DTT country. Further clarity was also provided in respect of certain US entities. In the case of 'check the box' entities, the interest will be considered subject to tax if it is treated for US purposes as paid to a US person who is subject to tax on an arising basis. In the case of US LLCs with only US investors, interest will be considered subject to tax. Where there are non-US investors in the LLC, interest will be considered subject to tax only to the extent that it is immediately (ie, within 20 days) paid to a taxable EU/DTT investor.

Whilst certain offensive structures are no longer viable, the Irish Revenue Commissioners recognise the importance of maintaining the ability to carry out public transactions through Ireland and for this reason many similar transactions may still be implemented through the use of listed/ wholesale debt instruments or hybrid instruments, the foreign deduction in respect of which is not computed by reference to the amount of Irish interest paid.

The Irish Revenue Commissioners are taking further steps to address other hybrid issues. Irish regulated funds which are established as corporate entities can currently only be established as plcs which are per se entities for US tax purposes. A new form of corporate fund is being formulated which will not be a plc and will have the ability to check the box for US tax purposes. A further anomaly which is being addressed is the tax treatment of Irish investment limited partnerships. These entities are currently treated as opaque from an Irish tax perspective but transparent from a legal perspective. The Irish Finance Act 2013 will change the tax status of these entities so that they are regarded as transparent from both a legal and a tax perspective.

United States

Paul Carman discussed recent developments in the interpretation of the meaning of the term 'beneficial owner' for DTT purposes. The OECD released a revised commentary on the subject in October 2012 and he noted that the commentary is likely to have a broad impact on financing transactions, both in the application of DTTs and in the interpretation of intergovernmental agreements. The April 2011 OECD commentary required the recipient to have 'the full right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass the payment received to another person'. This was not commercially viable in most cases as almost every company has obligations which must be met. The October 2012 OECD commentary has removed this requirement and whilst there are still certain issues with the interpretation from a tax advisor's perspective, it is a friendlier version.

Paul Carman discussed the international context in which the OECD commentary has developed.

Indofood Finance Limited v JP Morgan Chase Bank NA London Branch

The *Indofood* case involved a Mauritian finance subsidiary which granted a loan to its Indonesian parent. The DTT between Mauritius and Indonesia was terminated during the term of the loan resulting in a withholding tax charge. The issuer sought to accelerate the notes and this was resisted on the basis that withholding tax could be avoided through the interposition of a Dutch company. The matter was heard by a contract court in the UK which considered whether the Dutch company would be the beneficial owner of interest payments received by it. Whilst there were timing differences in the payments, identical amounts would be paid straight through the Dutch entity. The UK court held that the Dutch finance subsidiary would not be the beneficial owner of the payments received by it.

The Queen v Prévost Car Inc and Velcro Canada Inc v The Queen

These Canadian cases looked at the meaning of beneficial owner in the context of payments of dividends and royalties (respectively) by a Canadian company to a Dutch holding company. The *Velcro* case applied the *Prévost* analysis and ultimately considered whether the recipient company had any discretion with respect to the funds received. Both rulings were in favour of the taxpayer.

SAT Guoshuihan [2009] No 601

The Chinese tax authorities issued a circular in 2009 containing a list of bad facts which would indicate that an entity should not be regarded as the beneficial owner of payments received by it. Some of these indicators could be regarded as commonsense while others go much further than that.

There was concern initially as to whether this guidance would act as a treaty override and this was clarified in announcement 30 issued in June 2012. The Chinese tax authorities confirmed that in the case of public companies in treaty jurisdictions, Circular 601 is not a treaty override, however in the case of private companies in treaty jurisdictions, Circular 601 overrides treaty provisions. Subsidiaries of public companies also benefit from Announcement 30 provided they are formed and tax resident in the same jurisdiction as the parent.

As many multinationals hold their Chinese investments through tax havens, this is likely to cause problems with the beneficial owner analysis in many cases. A tax haven subsidiary must formally disclaim that it is the beneficial owner before the parent company can assert the DTT and this presents difficulties for all parties involved.

OECD commentary

The general rule which was set out in the April 2011 OECD commentary stated that if the recipient was obliged to pass on the payment received, it would not be treated as the beneficial owner of that payment. The October 2012 commentary draws back a little from this position in that the obligation to pay on must now be related to the obligation to receive in order for beneficial ownership to be denied. For example, the *Indofood* case involved clear related obligations to pay on the amount received immediately and would be likely to be caught under the new guidelines. Financing subsidiaries typically lend and borrow on a regular basis rather than entering into one-off transactions. It may be arguable that, in these scenarios, an obligation to pay on is not directly related to the payment received; however, this will need to be explored over time.

The word 'unrelated' is mentioned twice in the commentary and both instances are relevant. The best factual situation which could arise is a situation where, in the ordinary course of business, a financing entity borrows money to finance its operations and also receives payments from subsidiaries which are unrelated. There are also grey areas such as multi-transaction securitisation programmes where there is no one-to-one correlation of payments. It remains to be seen how these transactions will be treated.

Whilst the specific guidance provided in relation to collective investment vehicles is welcomed, the actual wording is relatively restrictive. Only funds that are legal persons, are widely held, hold a diversified portfolio and are subject to investor protection regulation stand to benefit.

In summary, under the new commentary:

- unrelated debt obligations are permitted;
- public financing vehicles are given preference over private financing vehicles; and
- single transaction SPVs that simply pass through the payments will have challenges.

Spain

Carlos Ferrer began by discussing trends in Spain in re-characterisation of transactions. He explained that Spain has a wide variety of anti-abuse legislation ranging from general to specific and recent changes have enhanced the powers of the Spanish tax authorities. General anti-abuse provisions include rules setting aside sham transactions and the doctrine of fraus legis. These provisions allow the Spanish courts to set aside transactions and disregard legal entities which are validly incorporated in circumstances where a transaction is solely tax driven.

The computation of Spanish corporate income tax is based on accounting results, as adjusted for tax purposes. Spanish GAAP contains similar substance over form provisions to IFRS. Spanish tax authorities can modify the accounts of a company based on the substance over form principle even without invoking sham transaction provisions. This is a very powerful re-characterisation tool which may be used in circumstances where the tax authorities are of the view the underlying transaction is different to what has been recorded in the accounts.

Spain has typically been a good jurisdiction for tax planning because of the fact that profits for tax purposes are based on accounting profits. For example, where an instrument is treated for accounting purposes as debt/equity, the tax treatment typically follows. Once international accounting standards are met, the treatment of the return as interest/distribution follows this analysis. Recent substance over form changes will give rise to significant room for re-characterisation in this regard.

Two very important limitations were introduced this year affecting interest deductibility.

Intragroup transactions

Financing expenses incurred by a Spanish company on an intragroup loan to acquire shares of/make an equity contribution to a group company are no longer deductible unless there is a valid economic reason for the transaction. The provisions were introduced to combat certain offensive transactions whereby multinationals used intragroup financing to buy foreign group companies creating a tax deduction in Spain. As there were historically very few limits in Spain on interest deductibility this led to artificial erosion of the Spanish taxable base.

General limitation

This rule was introduced to replace Spanish thin capitalisation rules with effect from 1 January 2012. The rule limits the level of deductibility of financing costs to 30 per cent of the borrower's EBITDA (excluding the first €1m which is always deductible). Excess expenses may be carried forward (for up to 18 months) and unused thresholds may be added to the following year's threshold (for five years). The rule applies to both intragroup and third party financing regardless of whether transactions are arm's length (with certain exceptions in the case of financial institutions, insurance companies etc).

Another key issue currently is the treatment of foreign hybrid entities. In assessing the nature of a foreign entity, the Spanish tax authorities look at:

- legal personality;
- tax personality;
- powers of the shareholders; and
- liability for debts incurred by the entity.

Foreign entities will be disregarded for Spanish tax purposes and Spanish DTTs to the extent that these characteristics are similar to a Spanish disregarded entity. The treatment of a vehicle (eg, foreign fund/securitisation vehicle) as transparent in a foreign jurisdiction and opaque under Spanish law can give rise to difficulties, particularly in the context of withholding tax and treaty access.

United States

Gerald Rokoff began by highlighting the commercial and tax friendly aspects of the US tax regime including:

- US entity classification rules allowing foreign and US entities to elect whether to be treated as pass-through (taxation at member/owner level) or blocker/corporate (taxation at entity level). This gives rise to opportunities for the US tax burden to be reduced without a corresponding US inclusion. Even in the case of per se entities,

it is typically the case that these can be converted to non-per se entities tax free in non-US jurisdictions.
- 'Double dip' opportunities allowing a deduction for the same interest in more than one jurisdiction on both outbound and inbound payments.
- US rules are 'substance' based while in many non-US jurisdictions, rules are 'form' based, permitting varying characterisations of the same transaction.
- As US pass-through entities are not subject to US tax simply as a result of organisation/formation under US state laws, non-US joint ventures have utilised US LLCs with no commercial activity or income in the US as 'tax haven' entities because of the minimal administrative costs and robust legal regime.
- The use of hybrid/disregarded entities to avoid what would otherwise be bad income for Subpart F.

He went on to discuss the main aspects of the 'check the box' rules, the types of hybrid entities and their interaction with US DTTs. Whilst certain structures no longer work, it is still possible to use hybrid entities in acquisition/capitalisation financing to create inbound and outbound double dip structures.

Significant tax planning opportunities exist for foreign investors investing in US real estate. The most common and simplest structure is to use a US corporate blocker, which acquires real estate directly or through a US pass-through. The US taxes gains on the sale of real estate but it is possible to mitigate the US tax charge if the US pass-through entity is capitalised in part with debt. Interest is deductible against operating profits or may be used to create an operating loss which can be set against future gains. Withholding may be reduced or eliminated under US DTTs or by borrowing from an unrelated entity. Provided the ultimate shareholding is diverse (ie, no ten per cent shareholders), the acquisition vehicle may be leveraged with shareholder debt creating an interest deduction and avoiding withholding.

More complex investment structures exist which give rise to enhanced tax benefits. For example, high yield debt instruments may be used to convert operating profits/gains on disposal to 'portfolio interest' which is not subject to US federal or state taxation. Whilst this alternative dramatically reduces US taxation, there are strict criteria which must be met in order to ensure favourable tax treatment is achieved in respect of the debt instrument. For example, the equity should be held by an unrelated party with favourable tax attributes which will acquire the real estate.

Another alternative for foreign investors in US real estate is to use a multi-tiered investment structure involving both foreign and US blocker entities. US federal/state corporate income tax will arise on sale of the underlying property together with potential withholding tax on distribution of the proceeds offshore. The sale of shares in the offshore entity will not trigger a US tax charge. Prior to the sale, the US company can do a section 1031 exchange which will establish the value of the real estate and purchase a property the stock buyer is willing to own.

Hedging including credit default swaps, equivalent payments and managing foreign tax credits

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Speakers
Richard Andrade *Goldman Sachs, London*
Stuart Leblang *Akin Gump Strauss Hauer & Feld, New York*
Scott D Newman *K&L Gates, New York*

Messrs Leblang, Andrade and Newman were the speakers on the panel on 'Hedging, including credit default swaps, equivalent payments and managing foreign tax credits'. Messrs Leblang and Andrade focused their remarks on section 871(m) of the US Internal Revenue Code of 1986, as amended (the 'IRC'), which was enacted in 2010 and provides that any 'dividend equivalent' will be treated as a dividend from US sources for all withholding tax purposes (regardless of the residence of the payor) and, in connection therewith, the temporary and proposed regulations issued by the US Internal Revenue Service (IRS) in January 2012 that expand and modify the scope of IRC section 871(m).

Mr Newman concentrated his remarks on legislative proposals introduced on 24 January 2013 by Representative David Camp, Chairman of the US House Ways and Means Committee, which, if enacted into law, would dramatically change the US tax treatment of financial instruments and simplify the tax rules with respect to the identification of hedging transactions. Messrs Leblang and Newman also commented on IRC section 1411 which imposes a 3.8 per cent tax on 'net investment income'.

IRC section 871(m) and the temporary and proposed regulations thereunder

Mr Leblang's presentation essentially tracked the slide presentation prepared by Rom P Watson of Ropes & Gray and himself in advance of the conference.[1] Mr Leblang reviewed the state of the law with respect to 'dividend equivalent payments' prior to the enactment of IRC section 871(m), commencing with the US Treasury Regulations issued in 1997. Under the 1997 regulations, a 'look-through' approach was adopted under which substitute dividend payments in connection with securities loans and repos of US equities are treated for cross-border tax withholding (and all treaties) as 'dividend' payments sourced in the US. By comparison, all dividend payments in the context of equity swaps (and other notional principal contracts) were sourced based on the residence of the recipient. Accordingly, a non-US party's income with respect to an equity swap that references the stock of a US issuer, including any notional dividend amounts, was generally not subject to US withholding tax.

Notice 97-66 further limited the withholding tax for substitute dividend payments by applying incremental tax rate percentages and hypothetical rates, not actual tax paid. In addition, same country/same borrower type securities loans were generally exempt.

Under IRC section 871(m), which is generally effective for payments made on or after 14 September 2010, the 'foreign-to-foreign' exception under Notice 97-66 is no longer applicable. Rather, section 871(m) treats as dividend equivalent payments the following transactions that are contingent on or determined by reference to US source dividends:

- substitute dividends pursuant to a securities lending or sale-repurchase transaction;
- an equity swap payment pursuant to a 'specified notional principal contract'; and
- other 'substantially similar' payments as determined by the IRS and which have been addressed, to some extent, in the temporary and proposed regulations.

In addition, Notice 2010-46, which formally withdraws Notice 97-66, provides a new exemption for 'Qualified Securities Lenders' (QSLs) and a 'credit forward' mechanism for proof of withholding in a series of loans. In this regard, Mr Andrade commented on the difficulties that QSLs may be facing under Notice 2010-46 while noting that some QSLs may be 'warehousing' US withholding taxes as a credit against the tax in foreign jurisdictions in which they are resident.

Under Notice 2010-46, a withholding agent may limit aggregate US gross-basis tax within a 'series of securities lending transactions' to the amount of US gross-basis tax applicable to the foreign taxpayer bearing the highest rate of US gross-basis tax; thus, the aggregate taxes paid in such transactions should not exceed the US statutory rate of 30 per cent. Excessive tax may be relieved by amounts previously withheld to the extent there is sufficient evidence of prior tax withheld.

A notional principal contract (NPC) relating to a US equity security is within the ambit of IRC section 871(m) if (in connection with entering into the contract):

- any 'long party' transfers the 'underlying security' to a 'short party';
- a short party transfers the underlying security to a long party;
- the underlying security is posted as collateral by any short party with any long party;
- the underlying security is not 'readily tradable' on an established securities market; or
- the contract is identified as a 'specified' NPC by the IRS.

A 'long party' is a party entitled to receive any payment pursuant to an NPC which is contingent upon, or determined by reference to, the payment of a dividend from US sources with respect to the underlying security. A 'short party' is any party to the NPC that is not a long party with respect to the underlying security. The 'underlying security' with respect to an NPC is the security with respect to which the US-source dividend is referenced. An index or fixed basket of securities is treated as a single security.

IRC section 871(m)(3)(B) requires that payments made after 19 March 2012 on any NPC contract will automatically be treated as made pursuant to a 'specified' NPC, unless a determination is made by the IRS that the 'contract is of a type which does not have the potential for tax avoidance'. The Temporary Regulations defer this date until 31 December 2013.

The related proposed regulations create additional new categories of 'specified' NPCs and also modify the statutory categories. Mr Leblang noted that other significant aspects of the proposed regulations include the following:

- dividend equivalents are the gross amounts of US-source dividends used in computing any net amounts transferred to or from a swap counterparty;
- a counterparty to a swap contract may have a withholding obligation even if not required to make an actual payment; and
- either party (including a foreign party) to a swap contract could be a US withholding agent with respect to a dividend equivalent payment.

Chairman Camp's proposed legislation with respect to the taxation of financial derivatives and hedging transactions

Mr Newman began his remarks by noting that while Chairman Camp's proposed legislation would result in material changes with respect to the tax treatment of financial derivatives and instruments, they would not necessarily effect 'wholesale' changes. For example, the proposals do not address active financing, the treatment of carried interests, the distinction between debt and equity, and the deductibility of interest. The thrust of the proposals regarding financial derivatives is to bring uniformity to the US tax treatment of derivatives which under current US tax law can vary significantly depending on the type of derivative (for example, futures, forward contracts, swaps and options), the taxpayer's profile and various other factors which can result in very different tax consequences for 'economically similar' transactions.

Under the Camp proposals, the 'mark-to-market' method of accounting under IRC section 475 (which is mandatory for securities dealers and applies to commodities dealers and securities and commodities traders who elect to be taxed under IRC section 475) to investors. More precisely, the Camp proposals would introduce new IRC sections 485 and 486, under which investors would be required to 'mark-to-market' at the end of each year their derivatives as if they had sold such derivatives for their fair market value and any changes in the value of such derivatives would result in taxable gain or loss. Moreover, all such gains or losses would be treated as ordinary (rather than capital) gain or loss. If enacted, new sections 485 and 486 would eliminate IRC section 1256 (and certain other statutory provisions relating to capital transactions), under which investors are required at the end of a year to 'mark-to-market' certain kinds of derivatives such as regulated futures contracts and specified 'foreign currency contracts' as if they had been sold for their fair market value. Under IRC section 1256, gain or loss is treated as short-term capital gain or loss to the extent of 40 per cent thereof and as long-term capital gain or loss to the extent of 60 per cent thereof. Complex rules/elections also apply to 'mixed straddles' under current law and would also apply under certain 'mixed straddle' provisions of the Camp proposals.

Because new IRC sections 485 and 486 would apply to all taxpayers not otherwise subject to the 'mark-to-market' method of accounting under IRC section 475 (except for derivatives entered into as part of a hedging transaction in the ordinary course of business and certain real estate transactions such as options to acquire real estate), it would apply to both privately-issued and publicly-traded instruments. Mr Newman commented that in connection with privately-held derivatives, valuation issues will arise of necessity and that under the proposed legislation the IRS to deal with such valuation issues in future regulations.

Mr Newman also noted that the definition of a 'derivative' is intended to be quite broad and, in addition to options, forward contracts and futures contracts would include, among other things, the embedded conversion feature of a convertible bond and most types of credit default swaps.

The Camp proposals with respect to the taxation of financial derivatives and instruments would be effective with respect to property acquired, positions established and/or transactions entered into after 31 December 2013.

IRC section 1411: the 'Unearned Income Medicare Contribution' tax

Messrs Leblang and Newman closed the session by commenting on IRC section 1411, which imposes a 3.8 per cent tax on 'net investment income' of individual taxpayers (and trusts and estates to the extent treated as individuals) whose adjusted gross incomes (as modified by IRC section 1411) exceed certain 'threshold' amounts.

Mr Leblang noted that for 'United States shareholders' (as defined under IRC section 951(b)) of a 'controlled foreign corporation' (as defined in IRC section 957) and United States persons owning stock in a 'passive foreign investment company' (PFIC) who have made a 'qualifying electing fund' election (QEF) as to a PFIC, the recently proposed regulations under IRC section 1411 appear to create 'two sets' of books with respect to income inclusions under Subpart F of the Code with respect to such 'United States shareholders' of a 'controlled foreign corporation' and United States persons who have made a QEF election with respect to stock held by them in a PFIC. For regular income tax purposes (ie, chapter 1 of the Code), such taxpayers would continue to include in income their pro rata share of a foreign corporation's income in accordance with the rules under Subpart F of the Code in the case of 'controlled foreign corporations' or under a QEF election with respect to a PFIC, as the case may be. However, under the proposed regulations such taxpayers would not seem to be required to include the amount of such inclusions under Subpart F or a QEF election in 'net investment income' for purposes of IRC section 1411 until the amounts of such income previously taxed to such persons under Subpart F or a QEF election are actually distributed to them, unless such taxpayers make an election under section 1411 to be taxed currently on such income inclusions as 'net investment income' in the same year as such amounts are otherwise taxed for regular tax purposes under Subpart F of the Code or a QEF election. The ostensible purpose of this election under the proposed regulations under IRC section 1411 is intended to relieve the taxpayer of maintaining 'two sets' of 'books' (ie, one for regular tax purposes and the other for IRC section 1411 purposes), although in the absence of such an election it appears that in many instances the tax on 'net investment income' under IRC section 1411 can be postponed with respect to current income inclusions under Subpart F of the Code or a QEF election. This concluded the panel's presentation.

Note
Unfortunately, Mr Watson was unable to attend the conference due to a severe snowstorm that blanketed Boston.

11 FEBRUARY 2013

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Taxation of offshore income of financial institutions

Speakers
Peter Blessing *Shearman & Sterling, New York*
Matthias Geurts *Noerr, Frankfurt am Main*
Guglielmo Maisto *Maisto e Associati, Milan*
Pano Pliotis *GE Capital Solutions, London*

Presentation on hedged tax sparing credits and hedging of internal transactions

The panel started with a presentation by Dr Matthias Geurts related to a case decided by the German Supreme Court on a hedged tax sparing credit (Supreme Tax Court judgment I R 103/10 of 22 June 2011). Shortly after, a German Corp bought a short-term note in Brazilian currency issued by Bank A, hedging with Bank B its currency exposure with a forward sale having the same maturity as the note.

The tax idea underlying these transactions was to use the tax sparing credit of 20 per cent on the gross income against the German tax due on the net income. At the time the case was judged, only expenses which directly related to the income had to be taken into account. In the meanwhile, the law changed and required that business expenses and decreases in business assets economically related to the respective revenues to be also deducted to the net income available to credit the foreign tax.

The Supreme Court held first that the tax credit is determined on the basis of the gross amount of the foreign income. However, secondly, the income against the foreign taxes that can be credit has to be determined according to the German income tax rules. In this respect, the Supreme Court held the opinion that if at the acquisition of a debt in a foreign currency the sale of the debt with a fixed currency exchange rate was predetermined, the gain or loss occurred in the currency was an inherent element of the income (interest). Consequently, the basis against the foreign taxes that can be credit will be minimal.

The question that comes up is if the same reasoning applies if instead of the forward sale, the parties entered into a swap agreement or a put-call combination. Furthermore, if between the debt contract and the forward agreement, is there no timing congruence? Or only if the coupon has been hedged?

In this respect, whether the income at least is predetermined will be key, that is, the economic interest is fixed.

The panellist ended his presentation with another example relating to hedging transactions: the acceptance of internal transactions (an internal swap between the trading and the treasury departments of a financial institution that may be located in different jurisdictions) for accounting and their relevance for tax purposes. The application is relevant to avoid potential accounting mismatches (mark-to-market for the derivatives and at cost for the loan). However, there is a risk of a split hedge if the hedging and the basis instrument (ie, the loan) are in different jurisdictions. Therefore, the acceptance for tax purposes might only be granted in cases where the basis and the hedging instrument are in the same jurisdiction. Additionally, these types of transactions shall be market priced, documentation should be available, they should have hedging purposes and be part of a regulatory risk management. On these grounds, until the hedge relationship is given then both legs should be booked through the p&l or, avoiding the volatility within the p&l, one single ‘frozen’ position should be shown.

Presentation on transfer pricing, guarantee fees, GAAR and foreign tax credits

Transfer pricing and guarantee fees

Professor Maisto presented a case related with the arm’s length remuneration of guarantees provided by parent companies to their subsidiaries, a topic that is receiving more attention by the Italian tax authorities.

In the case presented, the Italian parent company provided a guarantee to the bonds issued by its Dutch subsidiary whose proceeds were directed to finance other overseas subsidiaries of the group. The Dutch subsidiary paid a guarantee fee of 0.05 per cent to its parent that was subsequently recharged to the financed overseas companies of the group at the same rate.

The relevance of the theme was related with the arm’s length remuneration for the guarantee granted by the parent. It may be argued that the arm’s length guarantee fees should correspond to the difference between the interest rate applied on un-guaranteed bond issuing and the interest rate applied on guaranteed bond issue, being that the interest rate on un-guaranteed bond issuing is determined based on the subsidiary average credit rating.

Another question related with this case was whether the recharge of the guarantee fees to the overseas subsidiaries should include a mark-up. According to Professor Maisto, there should be no mark-up if the subsidiary’s credit rating equals or is higher than the parent’s credit rating. However, if the subsidiary’s credit rating is lower than the parent’s credit raking, in principle, there should be a mark-up.

GAAR and foreign tax credit

The other case presented by Professor Maisto was a case decided by Italian courts on the applicability of the GAAR in a situation related with the double use of foreign tax credits in two different jurisdictions.

In the case presented, a UK company issued a bond to a UK bank. By a repo agreement entered into between the UK bank and an Italian bank, the bond passed on to the Italian bank. The UK company paid interest to the Italian bank related with the bond that was subject to withholding tax in the UK and the Italian bank was entitled to a foreign tax credit because of the withholding tax suffered in the UK. As remuneration for the repo, the Italian bank paid a manufactured interest to the UK bank corresponding to the interest paid by the UK company less the withholding tax. The UK bank also claimed a tax credit on the withholding tax paid on the interest, therefore both the UK bank and the Italian bank benefited from a tax credit. The Italian tax authorities applied the GAAR and qualified the tax credit benefited by the Italian bank as an undue tax benefit.

Professor Maisto finished his presentation with an overview of the CFC rules in Italy. Regarding the requirement 'taxes levied' on the income, he provided an example of a restructuring operation.

Presentation on an overview of US anti-deferral legislation – Subpart F and the Active Finance Exception (AFE)

Pano Pliotis gave an explanation on the basic framework of the well-known US Subpart F rules created to prevent deferral of tax on passive income earned and retained by CFCs outside the US. Taking into consideration the topic of the seminar and of the conference, Pano focused his presentation on the key exceptions to Subpart F that are of relevance to non-US finance operations, such as the exception for CFC to CFC lending, exemptions for CFC which are dealers in securities, commodities, currencies and derivatives, and especially the Active Finance Exception (AFE) introduced in 1997 which covers a broad range of finance activities beyond the scope of traditional investment banking/securities dealing. The types of income covered by the AFE generally include income from personal and mortgage loans, factoring, leasing, credit cards, project finance, debt/equity securities and cash deposits and other similar types of income.

In order to benefit from the AFE exception, the CFC must be predominantly engaged in the active conduct of a banking, financing or similar activity. Predominantly engaged meaning that at least 70 per cent of the CFC's gross income derives from lending or finance transactions with non-US unrelated customers. For fully regulated CFC banking entities with substantial deposit funding, the 70 per cent test does not apply. Furthermore, the CFC's own employees located in the home country of the CFC (or of its branch) must conduct substantially all of the activities necessary for the generation of the income (namely initial solicitation of customers, negotiating terms, underwriting/credit risk analysis, entering into loans, collection/enforcement, etc). As explained by the panellist, besides this entity level test, a similar 'substantially all the activities' test is applied to each item of gross income earned by the CFC in its head office or branch. Finally, the panellist concluded their exposition with the presentation of some critical issues that arise in connection with this exception.

Additional issues relating to offshore operations of financial institutions, particularly from a US perspective

The session finished with a presentation by Peter Blessing. He started his presentation addressing the proposals for international tax reform in the US, in particular the proposed adoption of a territorial system in line with some major EU jurisdictions, instead of the current worldwide system. In this context, it was highlighted that the introduction of the exemption method to eliminate international double taxation of active income would not replace CFC provisions for passive income (and foreign tax credits (FTCs)). Certain proposed features are designed to prevent taxpayers from seeking to have high-taxed income brought within the US tax net and use of credits for excess foreign taxes paid thereon to reduce US tax payable in respect of passive income.

The presentation followed with Peter noting that continuation of the AFE (briefly explained in the previous presentation), if the exemption method were to be introduced in the US and on what terms, had not been addressed in connection with the proposal. Another critical issue regarding the adoption of the exemption system relates to the treatment of foreign branches, which would be treated as separate entities (as recently done under the UK system) and thus make them eligible for the exemption system and subject them to CFC rules, but prevent the flow of losses back home.

Peter Blessing went on in his presentation to address certain hedging and FX issues faced by financial institutions. He followed with an example of a subsidiary that obtained a loan from a third party bank or the capital markets with a guarantee rendered by its parent company. It was assumed that the subsidiary could independently obtain a loan from the same market, so the guarantee is given to lower financing costs, satisfy lender moral hazard concern or avoid covenants or need for audited financials. In this hypothetical example, the question was raised whether the parent could contribute the guarantee to the capital of the subsidiary (thus making it property of the subsidiary) and, if so, whether that could be done in a tax-free manner. If that is not done, the question of what is the benefit to the borrower from the parent guarantee must be faced, and whether the parent company charge a guarantee fee. He presented some considerations in pricing the guarantee fee, and dissented from the notion that proper pricing should necessarily disregard in all cases the passive association benefit, as suggested by the OECD guidelines and a recent Canadian decision.

The panellist then turned to certain other issues encountered by financial institutions. For example, he commented on the bipolar view taken by the courts in relation to cross-border tax arbitrage, demonstrating with case law where different views were taken depending on whether there was a tax shelter transaction involved.

Subsequent slides addressed the possibility of offsetting net operating losses of a branch of a foreign entity located in the US against the profits of a US subsidiary of the same foreign entity, and deemed dividend issues that might arise with the use of a profit split by a financial institution, if regulatory concerns prevent payment by one party to the other.

Finally, the presentation ended with an overview of FTC 'splitter' arrangement rules in the US, and particularly as they related to group relief, under regulations issued pursuant to IRC section 909.

Use of finance companies by multinationals

12 FEBRUARY 2013

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Speakers

Marcel Buur *Loyens & Loeff, London*

Stuart Chessman *Vivendi, New York*

Sara Luder *Slaughter and May, London*

Klaus Sieker *Flick Gocke Schaumburg, Frankfurt am Main*

In the introductory remarks, the panel pointed to the characteristics of monetary assets: they are mobile and easy to shift from high to low tax countries. Tax planning with respect to monetary assets has little impact on business and can prove to be very beneficial.

Tax planning in the area of monetary assets is also affected by the current political climate which is driven by the need to increase tax revenues and which scrutinises in particular the multinational companies regarding the suitability of their overall tax burden and the question of the appropriate allocation of the taxes paid to the involved countries. There are politically motivated developments at the level of the OECD and EU. The OECD produced a paper on Tackling Aggressive Tax Planning through Improved Transparency and Disclosure ('OECD 2011') and another on the issue of hybrid mismatch arrangements ('Hybrid Mismatch Arrangements: Policy and Compliance Issues, 2012'). On 12 February 2013, the OECD published its report on Addressing Base Erosion and Profit Shifting (BEPS) which was drafted at the request of the G20. The development in Europe has been initiated by a joint statement of UK and German officials (5 November 2012) proposing a push to make multinational companies pay their 'fair share' of taxes. It is expected that this initiative will give rise to new legislation on a country level and to changes of double tax treaties. One of the topics will be to combat double non-taxation.

Examples of group finance structures

Marcel Buur presented the group finance structures which are most used in Europe. There is the simple Luxemburg structure in which the parent company establishes a Luxembourg finance company granting loans to group affiliates. Whereas the finance income generated in the Luxemburg finance company is taxed at a very low effective rate, there is now withholding tax levied in Luxembourg on payments to the parent as the Luxemburg company is financed primarily through Preferred Equity Certificates (PECs) or Preferred Equity Share Certificates (PESCs), which are considered as debt from a Luxemburg point of view. And the same instruments are generally regarded as equity from the parent's point of view so that any payments received by the parent from the Luxembourg subsidiary are subject to favourable tax treatment in the hands of the parent. Another Luxembourg structure is to establish a Luxembourg branch which is holding the Luxembourg finance company.

There are two Luxembourg-Swiss structures which are widely used: one is that the Luxembourg finance company maintains a Swiss finance branch which is extending the loans to group affiliates and the other is that the Luxembourg finance company is holding a Swiss finance company. Both structures will lead to a combined tax rate on finance income of two to five per cent.

A special UK-Netherlands structure is used by UK parents involving a Dutch cooperative holding a Dutch BV which grants the loans to the affiliates. The main feature in this structure is that the Dutch cooperative is transparent from a UK perspective and that the cooperative and the Dutch BV are treated as one single tax payer. Finally, Marcel Buur referred to the Belgium-NID structure which has become less attractive and is less widely used today then in previous years.

New UK CFC regime

Sara Luder initiated the audience in the new UK CFC regime and the consequence of this regime for finance companies. The new regime takes effect as from this year.

Non-trading finance income is generally subject to CFC charge, but there are exemptions, mainly for 'qualifying loan relationships' (QLR). The centrepiece of the new CFC regime is the availability of partial or full exemption. If partial exemption applies, 75 per cent of QLR profits are exempt from CFC charge so that the effective CFC charge rate on finance income is 5.25 per cent taking into account the reduction in corporate tax rate to 21 per cent applicable in 2014. Full exemption is available to the extent that QLRs are funded from local source profits, assets acquired through certain equity – financed acquisitions and rights issue by group parent. Full exemption also applies for residual QLR profits exceeding a group's aggregate UK tax deduction for finance costs (net of finance income).

The new rules are designed to make the UK corporate tax regime internationally more competitive. It still remains to be seen whether the new rules are fully compliant with the EU position (*Cadbury Schweppes*).

Status quo in Germany

Klaus Sieker reported on the German status as regards the use of finance companies. Finance company structures mainly serve German parents to avoid the German withholding tax of 26.375 per cent which applies on interest paid on hybrid loans by the the German borrower. This can be reached by interposing, for example, a Luxembourg borrower whereby the Luxembourg borrower is avoiding any withholding tax and is lending the funds to the German parent as a straight loan. This structure is widely used and practiced today and the German tax authorities have not really challenged it so far.

Another structure is the use of hybrid instruments by the German parent. In this structure, the Luxembourg subsidiary issues Genussscheine to the German parent; the Genussscheine is a debt instrument from Luxembourg's perspective (no withholding tax) and an equity instrument from a German perspective for which a 95 per cent exemption from corporate income tax is available. There was an initiative to abolish such exemption, but the initiative has not yet been pursued and enacted, mainly for political reasons.

Klaus Sieker furthermore referred to the *Columbus Container* case on which the ECJ issued a preliminary ruling (6 December 2007). The corporate structure at stake was a Belgium coordination centre which was held by a German parent; whereas the Belgium coordination centre is taxed in Belgium as a corporation, it is a partnership from a German point of view. The ECJ held that the German switch-over clause does not make any distinction between taxation of income from a domestic partnership and from a partnership residing in another EU Member State. So the German law was judged to be compatible with EU law.

Klaus Sieker pointed out that Germany is not intending to become attractive internationally for finance structures (it is not a place for establishing German finance subsidiaries of foreign parents), but German CFC rules allow low-taxed passive income of EU/EEA finance subsidiaries (including branches outside EU/EEA) to escape from

German taxation provided that the taxpayer provides evidence that the subsidiary is engaged in a truly economic activity in its country of residence.

Netherlands' new deduction limitation

Marcel Buur explained the new Dutch rules on interest deduction limitations which have the ambition to maintain an attractive fiscal investment climate as well as being compatible with EU law.

The takeover holding rules, effective as of 2012, provide that the deduction of interest on acquisition debt is limited to stand-alone profits of the takeover holding company in fiscal unity with the target holding, but there is a franchise of €1m which is always deductible (so that small and midsized companies should not be hit) and there also applies a debt cap: the maximum leverage of 60 per cent of the acquisition cost is allowed and this maximum is reduced by five percentage points per year after the acquisition so that the maximum is reduced to 25 per cent in the eighth year and after.

As a result of the ECJ ruling in the *Bosal* case, new rules were introduced which apply as from 2013. Pursuant to these rules, interest on debt financing with respect to the acquisition of subsidiaries, whether Dutch or foreign, is no longer deductible. The main exception to this is that it does not apply to acquisitions increasing the operational activities. This new limitation of interest comes on top of already existing provisions aimed at restricting the use of abusive structures such as a double dip through hybrid structures or structures resulting in a tax deduction of interest without an adequate compensating levy on the corresponding income or an acquisition that is mainly tax inspired.

ATRA

The magic word in the context of taxation of finance companies is currently 'ATRA'. ATRA stands for American Taxpayer Relief Act of 2012 which was signed into law on 2 January 2013. Stuart Chessman guided us through the US aspects in this regard.

There is the extension of the look-through treatment of payments between related Controlled Foreign Corporations (CFCs) in the sense that finance income received by a CFC from other CFC constitutes, as a matter of principle, Foreign Personal Holding Company Income (FPHCI) in the hands of the recipient CFC and is taxable to the US shareholder of the CFC under Subpart F rules. The look through extension is specifically important where a 'check the box' election to make the payer CFC a disregarded entity under the recipient CFC or under a common CFC holding company cannot be made, for example, in case of a per se entity. This provision had expired for tax years beginning after 2011, but ATRA now retroactively extends the exemption for tax years of foreign corporations beginning before 2014.

Whereas unrelated party income and other financial income earned by a CFC is subject to tax in the hands of its US shareholder as Subpart F income, IRC has provided since 1997 an exception from taxation under Subpart F rules for certain income derived in the active conduct of banking, financing or insurance or as a securities dealer. These exceptions, introduced as a supposedly temporary measure, also expired for tax years beginning after 2011 and ATRA retroactively extends these exceptions again to the past.

Stuart Chessman concluded by stating that ATRA actually preserves the status quo, but there are new rules expected in this context in the very near future. These two described techniques, widely used today by US multinationals, seem to be at risk in the expected new rules.

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Transfer pricing considerations including guarantees

Speakers
Murray Clayson *Freshfields Bruckhaus Deringer, London*
Peter Steeds *HM Revenue & Customs, London*

This session addressed the current theory and practice as regards related-party loan and guarantee pricing with a particular focus on the existing related international case law.

The session began with a short introduction by the two panellists.

Murray Clayson referred to the little light that international conventions and related documentation shed on the issues at hand (eg, paragraph 7.37 of the OECD transfer pricing guidelines (2010) and various paragraphs of part 2 of the OECD Permanent Establishments Report (2008) ('PEs Report')).

He then pointed out that, however convenient and easy it may be to implement at a group level, the practice commonly seen in the market of adding a spread to the lender's own cost of funds may be inappropriately simplistic, when each and every transaction is separately reviewed from a transfer pricing perspective.

After noting the exemption provided by Part II paragraph 31 of the PEs Report in respect of branches from the general rule of evaluating the creditworthiness by reference to the bank as a whole (perhaps of relevance, for example, where national laws ring-fence the assets of a branch from the claims of general creditors), Murray Clayson went on to say that the panellists' focus would be on the interesting but diverse international case law on the subject matter.

In his introductory remarks, Peter Steeds stated that there has never been a greater media and political focus on transfer pricing as there is today, and it has been an item on the agenda of both the G-8 and G-20 latest meetings. He also observed that the key pressure area now seems to be the tax treatment of profits derived from the digital delivery of goods and services.

In this respect, he referred to the OECD report on Base Erosion and Profit Shifting (BEPS), which was published the same day, and more specifically to the third pillar of the project, addressing fundamental transfer pricing questions, such as whether the arm's length principle or the separate legal entity approach properly work under the current state of play.

Peter Steeds finished his introduction by stating that, starting from the conclusions of the BEPS report, we may soon see specific guidance being issued at an international level on the issue of transfer pricing and financial transactions, which (guidance) is currently missing.

The panellists then proceeded with commenting on the following case law (together with the latest administrative position of the German tax authorities) on transfer pricing of loans and guarantees; the merits of each one were first presented by Murray Clayson.

GE Capital Canada

In this case, the Canadian GE Capital subsidiary obtained funding from market investors, the claims of which were secured by a guarantee of the US GE parent company which had a triple A rating at the time. The Canadian revenue questioned the deductibility of the guarantee fees (100 bps) payable by the borrower entity to the guarantor, assessing that there existed in any case an implicit support by the latter to the former and therefore that the guarantee was worthless.

At the end of 2010, the Canadian Federal Court of Appeal dismissed the Crown's appeal upholding the decision of the Canadian Tax Court on the case (issued in 2009) by virtue of which the guarantee fee was found to be appropriate. The Canadian courts emphasised the separateness of entities approach, recognising that implicit support was part of the factual matrix, but declining to take the position that the implicit support of the parent to the subsidiary was equal to a guarantee or, in other words, that the subsidiary had automatically acquired the parent's rating due to such implicit support.

Murray Clayson, who characterised this case as a leading one due to the quality of analysis made in its course, gave an outlook of the two methods that may be followed while applying the arm's length principle, namely:

- the no-affiliation model, pursuant to which the borrower is regarded on a stand-alone basis; and
- the market affiliation model, pursuant to which the wider context, including the parent's and/or group's position, is taken into consideration when assessing what the borrower can do; the latter is found to be closer to the arm's length principle by Murray, who also reminded the audience of the importance of evidence offered by an analysis of creditworthiness, while substantiating the pricing of financing transactions.

After his reference to the lack of UK case law on transfer pricing in the context of financing (including guarantees) transactions, which as per his opinion proudly evidence the effectiveness of HMRC's compliance work that has delivered £4.1bn in the last four years, Peter Steeds commented that the court in the *GE Capital* case gave a suitable and sophisticated answer to the question of how someone should take into account the implicit support fact while pricing a related financing transaction, agreeing with Murray that the non-affiliation model does not look at the whole picture and referring to the fact that the OECD could obtain valuable help by the *GE Capital* verdict.

Diligentia AB

In this case a Swedish subsidiary had obtained from its parent company an unsecured loan with an interest rate of 9.5 per cent, the proceeds of which had been used to repay secured loans previously received from independent (market) lenders with a significantly lower interest rate (4.25 per cent). The Swedish competent administrative courts held in this case that actual control of the borrower by the lender should be considered as affecting the credit risk taken by the latter and thus the price chargeable for the financing granted; on such a basis, the courts decided to reduce the (deductible) interest rate to 6.5 per cent.

Murray Clayson mentioned that this case deals with the debate on assimilation of unsecured and secured lending pricing, in respect of which the Swedish administrative courts took the position that the de facto control was a proxy for security and that the interest therefore should be lower than that charged by the controlling lender. Murray concluded that this is a case in which the very fact of control is regarded, rather than disregarded, and therefore it could be seen as constituting an unwarranted victory of substance over form.

At the other end of the spectrum, Peter Steeds opined that one has to look at the substance after having looked at the form, which seems to have been disregarded in this case, and to that extent he characterised *Diligentia* as not such a helpful and consistent decision. Peter Steeds emphasised that the reality of the risk undertaken by the lender must be examined, accepting however that these are grey area issues.

German MoF Decree of 2011

Murray referred to the Decree issued by the German Ministry of Finance on 29 March 2011, which he considered as recognition of de facto security, since it confirms the principle of implicit parental support and its potential impact on creditworthiness, which should in any case be considered as relative.

Peter criticised the position taken by the German tax administration due to the absence of recognition of degrees of parental support, but also of justification of the existence of de facto security in the case where the loan by the parent is subordinate to existing unrelated but senior obligations of the subsidiary.

A Oy

As in the *Diligentia* case, this case also involved the refinancing of existing unrelated debt with related debt, which was more expensive than that refinanced, with the extra feature that no profit was being left to the associated lender, after taking into consideration its sources of (shareholder and third party) funding.

More specifically, the Finnish tax authorities disqualified any interest payable by the Finnish subsidiary to the Swedish parent to the extent that it exceeded the interest previously payable by the Finnish subsidiary to its third party lender (a bank) under the loan, which had been refinanced by the related funding.

During the respective administrative and judicial procedures, the rate of deductible interest had been raised to equal the average cost of the related parent towards unrelated parties (ie, excluding shareholders' loans), a proposition considered by Murray Clayson as dubious.

At the end of the day however, the Finnish Supreme Administrative Court accepted the state arguments and restored the original tax assessment, regarding on a stand-alone basis the creditworthiness of the Finnish subsidiary, which was better not only from that of the other group subsidiaries being also charged at the same rate by the Swedish parent, but also from the latter's.

As a comment to this case, Peter Steeds took the clear position that the independent entity principle should have priority over anything other when addressing transfer pricing cases and stated that when there is a clear answer on the basis of it, then there is no reason to seek assistance in any other principle or line of argumentation.

Indian case law

The panellists referred to the controversial decisions issued by the Indian tax courts, with specific reference to *Religare Finvest* and *Aithent Technologies*.

The *Religare* case involved payment by an Indian borrower of interest on intra-group unsecured loans, which was higher than interest on unsecured and secured third party loans. Such intra-group loans were used by the Indian borrower to provide unrelated loans to third parties with an interest rate higher than its funding cost. The Indian court decided that it is not possible to assume in-built security in a related party loan and that, therefore, intra-group unsecured loans should not be seen as secured, as well as that the former may have higher interest rates than the latter. More importantly the Indian court had issued its decision on the basis of the CUP method, rather than what multinationals seem to be commonly applying, that is, their cost of funding plus a margin.

The *Aithent* case had to do with the provision of an interest-free (ie, more equity like) loan by an Indian parent company to its US subsidiary with the purpose of funding the latter's expansion. The taxpayer, while justifying its zero profit from the loan, sought to apply the TNMM method, arguing that:

- it had no funding cost (shareholder capital injections);
- it was earning its revenue from the software development services it was also providing to its US subsidiary; and
- the interest cost was factored into the service fees.

The Indian court rejected the arguments of the taxpayer, held that CUP is the most appropriate method, unbundled the loan from the provision of services and declined to accept as relevant the lender's cost or source of funds.

After noticing that Indian authorities have been taking rather unusual positions, whereas the highest Indian courts do respect international standards, Peter Steeds referred to the UK tax authorities' practice for outbound interest free-debt, stating that they:

- first look into the form of the agreement and then on a subordinate basis any substance behind it;
- do not necessarily follow the position taken by the tax authorities of the borrower; and
- in some cases they do accept the predominance of the equity character of the transaction, which however has to be proven by the taxpayer.

Conoco Phillips

The last case to which the panellists referred dealt with an intra-group cash pooling system run through a credit institution, which was paying an interest rate of LIBID minus 25bps on positive balances (that was also the rate being charged within the group) and charged LIBID plus 25bps on negative balances. The Norwegian tax authorities, as well as the competent Norwegian court, took the position that the remuneration earned by the Norwegian group members, which were depositing the cash to the pooling structure, was inadequate relative to their contribution thereto, and therefore increased income has been assessed at their level.

Murray Clayson commented that *Conoco* is an interesting case, since it deals with cash pooling, an issue not often seen in transfer pricing case law. He mentioned that the court in this case seems to have taken the position that 'who has the cash is what matters' and considered that investing such cash for the specific return was too big of an intra-group favour to accept for transfer pricing purposes, even though it exceeded bank deposit interest achievable on a standalone basis.

Peter Steeds concluded his presentation with some comments and figures in respect of the Advance Thin Capitalisation Agreements (ATCAs), which form part of the wider UK framework on Advance Pricing Agreements (APAs). In the last three years, there have been over 450 ATCAs dealing with one single financing instrument or a whole debt package of a taxpayer. As to the timeframe, Peter illustrated figures, pursuant to which ATCAs are concluded on an average basis within a period of seven to eleven months and therefore do follow the respective transaction(s), but are in place before filing of the respective return.

Murray Clayson concluded with the session's key points:

- he stressed that there is an overall need for greater rigour and a 'whole facts' analysis in transfer pricing cases of financing transactions, including cash-pooling;
- he then pointed out that the market has to find out the appropriate manner in which the implicit parental support – a concept now having been clearly recognised by the OECD, various authorities and courts – fits in debt pricing;
- specifically with regards to guarantees, he noted that there are only few related court cases, whereas he opined that now the UK legislation, following the addition of the phrase 'reasonable expectation' of payment to section 154 TIOPA, includes almost any kind of support element;
- in respect of creditworthiness, Murray reiterated that credit ratings are useful tools and sources of information, whereas he told the audience that someone should always take into consideration that a subsidiary can sometimes be in a position to borrow at a lower rate than the parent or the group as a whole or, by the same token, a subsidiary can sometimes borrow through an unrelated secured (and therefore at a lower cost) loan, and therefore not require a related unsecured, more expensive, one;
- he also referred to the other terms and conditions, as well as the wider context, within which a related party loan is concluded and the extent to which such features may be considered as relevant and accepted as valid justifications for the intra-group debt pricing; and
- finally, he pointed out that a finding of excessive debt (thin cap, etc) may have other adverse consequences, for example, the denial of deductions for impairments and FX losses on 'excessive' lending.

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Capital raising for banks under regulatory constraint

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Speakers
Eugen Buck *Rabobank Group, London*
Michael Nordin *Schellenberg Wittmer, Zurich*
Yash Rupal *Linklaters, London*
Jonathan Winstanley *Lloyds Banking Group plc, London*

In this panel the speakers addressed the main tax and regulatory concerns on capital raising for banks arising as a consequence of the global financial crisis which started in late 2008 and has further developed over the following years.

Taking into account the set of transactions that triggered the crisis in the first place, changes in the regulatory framework throughout the various jurisdictions was unavoidable. One of the key points in this context is the discussion on moving from bail-out remedies, where the taxpayer ultimately bears the cost of avoiding potential systemic financial collapse, to bail-in strategies by which certain convertibility features would be implemented into debt instruments so as to avoid bankruptcy/insolvency and, with that, prevent the corresponding loss amplifier effects.

After tackling the developments in such areas since Basel was agreed and implemented back in 1988, where the solvency requirements for banks were based upon simple fixed risk weights, and the revised version in 2000 (Basel II) that made such requirements of banks more sensitive to correlated risks, the panel addressed certain aspects of the package of reforms designed as a response to the global financial crisis, the so-called Basel III, expected to be effected at some point in 2013.

As explained by the panel, Basel standards are usually ratified (with certain time mismatch) by the European Commission (EC) to be enforced as part of the European Union (EU) Single Market Policy Framework. The last version of the Capital Requirements Directive ('CRD4') issued by the EC has already adopted certain measures to strengthen the regulation of the banking sector since July 2011. As to the main recommendations issued by the G20 Financial Stability Board, it is worth mentioning the recommendation to split bank activities into deposit taking and investment banking, and also that bail-in should be applicable to a particular category of debt instrument.

Regulators urged for 'more and better quality' in the capital structure of banks. Under Basel regulations, the capital requirements of a given bank are determined as a percentage of its Risk Weighted Assets (RWA), which is eight per cent both in Basel I and II. While the eight per cent was maintained all the way since Basel I to Basel III, the proportion of the highest quality capital was dramatically increased in Basel III, which requires more than twice the Core Tier I Capital (the highest quality capital, including common equity and additional Tier I capital instruments) of Basel II.

Basel III also requires that banks hold, as part of Core Tier I capital, certain buffers (capital conservation, countercyclical and systemic risk buffers) that are intended to absorb losses whenever needed so that the bank can continue running. These buffers and Tier I capital instruments are part of the so-called 'Going Concern Capital'.

On the other hand, Going Concern Capital states for instruments like Tier II capital which are intended to absorb losses when a bank reaches a point of non-viability (PONV). On top of Tier II capital instruments, new regulation requires a still yet to be determined percentage of the capital to be held in new-era capital instruments, the so-called 'bail-in debt' instruments, also referred to as contingent capital securities or contingent convertible bonds, which are designed to absorb additional losses once all regulatory capital is consumed.

The loss absorbency mechanism of bail-in debt instruments implies either:

- the conversion of a given instrument, in whole or in part, into an equity stake in the bank; or
- a write-off of the instrument to increase common equity account.

The panel cited various recent examples of the issuance of these new style instruments, among which is the case of Loyds Banking Group that issued the first contingent capital security essentially designed to protect depositors through automatic re-capitalisation to provide a source of Core Tier 1 capital. The trigger for the convertibility into common shares in this particular security is determined as whenever the Core Tier 1 capital ratio falls below five per cent. Other examples of new-era capital instruments take into consideration the PONV as a trigger event for the convertibility feature.

In this scenario, there are obvious deep concerns with the tax aspects involving the new-era capital instruments, in particular those connected to the coupon payments, convertibility features or with the write-off of the instrument.

Concerning the Swiss tax aspects, the panel discussed the proposals to abolish the issuance stamp tax on Swiss bonds, the stamp tax upon conversion of the debt instrument into capital, as well as the withholding tax on coupon. As debated, under Swiss income tax law, coupon is to be split between: (i) taxable bond interest; and (ii) the reminder, which should amount to a put option (convertibility feature) premium, a tax free capital gain. On the other hand, at present the deductibility of coupon for corporate income tax purposes is a matter not entirely clarified. Under Swiss tax law the write-off of the instrument constitutes taxable income.

After tackling Swiss tax aspects, the panel addressed the key tax concerns from the UK perspective, by which perpetuals, convertibles and mandatories are generally deductible, except if the interest payable to the creditor depends to any extent on the results/profits of the debtor, in case the deduction is not allowed pursuant to 'results-dependency' rules. Deductibility is also not allowed in case interest payable to the creditor represents more than a reasonable commercial return for the use of the correspondent principal amount. As debated, from a debtor perspective the amount written down is a taxable event under UK tax laws, unlike the extinguishment of liability upon conversion into common equity which is not subject to tax.

Recent UK developments addressed by the panel includes discussions on potential changes in law to address those impacts, and the recent papers issued by HMRC in August 2011, 26 June 2012 (updated September 2012) dealing with the treatment of perpetuals (true perps would not be deductible, while contingent perps would be deductible). Under such papers, new-era instruments (CRD4 complaints) are likely to be considered results-dependent and consequently not deductible.

As a result of the issues exposed by the panel, it is clear that banks currently face material challenges when it comes to capital raising under regulatory constrain, having to deal with new-era capital instruments to comply with the new capital requirements and also with unsolved tax issues derived from the particular features of such instruments.

Withholding and reporting compliance issues (including FATCA and beneficial ownership)

12 FEBRUARY 2013

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Speakers
Tim Adam *Rabobank Group, London*
Andrew Solomon *Sullivan & Cromwell, New York*
Malcolm White *HM Revenue & Customs, London*

Andrew Solomon opened by noting that the initial intention had been that the panel would address general withholding tax compliance issues but it had then been decided to focus on FATCA. However, the following additional withholding tax compliance issues were mentioned:

- The French and proposed EU financial transaction taxes will give rise to changes in the reporting obligations of financial institutions. Financial transaction taxes will be as important an issue for some financial institutions as FATCA.
- IRC 871(m) will introduce a new US withholding tax on equity derivatives with respect to US stocks and securities. The new rules require final regulations to determine the effective date.
- 'FATCA-lite' relates to rumours of the UK imposing requirements similar to FATCA on Crown dependencies/overseas territories such as the Isle of Man and the Cayman Islands.

FATCA

Andrew Solomon provided background to FATCA. The FATCA legislation was enacted in 2010 as a deterrent against offshore tax evasion by US persons holding assets through offshore accounts. FATCA requires certain foreign entities (known as Foreign Financial Institutions or FFIs) to report information to the US Internal Revenue Service (IRS) about US account holders. If an FFI does not sign an agreement with the IRS and satisfy the reporting and other requirements of the agreement, it will be considered a non-participating FFI, and the FFI will be subject to a 30 per cent withholding tax on 'withholdable payments' (eg, US source dividend, interest, and principal proceeds) made to it by US persons and other withholding agents. FATCA also applies the 30 per cent withholding tax to 'passthru' payments made by participating FFIs to non-participating FFIs and account holders that fail to provide sufficient information to determine their status ('recalcitrant' account holders). A payment by a participating FFI is a 'pass-thru payment' to the extent that it is a US source withholdable payment or is a foreign source payment that, under regulations to be promulgated, is attributable to a US source 'withholdable payment'.

FATCA will impose an administrative burden on FFIs and to a lesser extent on withholding agents. An issue which arose was that compliance with FATCA would violate data protection and privacy rights under the laws of various non-US jurisdictions, in part because the provision of information by FFIs to the US government would be voluntary, at least in form. This led to the need for intergovernmental agreements (IGAs). Two model IGAs have been published. The first was published on 26 July 2012 and provides rules for the identification and reporting of information to local tax authorities, with those authorities then sharing the information with the IRS. These 'Model 1' agreements can be either unilateral (a one way information flow) or bilateral, where the US agrees to also supply information. The Model 2 agreement, published in November 2012, involves the local jurisdiction directing the FFIs to report directly to the IRS. In September 2012, the first IGA was entered into between the UK and the US. It follows Model 1. Ireland, Denmark and Mexico have also followed Model 1. Switzerland and Japan are understood to be considering a Model 2 agreement. Other countries are in discussions.

On 17 January 2013, the final US FATCA regulations (the 'Final Regulations') were released. These Final Regulations include detail on the IGAs. The Final Regulations provide for grandfathered instruments, which means that most existing term debt securities will be outside the rules. The Final Regulations also provide for some simplification in relation to documentation.

The UK-US FATCA Agreement

Malcolm White of HM Revenue and Customs summarised the UK experience of implementing FATCA. The political environment in which the FATCA rules were developed, including the *UBS* controversy, was noted. Although the US has published the Final Regulations, the fact that they exceed 500 pages means that they are still under review by HMRC. The move towards greater exchange of data was welcomed and the UK Government supports the US aims to combat tax evasion, but in a balanced way. It is important for HMRC to have a straightforward mechanism to enable compliance. The ramifications of a 30 per cent withholding tax on businesses would be very serious so it was important that it be as easy as possible for entities to comply. Negotiations with the US had been good and there was an understanding of the UK concerns. The HMRC concerns conveyed to the IRS were twofold:

- the constraints on data transmission due to data protection and other rules;
- the administration burden that FATCA would place on FFIs.

HMRC favours a risk-based approach and welcomes the Final Regulations and related IRS statements which seem to offer a better solution to the issues based on the risk level attached to the particular products. It was important for HMRC that the burdens on FFIs and customers and the costs of compliance are minimised where possible.

The jurisdictional legal impediments needed to also be addressed. A key benefit of the IGAs is that if a double tax treaty includes an exchange of information agreement, this, combined with the IGA, will provide a legal ability for the FFI to provide information to the local revenue authority (in this case HMRC), which can in turn provide this to the IRS. It was noted that the IGA is not like a double tax treaty but rather is a 'full blown' international agreement. This is a new development in information exchange. Previously, information was exchanged by request but this will provide for the automatic exchange of information (both ways in some cases). It was acknowledged that this would open the door for opportunities for future treaties with other countries and that the UK was looking at a similar agreement with the Isle of Man. HMRC are also willing to explore the possibilities of further agreements with other jurisdictions.

The IGAs are based on the location principle which was explained by way of an example of a UK bank with a branch in Holland. That branch would be in Holland for the purposes of any IGA, even though the UK parent would be an institution governed by UK law. It was noted that there is a list of over 50 countries which the US is engaging with in relation to IGAs but that more were likely to engage. The influence that the agreed IGAs had on the Final Regulations was noted.

The provisions around passthru payments were discussed. It was noted that there is no withholding tax if an IGA is in place and that it would be expected that more IGAs will be in place before the passthru rules come into effect in 2017. However, it would be important to deal with the passthru issues in time. It was noted that some people are of the view that the passthru provisions are illegal and extraterritorial.

The issue of the draft UK implementing regulations was discussed. Andrew Solomon queried whether HMRC had discussed the regulations in detail with the IRS to ensure there was mutual understanding. Malcolm White said that HMRC was for the most part implementing the IGAs itself, although there was an ongoing dialogue with the IRS. Although HMRC may not be aware of all possible scenarios that may arise, HMRC is clear on the purpose and parameters of the IGAs and has access to speak to the US Treasury if required.

Reference was made to the Irish statement which was released stating that Ireland would follow the UK IGA and it was suggested that the UK was in something of a pioneer role. Malcolm White said that the UK had spoken to other countries and because the UK was first they can assist in ensuring consistency across other jurisdictions. It was noted that the UK had set the agenda for other countries and that the UK recommends Model 1. Annex II is intended to deal with regional differences and this would vary from country to country. HMRC was grateful to be able to work so closely with the US Treasury on the issue.

Some discussion took place around the benefits of the IGAs, including the eased requirements for registration. Malcolm White noted that if a business wants to trade with another business, it will need to consider in the future whether the other business is in an IGA country, what model IGA is followed by that other country and what the business's status is under the relevant IGA. HMRC had strongly made the point that a single global registration system was needed and the Final Regulations suggest this is the intention with the GIIN system.

FATCA compliance for UK FIs

Tim Adam of Rabobank provided some further comment on issues for UK financial institutions (FIs) arising from the UK IGA. He noted that Finance Act 2013 was expected to contain the UK legislation implementing FATCA (or it would facilitate statutory instruments to implement FATCA).

There are four categories of entities affected: (i) custodial institutions, (ii) depository institutions, (iii) investment entities and (iv) specified insurance companies. The draft UK regulations define 'depository institution' by reference to the UK Financial Services and Markets Act 2000. It will be important to understand which category a client will fall into as this will have an impact on what must be reported and when. It is not expected that it will be difficult to determine which category in general but in the case of collective investment vehicles, it could be difficult to decide which entity has the reporting obligations. Draft guidance is helpful in this respect. For example, in the case of collective investment vehicles, the only FI with reporting obligations will be the trust/fund itself, although it may delegate the reporting to another entity. This was a good result. The Society of Trust and Estate Practitioners (STEP) had concerns that small family trusts might be within scope but there is a carve out under the draft UK Regulations such that only professional trustees will be considered to be FIs with obligations under the rules.

The geographical scope of the regime was discussed and it includes UK resident entities (excluding non-UK branches). It also includes UK branches of non-resident entities. Therefore, for example, a UK branch of a German legal entity must comply with the UK rules.

Certain entities are excluded and these include deemed compliant FFIs such as charities and entities with a local client base.

In relation to what is a reportable account, it was noted that clarity is required in relation to certain legal relationships. For example, derivatives held in custodial accounts fall within the definition of financial accounts and are, therefore, within the scope of the regime but it is unclear as to whether principal-to-principal, OTC derivative relationships would be considered to be accounts. It was further noted that there is an exclusion for accounts held by listed companies and members of listed groups.

The necessary reporting to HMRC was discussed. Malcolm White spoke about the timing of the reports. He noted that the UK Government must provide reports to the US by 30 September in respect of the previous 31 December. It is proposed that the FI reports to HMRC by 31 May (to be confirmed) for the year ended 31 December. The first reports for both 2013 and 2014 are due in 2015.

The issue of penalties for institutions which are non-compliant FIs was raised. Malcolm White noted that UK penalties would be aligned with the existing regime, for example, under the European Union Savings Directive. In terms of compliance it is expected that IT systems may have difficulty coping with data but that data issues should not give rise to significant non-compliance and the IRS can deal with the FFI directly on minor matters. Should there be significant non-compliance, the issue is first raised with HMRC and there would be 18 months to try to agree. If the issue cannot be resolved in the timeframe, the IGA will not apply and the FI would be within the scope of the US regulations.

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Impact of GAAR on financing

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Heather Gething *Herbert Smith, London*
Wilhelm Haarman *Haarman Partnerschaftsgesellschaft, Frankfurt am Main*
Stephen Hoyle *DLA Piper UK, London*
Richard Rogers *HM Revenue & Customs, London*
Micheal Whalley *Minter Ellison, London*
Barbara Worndl *Aird & Berlis, Toronto*

On 12 February 2013, as part of the 2nd IBA/CIOT Conference, a panel of senior international tax advisers from four continents came to discuss their experiences of General Anti-Avoidance Rules in a global context. Included among the illustrious speakers was Richard Rogers, a member of the team at HM Revenue & Customs (HMRC) tasked with drafting and implementing a General Anti-Abuse Rule in the UK.

GAAR – the Australian, German and Canadian experience

As Michael Whalley, partner at Minter Ellison, stated, General Anti-Avoidance Rules (GAAR) are not a recent development in jurisprudence and it is a concept that has been around for several decades in Australia. The current iteration of the Australian GAAR was introduced in 1981 and is contained in Part IVA of The Income Tax Assessment Act 1936 ('Part IVA'). When Part IVA was introduced, the presiding government explained that it was intended to legislate the test of tax avoidance enunciated by Lord Denning in the Privy Council in *Newton*. Pursuant to this test, an arrangement would not be classed as tax avoidance where one could predicate on the face of the transaction that it was 'capable of explanation by reference to ordinary business or family dealing without necessarily being labelled as a means to avoid tax'.

Put briefly, Part IVA may apply if there was a scheme from which a taxpayer obtained a tax benefit and, having regard to eight factors set out in 177D(b) of Part IVA, it would be concluded on an objective basis that the sole or dominant purpose of any person who entered into or carried out the scheme or any part of the scheme was to enable the relevant taxpayer to obtain the tax benefit in connection with the scheme. If those elements exist, on a facts-based analysis, the commissioner of taxation may make a determination to cancel the tax benefit and impose penalties. Tax benefit is widely defined and requires comparison with what would have happened or what might reasonably be expected to have happened absent the scheme (known as the 'alternative postulate').

As a result of high profile losses based around the application of the alternative postulate by the Australian Taxation Office in cases such as *RCI*, *Futuris*, and *AXA*, on 13 February 2013 the government introduced into parliament the Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 ('Part IVA Bill').[1] The Part IVA Bill proposes amendments to counter perceived weaknesses with the Part IVA. Under the proposed new law, the commissioner of taxation will effectively have two ways to attack transactions entered into by taxpayers. The first avenue is referred to as the 'annihilation approach'. Under this approach, to determine whether a tax benefit has arisen, the scheme must be assumed not to have happened – that is, it must be 'annihilated' or 'deleted'. This approach would typically be used where the scheme in question does not produce any material non-tax results or consequences for the taxpayer. The second method is employed only if an incoherent result is reached using the annihilation approach and is referred to as the 'reconstruction approach'. Under the reconstruction approach, it is not enough to simply 'annihilate' or 'delete' the scheme in order to provide a useful and alternative postulate. Rather, it is necessary to determine a reasonable alternative to the scheme by considering what scheme or arrangement could have taken place instead. Two key limitations are placed on the reconstruction approach in determining whether the resultant alternative postulate is reasonable:

- Limitation 1: regard must be had to:
  - the substance of the scheme; and
  - any result or consequence for the taxpayer that is or would be achieved by the scheme (other than a result arising under the tax laws).
- Limitation 2: the tax outcomes of the alternative postulate must be disregarded.

Limitation 1 effectively means that any alternative postulate must achieve the same commercial or economic result as the scheme actually entered into. Limitation 2 effectively means that it would no longer be possible to argue that an alternative postulate is not reasonable (and would not have been entered into) on the basis that the associated tax costs would have been too high.

The proposed amendments also seek to shift the courts' approach in their application of Part IVA. In recent cases, the court has approached Part IVA by, first, determining whether there is a tax benefit and, if a tax benefit exists, only then going on to consider whether a participant in the scheme had the requisite purpose of securing that tax benefit. In some cases the court has found that there was no tax benefit and that therefore it was not necessary to consider the issue of purpose. The proposed amendments seek to unify this approach into a single holistic inquiry about whether a person participated in a scheme for the requisite purpose of obtaining a tax benefit. This shift may further increase the scope for the application of Part IVA.

The proposed reform will impact upon transaction alternatives being considered by taxpayers and places greater importance on the need for contemporaneous documentation recording the purpose of transactions and steps in transactions. The reform will make evidence of this nature even more critical in subsequent questioning by the Australian Tax Office. Clear and consistent documentation of the reason, effect of, and purpose for each step of an overall transaction as part of governance processes will be vital to minimising the risk of the GAAR being applied. The 'purpose' of the transaction and each step of it will be the major focus.

As with Australia, Germany has had an Anti-Avoidance ('Misuse') clause in section 42 of the General Fiscal Code for over a decade ('Sec 42') as set out below:

> '(1) By way of misuse of possibilities of legal structuring the tax law cannot be circumvented. [If] the prerequisites of a rule in an individual tax law [are] fulfilled, which shall prevent the circumvention of taxes, then the legal consequences are determined in this rule. Otherwise, the tax claim arises in case of a misuse in the meaning of Para. 2 so as it arose in case of a reasonable legal structuring of the economic affairs.
>
> (2) A misuse exists if an unreasonable legal structure is chosen which for the tax payer or a third party results in a tax benefit which is in comparison to the reasonable structuring legally not intended. This does not apply, if the tax payer can prove non-tax reasons for the chosen structure which are according to the overall picture of the circumstances substantial.'

Unlike Australia, where the courts have tried but failed to apply their equivalent of a GAAR, Professor Dr Wilhelm Haarman of Haarmann Partnerschaftsgesellschaft explained that the courts in Germany are very reluctant to apply Sec 42. On the contrary, the German Parliament has introduced targeted anti-avoidance provisions (TAARs) to deal with such misuse. As these TAARs prevail over Sec 42 and have become more extensive, they have effectively limited Sec 42's application in Germany.

Barbara Worndl, partner at Aird & Berlis, explained that GAAR was introduced in Canada in 1988 with the intention of giving the Canadian Revenue Agency (CRA) increased abilities to target and challenge possible cases of tax avoidance and/or abuses in the tax system. Until Canada's GAAR was introduced, no anti-avoidance measures had been in place. Up until 1995, subject to a circular issued by CRA detailing what GAAR covered, no judicial pronouncements were made. Following 1995, the CRA became successful in finding several cases in which the GAAR did apply.

The following is the general framework provided by the Supreme Court of Canada. In order for GAAR to apply, lower courts would need to establish the following:

1. a tax benefit resulting from a transaction or part of series of transactions;
2. that the transaction is an avoidance transaction – not reasonably undertaken for bona fide purpose other than to obtain a tax benefit; and
3. abusive tax avoidance – tax benefit not reasonably consistent with object, spirit or purpose of provisions in the Income Tax Act (Canada) or a tax treaty relied upon by the taxpayer with the burden on taxpayer

to refute (1) and (2) and the burden on the minister to establish (3). CRA has lost on (3) where it has not been able to establish a clear tax policy offended or specific abusive tax avoidance undertaken.

If GAAR applies, the tax consequences of an arrangement will be revised to deny the tax benefit that resulted from the series of transactions, but there is no penalty other than interest for any underpaid tax. For example in the recent case of *Copthorne*, where GAAR was applied by the court to enforce withholding tax in respect of a payment to a non-resident, the court refused to apply a penalty for failure to withhold the tax.

An assessment under GAAR cannot be made without approval of the GAAR committee unless the fact situation itself has already been approved. The committee is designed to ensure consistency and fairness in the application of GAAR across the country. CRA may assess taxpayers on the basis of GAAR in cases where a specific anti-avoidance rule applies; however, GAAR cannot apply unless and until it is determined that the transaction achieves the taxpayer's desired result.

CRA has had mixed results in court and the rulings made stating that the GAAR did or did not apply seem to conflict one another. For instance, in the case of *Overs*, in order to repay a shareholder loan payable to his corporation, Mr Overs sold shares to his wife. She, in turn, took out a loan to pay for these shares and deducted the interest charged on the loan. Mr Overs used the proceeds of the share sales to repay the shareholder loan. Had he taken out a loan to repay the shareholder loan himself, his loan interest would not have been tax deductible. Thus, Mr Over avoided taxation but the GAAR was not found to apply.

In the case of *Lipson*, the taxpayer's spouse purchased shares of the family company from the taxpayer using a demand loan. The taxpayer in turn used the funds to purchase a home (as opposed to paying off a shareholder loan). The couple then applied for permanent financing secured by the mortgage on the home to repay the spouse's loan. In the *Lipson* case, however, the court ruled that the GAAR did apply.

The German, Canadian and Australian examples illustrate the difficulties in the interpretation and application of GAAR and demonstrate that it is not a completely effective method in policing tax abusive arrangements.

GAAR – not in place in all jurisdictions

Not all jurisdictions have a GAAR in place. As highlighted by Aseem Chawla, partner at MPC Legal, India has taken many years to consider how best to implement a GAAR in its jurisdiction. Aseem noted India's concern that GAAR could detrimentally impact the efficacy of both the India-Mauritian double tax treaty and, more importantly, the India-Singapore double tax treaty. Eric Chun from Ernst & Young in New York explained that the US model relies on common law jurisprudence to deal with certain tax abuse matters rather than a specific identifiable GAAR. However, in March 2010 the US codified this position, at least in part, with the economic substance doctrine in section 7701(o) of the ESD.

Under section 7701(o)(1), a transaction is treated as having economic substance only if:

- the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position, and
- the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into such transaction.

ESD enacts the common law doctrine under which tax benefits with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose (section 7701(o)(5)(A)). The principal purpose for codifying the ESD was to deal with the inconsistency in the Inland Revenue Service (IRS) and courts applying this doctrine. Under Notice 2010-62, it is indicated that the IRS would continue to apply the ESD in the same manner as before codification.

As well as the codified ESD, substantial administrative guidance has been put in place to safeguard the correct application of the ESD. Pursuant to the LMSB 20-0910-24, known as the 2010 Directive, before applying any penalty under ESD, any examiner must obtain approval of the appropriate director of field operations. Further, the LB&I-4-0711-015 complements the 2010 Directive by setting out a four-step enquiry procedure providing a framework for examiners to consider the elements of the transaction, narrowing the potential breadth of the ESD.

The approaches taken by the US and India both highlight their concerns with implementing a full-blown GAAR, preferring to either:

- defer the implementation of GAAR; or
- codify the common law position, albeit in a narrow manner.

UK GAAR is coming

Like other jurisdictions, the journey to implement a UK GAAR has been a long one. Heather Gething, partner at Herbert Smith Freehills, highlighted a number of elements which have instigated this journey:

- the implementation of the Disclosure of Tax Avoidance Arrangements in 2004 resulted in vast quantities of rule changes to counter specific schemes, most of which would not have worked in any event;
- a modern drafting style facilitating abuse as there are no umbrella provisions from which purpose can be readily ascertained; and
- leaked details of high profile company and individual settlements and the investigation by the Commons Public Accounts Committee which increase political pressure to adopt a general anti-avoidance provision and put a stop to the adoption of tax avoidance schemes.

In consequence, Graham Aaronson QC was asked to form a committee to consider whether a UK GAAR was required and, after wide consultation, to create a draft UK GAAR which was the genesis of the provisions to be enacted later this year.

Stephen Hoyle, partner of DLA Piper UK, highlighted the statement by Graham Aaronson QC to the Finance Bill Select Committee on 21 January 2013 as illustrating the political motivations behind the GAAR succinctly:

> '… the whole inception of the UK GAAR study Group was predicated on the basis that we are entering into a period of austerity and it will be intolerable to have people playing fast and loose with tax planning….'

Against this backdrop is the fact that HMRC is successful in more than 90 per cent of all cases it litigates, so it is questionable whether it is needed.

Richard Rogers of HMRC commenced his address to the attendees by simply stating that:

- UK GAAR will be in force on Royal Assent (expected sometime in July 2013);
- the form of UK GAAR is unlikely to be materially different to the provisions published on 11 December 2012 in the Finance Bill 2013; and
- UK GAAR is not meant to cut across the centre ground, but agreed it would create an effective shadow which would have a deterrent effect on aggressive tax planning.

Richard Rogers also did not expect that UK GAAR, at least at the outset, would be in a form which could readily be opined on nor is expected to be.

UK GAAR provides for the counteraction of tax arrangements that are abusive, applying to transactions which occur after Royal Assent (scheduled for July 2013). Described as a general 'anti-abuse' rule rather than 'anti-avoidance' rule, on the basis that the centre ground of tax planning must be protected, it will take precedence over any other existing legislation. For any counteraction to be made there must be a tax arrangement and such arrangement is abusive.

An arrangement is a 'tax arrangement' if, having regard to all of the circumstances, it is reasonable to conclude that the obtaining of the tax advantage is a/the main purpose. This being an objective test, HMRC are not concerned with the actual motivations of the participants in the arrangements. The tax arrangement is abusive if entering into or carrying out the arrangement cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions having regard to all of the circumstances including whether:

- the substantive result of the arrangement is consistent with the express or implied principles on which the provisions are based and the policy objectives of the provisions;
- the means of achieving the result involves one or more contrived step; or
- the arrangement is intended to exploit any shortcomings in the provisions.

There are a number of indicators to determine if an arrangement is abusive:

- a loss is claimed greater than the commercial loss;
- a taxable profit is less than the commercial profit; or
- there is a claim for repayment of tax that has not actually been paid.

The critical question is how can a court determine whether an arrangement can reasonably be regarded as a reasonable course of action in relation to a provision (known as the double reasonable test). If the purpose of the legislation is clear from the words construed in context there will be no problem, but then UK GAAR was not needed to achieve that result. If no purpose can be discerned from the legislation, so-called closely articulated legislation, the legislation then requires us to consider:

- the contrived nature of the arrangement; however, one person's contrivance is another's creative solution so this seems to require the subjective view of the judge on the degree of contrivance; and

- whether the arrangements are intended to exploit any shortcoming, which requires consideration of the intention of the parties and is subjective if a purpose can be discerned in the legislation a 'shortcoming' will be obvious, but if purpose cannot be discerned a shortcoming is difficult, if not impossible, to discern.

Although the judiciary will have to consider a range of reasonably held views, can it ever be reasonable to plan to mitigate taxation except through the use of tax incentives? Accordingly the range of reasonably held views is likely to be a range of one.

It is with this backdrop that the UK GAAR will arrive in the UK in July this year. If we can take anything from the experiences of other jurisdictions, it will not operate as the desired panacea for tax abuse in the UK. However, until we see some judicial decisions on its application, it will inevitably create the shadow over tax planning which HMRC and political pressure require.

Note

See: www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=r4965.

12 FEBRUARY 2013

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Distressed debt issues including debt buybacks

Speakers
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Albert Collado *Garrigues, Barcelona*
Jean-Marc Groelly *Nauta Dutilh, Luxembourg*
Mark Weinstein *Hogan Lovells, New York*
Simon Yates *Travers Smith, London*

The session addressed the question of distressed refinancings and the trading of distressed debt in a number of different jurisdictions, being Bulgaria, Luxembourg, Spain, the UK and the US. The speakers considered both the markets in those jurisdictions and how the tax regimes affected companies in distressed debt situations. It was noted that given the current global economy, a number of practitioners were increasingly encountering groups needing assistance with their debt and that tax efficiency was often paramount.

Two key topics were covered: first, dealing with distressed refinancings, including the questions of debt waivers, debt buy backs and debt for equity swaps; and secondly, the challenges created by the increasing market in the trading of distressed debt.

Distressed refinancings

Three distressed refinancing case studies were presented, with each speaker addressing the consequences arising in their own jurisdiction. The case studies covered the modification of debt conditions (including debt waivers), the tax effects of debt buy-ins and the consequences of debt equity swaps. In many cases, the tax treatment of the transactions was thought to follow the relevant accounting rules, with specific exceptions where legislative policy required a different economic outcome. However, it was noted that legislation was often unclear and could give rise to surprising results. Each of the case studies is considered in detail below. While a variety of topics were covered, including the effect of the transactions on transfer pricing, stamp duties, accrual of original issue discount and carried forward losses, the focus of the workshop was on the initial impact of each transaction for the debtor and creditor entities.

Case study 1: modification of debt conditions, including debt waivers

This was discussed for each relevant jurisdiction both in the context of a bank loan and of a holding company ('Holdco') loan. As a general rule, there is a potential for tax charges to arise in each jurisdiction as a result of debt waivers or fundamental modifications to the terms of a debt, with the tax effect often mirroring the treatment in the company's accounts. More detailed analysis in relation to each country discussed is set out below.

Bulgaria

It was noted that in Bulgaria, the waiver of a debt (and the modification of a debt if the result is a substantially different debt) would result in taxable income for the debtor. For the creditor, a waiver would not be tax deductible since it is regarded as a tax abusive transaction. A modification may be tax deductible unless it is requalified as a partial waiver.

Luxembourg

In Luxembourg, there would be a tax charge for the debtor on the amount waived but modification of the conditions should not usually give rise to income for the debtor. It may be possible to exempt the income subject to certain limits and conditions and (in the case of a Holdco loan), if the waiver were treated as an informal capital contribution. An unrelated creditor would be able to claim a deduction for the amount waived but for a Holdco loan, there would be no deduction to the extent that the waiver had been treated as an informal capital contribution.

Spain

The Spanish rules mean that there would be a charge for the debtor on a waiver of a third party loan amount, including if a modification of conditions such as interest rate or maturity actually lead to a lower liability. In the case of a Holdco loan, however, the waiver is likely to be treated as an informal equity contribution with no charge arising, save where there are minority shareholders, when tax may be payable. A bank waiving a loan would be able to claim a loss as an unrelated third party. In the case of a Holdco loan, Holdco should be entitled to a step-up in its tax basis in the portfolio company.

UK

The UK provisions provide that in relation to a third party debt, any release shown in the accounts (because there has actually been a release or because of a fundamental change to the terms of the debt) would result in a tax charge. The third party creditor will be able to claim the loss as and when it provides against the loan. In contrast, on a release of a loan between grouped companies, no tax charge should arise on the release but Holdco would not be entitled to a deduction in respect of the release.

US

It was noted that the US rules were uncertain and that they could be improved by ensuring that tax consequences are matched to economic consequences. In relation to the detailed rules, it was explained that cancellation of debt (COD) income should be recognised by the debtor on the waiver of a debt or if there is a significant modification of the debt instrument. The tax consequences for the creditor will depend upon whether the instrument issued constitutes a 'security', which would generally include any debt instrument with a term of more than five years. In the case of a security, no gain or loss would be allowed. Where the debt is not a security, the creditor would be required to recognise a gain or loss on the waiver or modification. Where the debtor and creditor are part of the same US consolidated tax group, income, gains, losses and deductions can be deferred under the consolidated income tax rules.

Case study 2: purchase of debt at a discount/ debt buy back

This case study was considered both in the context of a purchase of debt by a Holdco or a third party and of a debt buy-back by a borrower. In each jurisdiction, a borrower debt buy-in was thought to be treated in a similar way to a waiver. The rules on debt buy-ins from Holdcos or third parties varied between jurisdictions with some jurisdictions making a clear distinction between the two and treating a Holdco buy-in as more closely related to an effective waiver. More detailed analysis on third party and Holdco debt buy-ins is set out below.

Bulgaria

In case of a Holdco or third party debt buy-in, there should be no tax charge for the borrower company provided that there is no subsequent waiver or substantial modification to the terms of the debt. The seller of the debt would be entitled to a deduction if the acquisition cost exceeded the sale price, although there may be a time delay in claiming certain impairment losses.

Luxembourg

There should be no income recognition for the borrower on a Holdco or third party buy-in unless there is a subsequent waiver of the debt. The seller of the debt should also be entitled to a deduction.

Spain

No income recognition would occur on a Holdco or third party debt buy-in unless there were a subsequent waiver or modification of debt conditions. The seller of the debt should be entitled to a deductible loss.

UK

On a third party debt buy-in the treatment follows the accounts and if they show a profit, a tax charge will arise. A third party seller should be able to claim a loss in respect of the sale. Specific rules relating to Holdco buy-ins mean that (with some limited exceptions) a tax charge will arise to the extent of the discount to par paid by Holdco on the purchase. The seller should be entitled to a loss on the sale, although it is possible that the loss will have been claimed at an earlier stage and if the sale is for more than the tax written down value of the debt, the seller will have a taxable profit.

US

On a third party debt buy-in there should be no income recognition by the borrower unless there is a subsequent waiver or modification of the debt, the seller of the debt will be entitled to a deductible loss. On a Holdco buy-in, the acquisition is treated as the acquisition of the debt by the borrower, with COD income being recognised on the excess of the adjusted issued price of the debt over purchase price. It is possible that the COD income may be excluded under the general rules. An unrelated seller will generally be entitled to a capital loss.

Case study 3: debt equity swap

The group considered the effects of debt for equity swaps. As with the other case studies, this was addressed both in the case of a third party bank debt and a Holdco debt. The rules varied quite widely between jurisdictions with certain jurisdictions having specific exemptions on debt equity swaps, and others requiring income to be brought into account. A summary of the position in each jurisdiction is set out below.

Bulgaria

It was noted that there is a general requirement under Bulgarian corporate law that a valuation is carried out and that the value of shares issued in debt for equity swaps should be equal to the fair market value of the debt released. Usually there would be no income recognition for the borrower on the swap unless the debt is impaired. For the holder, the swap may be treated as giving rise to a loss to the extent that the debt is impaired, unless it is treated as an additional equity contribution under the relevant accounting rules.

Luxembourg

The treatment for the debtor follows the accounts such that there may be income recognition if the debt is contributed at fair market value. In the case of a Holdco transaction, the contribution may in certain circumstances be treated as an informal capital contribution and constructive distributions issues (including potential withholding tax exposures) may result from the presence of minority shareholders. An unrelated creditor may claim a deduction in respect of the swap.

Spain

Following the accounts, the debt is deemed to be contributed at market value and therefore income or loss is recognised for the amount of the discount. An unrelated holder would be entitled to a loss on the swap. A Holdco transaction may be treated as an equity contribution with a subsequent step-up in the tax basis of the portfolio company. Only distressed debt previously acquired by Holdco at a discount will trigger an accounting (and thus taxable) gain at the subsidiary level when converted into equity.

UK

No tax charge should arise provided that the equity into which the debt is swapped constitutes ordinary share capital, with a specific exemption existing for this even where the accounts would reflect a credit. HMRC are reluctant to allow this capitalisation relief if shares are rapidly sold by the lender. On a swap into shares other than ordinary share capital (except a Holdco swap, assuming that that companies are grouped), a taxable credit would arise for the borrower company. No loss will be available on the swap for a Holdco lender but an unrelated party should be entitled to a deduction in relation to the swap. The base cost in the shares going forward would be the lower of the market value of the shares on issue and the market value of the debt when the capitalisation occurs.

US

Under the debt for equity exchange rule, the borrower would be required to recognise COD income equal to the difference between the adjusted issue price of the debt over the fair market value of the stock transferred. The tax consequences for the holder will depend upon whether the debt instrument is a security and, if so, the exchange may qualify as a tax free recapitalisation; if not, the holder will be required to recognise a gain or loss equal to the difference between the fair market value of the stock received over its adjusted basis in the original debt.

Trading of distressed debt

The section of the workshop dealing with trading in distressed debt focussed on the use of intermediate vehicles including the use of SPVs, the reorganisation of debt in aggregating vehicles and investments made through arrangers.

SPVs and aggregating vehicles

It was noted that intermediate vehicles were often used by offshore funds for both tax and other reasons. From a tax perspective, they were often useful in accessing relevant treaties but the use of the vehicle and choice of vehicle (for example, as between standard companies and securitisation vehicles) was often driven by other non-tax issues.

Key tax considerations on the use of intermediate vehicles were managing the beneficial ownership position (including through ensuring adequate local substance, using double as opposed to single tier structures and introducing mismatches in funding instruments), ensuring a low effective tax rate in the vehicles themselves and ensuring that no withholding tax exposures arose, for example, by listing relevant instruments. In the context of withholding tax, the risks around debts being taken out of a Luxembourg holding structure on the enforcement of security and the potential to lose the ability to pay gross was emphasised. In particular, in jurisdictions taxing by reference to accounting results, the right answer can be difficult to identify when the amount is derecognised from the intermediate vehicle's accounts altogether.

The case studies in this area addressed the use of European debt platforms and investments through 'loan to own' entities. It was noted in the context of a case study on European debt platforms that the US rules on pools of loans in particular can lead to strange results where loans are pooled through an intermediate vehicle, since allowable tax losses will not always match real economic losses. There was also discussion of the UK rules around debt buy-ins and the potential for charges to arise if the relatively limited corporate rescue exemption did not apply.

Investing through arrangers

The final section of the workshop considered a case study including an investment by an arranger in distressed debt followed by trading or syndication through contractual arrangements such as trusts and participating loans. The discussion on this case study focussed on the position in Spain, the UK and the US.

In relation to Spain, it was noted that there was no recognition of the concept of a trust and no explicit regulation of beneficial ownership (although the concept was accepted by the Spanish courts). This led to some uncertainty around the tax treatment of such arrangements particularly around the true beneficial owner of the loan and whether the beneficial owner is simply the person who bears the risk of insolvency of the borrower. It was indicated that the Spanish authorities have an emphasis on the importance of business purpose and economic substance in this area.

In the UK, the key consideration in relation to such arrangements is often the risk of creating a permanent establishment in the UK (although this could be mitigated if the collecting agent can be viewed as the independent agent of the buyer). In addition, withholding tax will need to be considered and the beneficial ownership position managed, although it was noted that the UK law on beneficial ownership was more generous than the standard *Indofoods* position.

Finally, the position in the US was discussed, with the key issue raised being how to avoid being caught in the US tax web. This could be relevant to a person originating more than a small number of loans in the US, although may be avoided if the loans can be originated by one party and sold by another. As a general rule, the IRS will consider whether the person has regular and continuous activity in the US directly related to the active pursuit of profit as well as where its core profit making activities occur. Independent collection agents will not normally be caught as a result of a safe harbour provision.

It was concluded that similar issues were faced in each of these jurisdictions in attempting to ensure that the investment did not create a taxable presence in the relevant jurisdiction and that the true beneficial ownership of the debts could be properly established.

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Plenary case studies: how does the arm's length method work in today's economy? Intangibles assets and profit allocation

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Peter H Blessing *KPMG, New York*
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Speakers
Jos Beerepoot *Unilever, Rotterdam*
Mark Carnduff *HM Revenue & Customs, London*
Stephen Edge *Slaughter and May, London*
Klaus Sieker *Flick Gocke Schaumburg, Frankfurt am Main*

Introduction

Based on several case studies, it was discussed during this session how the arm's length principle is functioning in a world in which the weight of IP as contributor to the profits of multinationals (MNEs) has increased.

Peter Blessing provided, as background, a brief overview of the difficulties faced by tax systems with respect to intangible assets and assets allocation. The problems are not new problems; they have existed for years. The problems include difficulties relating to the identification of IP as opposed to, for example, services, the contribution of one generation of IP to future generations and other useful life issues, the inability to accurately project revenues at the time of transfers, the fact that all relevant information often is not available to both sides, and the commercial ease of transfer of possession and other ownership rights in view of the intangible nature of the property. Although the difficulties and issues may not have changed, the importance has ratcheted up as taxpayers have more assiduously identified and segregated IP from other assets when advantageous and as the value ascribed to IP in today's economy has increased. A related development is the ability to sell remotely into a country and so more easily achieve local sales without a physical presence.

Supply chain case study

The first case study discussed was the supply chain case study and was discussed by Jos Beerepoot.

Several different units are mentioned, such as the principal, a sourcing unit, a service unit and the IP owner. Jos Beerepoot mentioned that, in the beginning, he was sceptical about separate service units supporting the principal, especially with respect to the avoidance of permanent establishments (PE).

Furthermore, he mentioned that the IP is often structured in separate companies for several legal issues.

After explaining the model, he explained that the question where a unit should be situated is not only affected by tax considerations but also by important non-tax business reasons. MNEs are challenging different markets and several drivers to a change in structure were described, such as the growth of customers and further globalisation.

The BEPS report also shows that it is difficult to answer the question where profits should be located and how the real world ties to the paper world.

Three main issues were mentioned with respect to business restructuring:

- exit charges with respect to the restructuring transactions;
- transfer price after the restructuring; and
- PE issues.

Another important issue with respect to the transfer of IP is VAT.

It is also important to place tax analysis in perspective, taking into account business reasons to change the IP structures from local to global. With respect to the pricing of the IP in such cases, query whether a third party would pay for any existing inefficiencies. Steven Edge affirmed Jos Beerepoot's suggestion that there are often business reasons to restructure, by stating that business considerations typically drive the decisions and that tax considerations follow thereafter.

Cost sharing/centralised IP case study

Klaus Sieker discussed the cost sharing/centralised IP case study. This case study is based on a simple example in which an American company ('A') acquires a German company ('B'). A and B are both pharmaceuticals and invest heavily in R&D. The business objective is to integrate both R&D operations. This objective can be reached in a number of ways, but the tax implications are very different. The assignment of the existing R&D by B, for instance, will most likely result in a huge tax burden in Germany. A suggestion is to use a cost sharing agreement. For completely new developments, there are no upfront tax costs. Each party pays a pro rate part of the cost that relates to the expected future sales in its own market. While this works easily for new products, it is difficult for products in progress. What is the buy-in payment for these products?

Klaus Sieker also discussed two examples from the BEPS report (Annex C) and the risk that cost sharing is used for (aggressive) tax planning. The OECD is afraid that the buy-in payment is not high enough and that the IP will be placed in low taxed countries. Both Germany and the US have special rules with respect to cost sharing agreements to avoid (too large) payments to low taxed companies. Cost sharing is not per se aggressive, but has a huge potential for disagreement.

Hypothetical US Group case studies

Several methods have been used to migrate intangibles from the US. Amongst others, these include licensing, cost sharing and corporate reorganisations.

Based on a study of the corporate structures of six companies as relevant to their use of IP prepared by the US Joint Committee on Taxation, two different examples of IP structuring were discussed.

Delta Company: summary of transaction flows

The first example, Delta Group (a fictitious name), involved Delta US, which granted a licence to Delta Singapore, an offshore company, and Delta Netherlands, a Dutch intermediate company. Delta Singapore manufactures and sells the products to Delta US and foreign distribution companies. Delta Singapore pays a royalty to Delta US, but also receives compensation from Delta US for the products manufactured for the US market. Overall, a substantial part of the offshore profit of Delta Group is low taxed. From a US tax perspective, there will be taxable income from licensing income and US low risk distribution activities on behalf of Delta Netherlands; the licensing income will produce foreign source income that will permit use of foreign tax credits. Furthermore, there will be no Subpart F income due to the manufacturing exception.

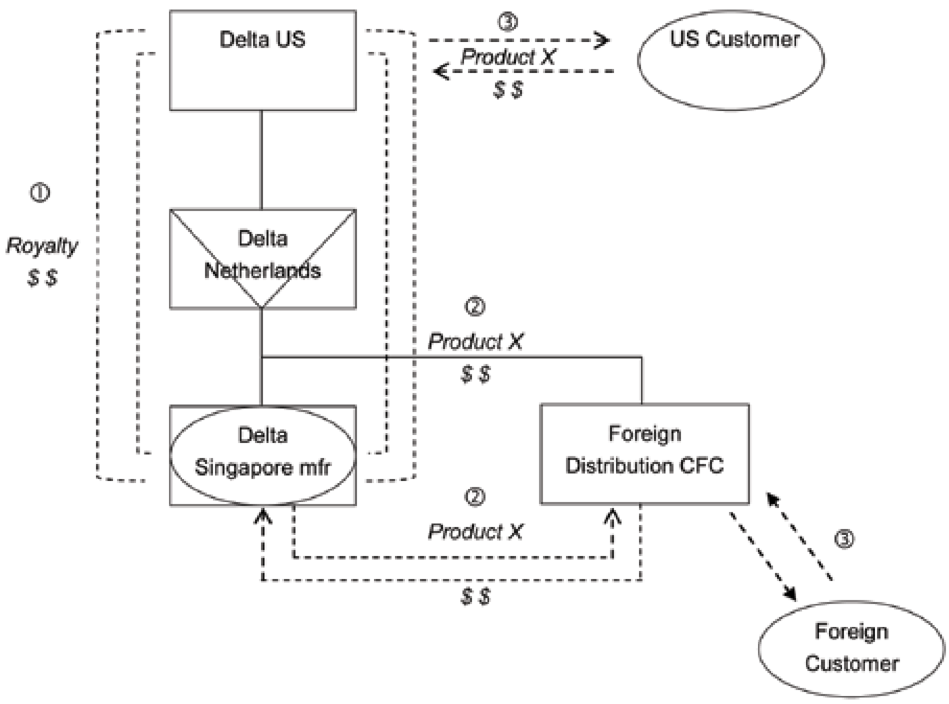
Bravo Company: summary of transaction flows

Bravo Company (again a fictitious name) was the second example. In this situation, the IP has been migrated from Bravo US to Bravo Switzerland.

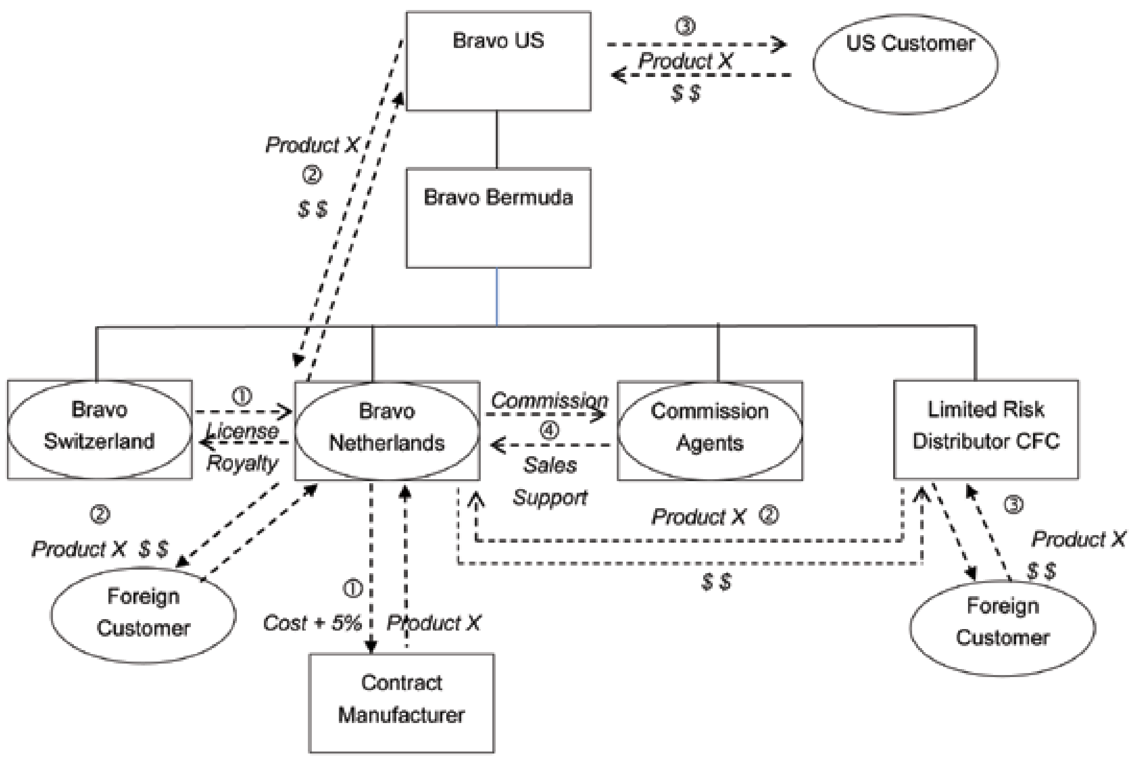
Bravo Netherlands is the entrepreneur, but only has a small taxable basis because it has to pay substantial royalty fees to Bravo Switzerland. The royalty income Bravo Switzerland receives is taxed at a rate of less than five per cent.

From a US tax perspective, Bravo US receives compensation for its limited risk distributor activities and performance of support services. Furthermore, there is no Subpart F income due to the manufacturing exception as well as the disregard of intra-group transactions under Bravo Bermuda.

Delta Company: summary of transaction flows

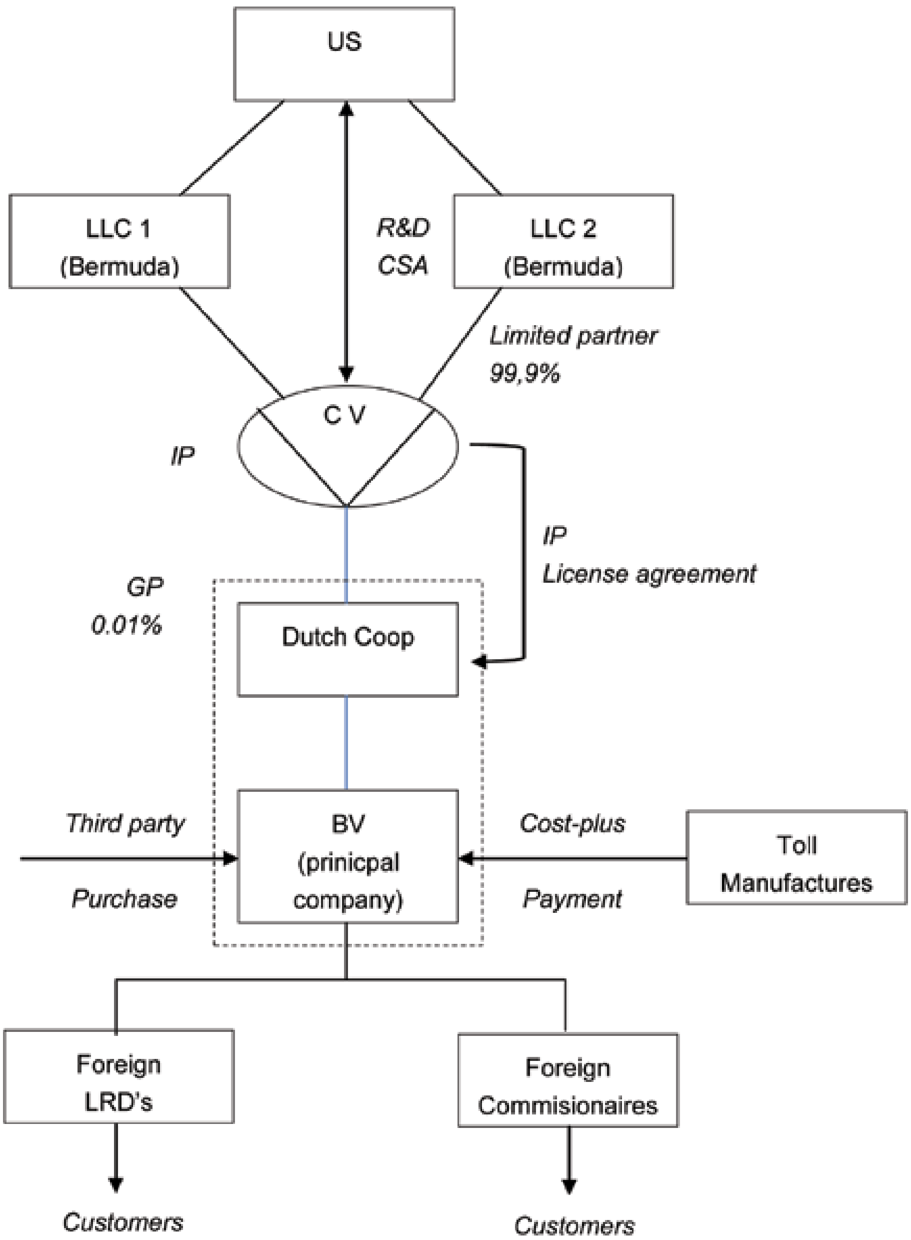


Bravo Company: summary of transaction flows



The Netherlands

Typical use of NL in principal structure (see figure C 2 in OECD BEPS Report)



Based on the above example, which is comparable to one of the examples mentioned in the BEPS report, Peter Flipsen discussed the typical use of the Netherlands in a principal structure. Both IP royalty and remuneration of LRD's or commissionaires are based on transfer pricing analyses and thus at arm's length. In the Netherlands, an advanced pricing agreement (APA) or advanced tax ruling (ATR) can be obtained to acknowledge and confirm the Dutch tax implications of the structure in advance.

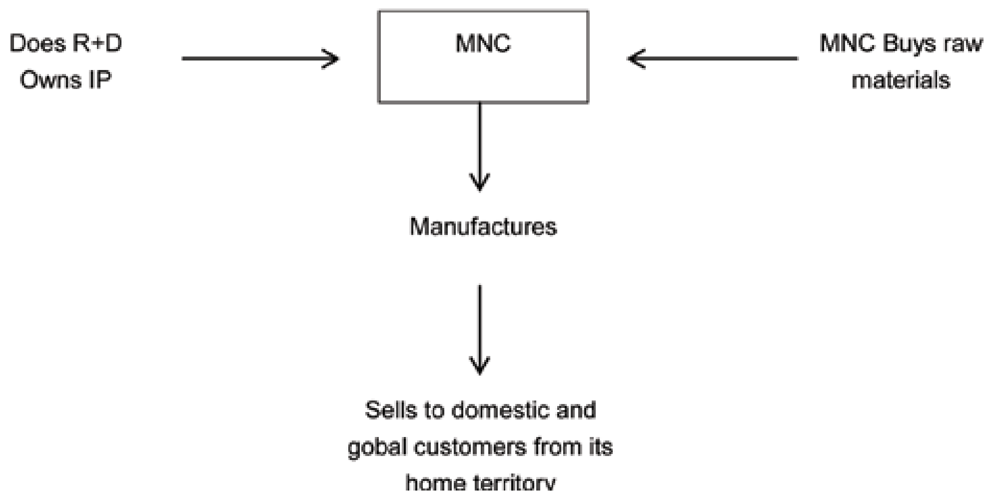
Peter Flipsen mentioned that the Netherlands have been frequently mentioned in the publicity about aggressive tax planning and there is currently a political debate in the Netherlands to stop the use of the Netherlands as a tax haven. He emphasised that the Netherlands are no tax haven. There is no low tax rate in the Netherlands, no specific tax freedoms and no bank secrecy. The Dutch share of the taxable profits from royalty structures is based on the application of the OECD arm's length principle and

OECD transfer pricing guidelines, taking into account the location of the risk and where functions are performed. The examples mentioned in the BEPS report are mainly based on the possibility under US tax law to defer taxation. Given the tax competition in Europe, and in order to avoid a negative impact on the Dutch investment climate, the Dutch Government has stated in Parliament that there should be international initiatives to tackle the issue of aggressive tax planning by making use of hybrid mismatches and instruments and no unilateral approach.

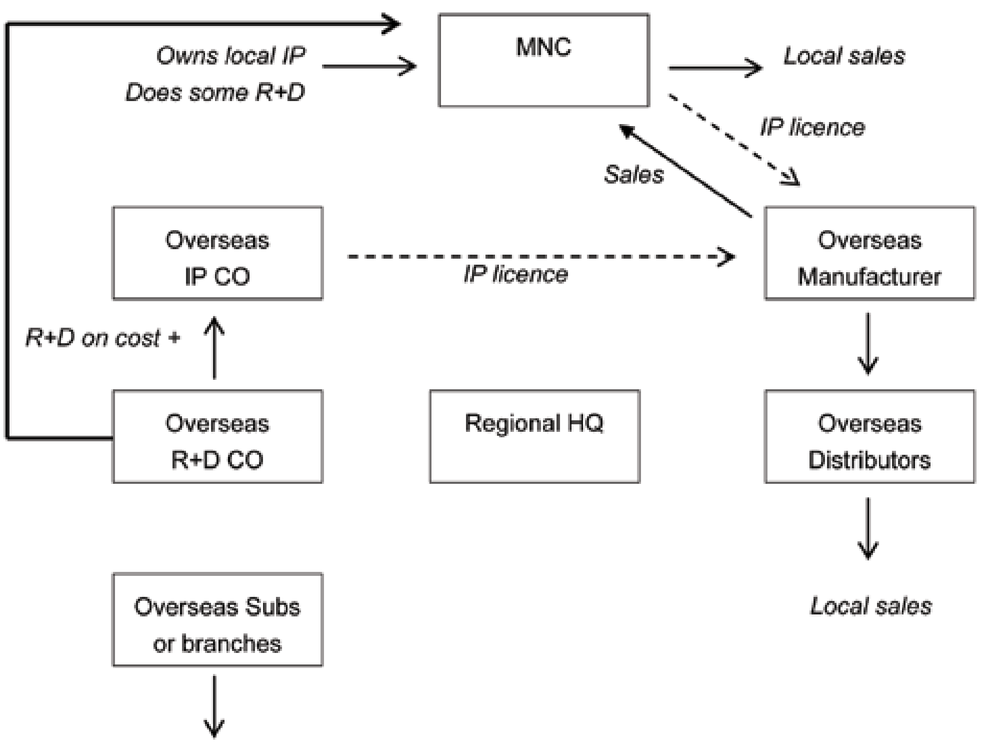
Fragmentation case study

In the last case study, Mark Carnduff and Steven Edge analysed the several individual

Single jurisdiction manufacturer and exporter



A fully fragmented structure



functions. They noted that a fragmented operational model can be more efficient. They presented several illustrations, starting with a single jurisdiction manufacturer and exporter and modifying the structure until he reached a fully fragmented structure.

In the single jurisdiction, all profits of the manufacturer and exporter will be taxed in the home jurisdiction. One of the structures in between is a situation in which the fragmentation is only limited to overseas buying, storage and customer support. Mark Carnduff mentioned that the compensation for these functions would normally be limited to a cost plus.

An example of a more fragmented situation is where the IP has been transferred to an overseas company. To stand up for tax purposes, the reality and economic substance must support the transfer. One question is whether the crown jewels (the IP) can ever really leave the home jurisdiction. Issues regarding how a fair royalty payment can be determined and how a correct valuation for the transfer of IP can be determined were raised.

In case of a fully fragmented structure, other important questions arise. How should you value the several transactions? Should the total of all compensation be equal to the overall profit? Or should all transactions be priced separately and if so, where should any residual be taxed? It was noted that every case has its own facts and should be assessed accordingly.

Conclusion

At the end of the session, the co-chairs and speakers had their final remarks about how the arm's length method should evolve. The common idea is that centralisation is real, that companies have to go forward and that they must order their tax affairs taking account of the interests of their shareholders and the law as currently in effect. Future changes in the law may well come and will take the form both of unilateral changes, including anti-abuse rules, and, with much more effort by tax authorities, multilateral changes. Taxpayers can make their contribution to the process by engaging in their transfer pricing in a transparent way.

FATCA – it is here, now do something about it!

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Peter Utterström *Stockholm*

Introduction

The US Congress enacted the Foreign Account Tax Compliance Act (FATCA) in 2010 in response to concerns that US persons were hiding assets in foreign jurisdictions without reporting the income. US persons are taxed on their worldwide income regardless of where they reside, and FATCA is designed to require reporting on accounts of US persons held by foreign financial institutions (FFIs). If an FFI does not participate or is not deemed to participate, then it is subject to 30 per cent withholding on certain payments of US-source fixed, determinable, annual or periodic payments. By 2017, FATCA withholding applies to gross proceeds from the sale or disposition of assets that give rise to dividend or interest income.

The purpose of this panel was to explore FATCA in practice, or in the tranches, and how to manage FATCA to avoid penalties. To that end, the focus of the panel was on intergovernmental agreements (IGAs) executed between the United States and various countries and how certain industries are addressing FATCA. More than 50 countries are in the process of negotiating and executing IGAs with the United States.

The United Kingdom, Denmark, Germany, France, Italy, Mexico, Norway, Switzerland and Spain have signed or initialed agreements.

Initially, European countries disliked FATCA, but now governments realise it is a good tool and a method for obtaining through automatic exchange information regarding their residents. As a result, IGAs have become the main part of FATCA, and the panel was devoted to exploring the perceived benefits and obligations of FFIs under these agreements.

Mr Utterström made a few observations about FATCA and IGAs. First, practitioners should learn all of the abbreviations, as FATCA has its own language. Secondly, the reason IGAs exist is due to the local concerns of partner countries regarding information exchange with the US Internal Revenue Service (IRS). The IGAs provide a method of solving these issues and making local law changes. Thirdly, from the Swedish perspective, potential FFIs are hiding their heads in the sand, which is scary because FATCA withholding begins on 1 January 2014. Finally, FATCA is not about taxes; it is a compliance tool, and it is important for FFIs to establish compliance systems.

IGAs

There are three model IGAs. Model 1 has two versions, reciprocal and nonreciprocal, that are otherwise identical. Model 1 IGAs provide a system for gathering local information, which is then reported to the local government, who then transmits the information to the IRS. The IGA negotiations between the US and foreign countries has been a take it or leave it approach, other than Annex 2, which contains local specifications (eg, exempt accounts, exempt institutions). Annex 1, which contains the due diligence provisions, is generally fixed. When comparing IGAs, Annex 1 is generally the same, while Annex 2 contains variations.

The Model 2 IGA provides that the FFI sends US account information directly to the IRS and requires the FFI to enter into an FFI agreement with the IRS. These are the main differences between the two models. Consequently, Model 1 requires the IGA partner country to implement the system, thereby increasing costs to the government. Model 2 shifts the costs to the reporting FFIs.

The United Kingdom's experience

The UK was the first country to enter into an IGA. It saw the benefit of FATCA, specifically that the US would obtain information regarding its citizens. The UK wanted similar information regarding its citizens. Ms Charkin noted that the UK is the first country to publish regulations implementing an IGA.

FATCA does not end with the signing of the IGA. Each country will need to enact local laws to implement the IGAs. FFIs will want consistency across jurisdictions to avoid duplicate reporting and gaps in reporting, but implementation will be tricky. Part of the difficulty is that the IGAs are drafted on US tax principles and not on local law principles (eg, corporate residence versus managed and controlled for purposes of determining whether a corporation is a UK corporation). These complications also extend to when and how FATCA and an IGA apply to funds and partnerships. The UK is working with industry to try to make the UK IGA work.

The UK draft regulations are 60 pages and are not detailed. They contain a set of rules to address IGA implementation. However, the US issued the final FATCA regulations in January 2013, well after the UK entered into an IGA with the United States, and the UK business community is waiting for the final UK regulations. Ms Charkin hopes that the final UK regulations match the US final regulations, as UK FFIs do not want to break UK data control laws by disclosing account information to the IRS. The final regulations will likely exceed 200 pages and were due to be released on 17 May 2013.

The UK is also working through finance documentation to determine who has the risk with respect to FATCA withholding. In the US, the risk is typically on the lender, while in the UK, the issue has not been resolved. One open issue is whether there should be a gross-up clause for FATCA withholding. Moreover, another issue is whether a purchaser can conduct FATCA due diligence in a merger or acquisition.

Switzerland's experience

Mr Altenburger made a few observations about FATCA and the Swiss IGA, which was signed on 14 February 2013. First, FATCA is a paradigm shift. It is the first global automatic information exchange agreement. Secondly, FFIs will bear enormous costs under the Model 2 IGA. Thirdly, FATCA has offspring, which are more dangerous than FATCA itself.

Switzerland signed a Model 2 IGA, the first country to do so. It pursued a Model 2 IGA in order to preserve bank secrecy. Holders of US accounts existing as of 31 December 2013 must sign a waiver allowing a Swiss FFI to exchange information with the IRS. If an account holder does not consent, then the account holder's information will be provided on an aggregate basis with other non-consenting account holders to the SFTA, which may transmit the information to the IRS pursuant to a group request. The IGA does not affect a US taxpayer's right to appeal to the Swiss Federal Administrative Court. The Swiss IGA provides that non-consenting account holders will become recalcitrant account holders and subject to FATCA's 30 per cent withholding within eight months from the IRS' request to the SFTA.

The IGA is not self-executing and is treated like a treaty that must be approved first by the Swiss parliament and then by the public through a facultative referendum. The Swiss Government will then release a federal law to implement the IGA. The Swiss IGA relies on the recent US-Swiss double tax treaty, which has not been ratified by the US senate, which may complicate the implementation of the Swiss IGA.

There are still some unresolved issues under FATCA, and the multiple sources of information will create confusion. There are still some unresolved issues, such as whether a bank deposit box is a financial account, and whether Switzerland will issue a memorandum of understanding regarding the IGA.

Italy's experience

For Italy, FATCA is the first step in a wider exchange of information strategy. The US will exchange information with Italy pursuant to a Model 1 reciprocal IGA. Italy has signed an English version of the IGA. The US state department is checking the Italian translation, and once the parties agree on the adequacy of the translation, Italy will enact local laws to implement FATCA.

The Italian IGA will replace the due diligence standards in the final FATCA regulations with the Italian anti-money laundering standards. Also, Italian FFIs will be able to rely on self-disclosure/declarations by account holders. Thirdly, one qualified intermediary will act as a clearing house and with holding agent for Italy's FFIs.

Implementation in Italy is a compliance issue, not a tax problem. Italian banks view compliance as an information technology driven issue.

One open issue is how FATCA should be addressed in loan agreements with counterparties, specifically who should bear the risk of the FATCA withholding tax.

Lichtenstein's experience

Lichtenstein has a robust financial services industry that has been dealing with FATCA and other transparency issues since 2008. On 12 March 2009, Lichtenstein issued a declaration that it is committed to enter into tax information exchange agreements and bilateral double tax treaties. It is committed to following foreign tax laws and OECD transparency. Recently, the US asked for the number of foundations with US connections, and Lichtenstein provided the data. This is a significant shift in behaviour.

As a result of FATCA and other transparency initiatives, Lichtenstein realises that it must change. In the past, it relied on trusts and foundation for its economy. Now, it needs to change clients to include business beyond the financial industry. It must convince clients to play by the rules. Also, Lichtenstein will need to implement the variety of international laws, which will pose a challenge due to the tight implementation timeframe.

Mr Ritter observed that Lichtenstein has entered into several transparent agreements, and all of these agreements will be implemented at the same time. Additionally, implementation will greatly increase labour costs. Automatic exchange of information will lead to more costs, less tax collected than under withholding, and concerns about bank secrecy and privacy.

Lichtenstein will continue to focus on non-tax structures to be the lead place for investment. In any event, the transition to FATCA will be rocky.

The in-house perspective

FATCA is ultimately a client communication and relationship issue, followed by reporting. The first goal in preparing for FATCA is to remove the internal tax function from leading FATCA projects. Tax should provide the technical support rather than act as the project sponsor. FATCA not only includes the tax department, but also the financing team, the treasury function, investment relations and client teams.

From an in-house perspective, FATCA did not provide enough detail until this year with the publication of the final regulations. The IGAs helped to a certain extent, but they have also made the problem bigger. FFIs will need to rationalise and implement 544 pages of final regulations and more than 50 IGAs. The key point is that FFIs will want to be compliant, but FFIs will also need to develop practical solutions.

Venture capital and private equity funds were worried about recalcitrant accounts. The final regulations require FFIs to withhold on and eventually close recalcitrant accounts. A recalcitrant account is an account where the account holder refuses to provide documentation that would permit the FFI to determine if the account holder is a specified US person. The UK IGA varies from the final FATCA regulations and does not require UK FFIs to close recalcitrant accounts.

Organisations need to set a plan. It is important for an FFI to determine how many entities within the expanded affiliated group (EAG) are FFIs. The organisation needs to determine the following for each potential FFI: (i) the ownership, (ii) location where it does business, (iii) place of incorporation, (iv) its principal business, and (v) if dormant, should the entity be retained. Additionally, an FFI needs to figure out if there are local law conflicts with FATCA, and if so, whether it is worth keeping the entity with the conflicts. FATCA requires all FFIs in an EAG to participate (eg, report on US accounts). The EAG is tainted if one or more FFIs does not participate or is deemed to participate, even if the lack of participation is due to a local law.

The next issue is how to classify and communicate with clients. A client may have multiple accounts in multiple locations or entities. A major issue is what to do with a pre-existing client who is a US person or recalcitrant account holder? FFIs need a communication plan in order to obtain data once from clients. FFIs need to create automatic systems to reduce the number of times the FFI must contact clients for documentation.

FATCA compliance is more challenging with the voluminous final regulations and 50 IGAs that have been signed or will be signed in the near future. The reality is that FFIs need one set of classification rules and process controls to obtain the appropriate data from clients.

One question is whether anyone will check the controls that an FFI establishes. The Model 1 IGA permits the IRS to directly audit an FFI.

The future: FATCA for everyone?

The G-5 (France, Germany, Italy, Spain and the UK) is trying to bring FATCA to the European Union by creating a multilateral system based on FATCA. Also, the UK has a FATCA-like agreement with the Isle of Man and the Channel Islands. The panellists agree that tax transparency is on the radar.

One unresolved issue is how FATCA will work with US FDAP withholding, which the US treasury will address in subsequent guidance.

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Debt equity characterisation and interest allocation issues

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In many jurisdictions, the characterisation of an instrument as either debt or equity will have a significant bearing on its tax treatment. Tax asymmetries can also arise where the same instrument is characterised as debt in one jurisdiction and as equity in another. The panel (made up of tax experts from the US, Finland, Austria, Belgium, Germany and Spain) discussed the characteristics of debt and equity instruments in their respective jurisdictions, developments in the approaches taken by their domestic tax authorities to such instruments and various tax planning issues that may arise.

To illustrate the relevant tax rules and the various issues that may arise, each panel member applied the facts of a simple case study to their respective jurisdictions. To the extent necessary, panellists referred to this case study and adapted it to illustrate particular points of interest. In broad terms, the facts of the case study were:

- a US corporate ('USCo') is to acquire, either directly or indirectly, the whole of the issued share capital of a target holding company (such target holding company could be organised in any jurisdiction) ('HoldCo');
- HoldCo has numerous subsidiaries organised in various jurisdictions (including those jurisdictions represented on the panel);
- USCo may form a new company ('NewCo'), which may be organised under US or non-US law, to act as the acquisition vehicle for the purchase of the shares in HoldCo; and
- either USCo or NewCo will apply a combination of its own funds and money raised through external finance to fund the acquisition of the shares in HoldCo.

United States

On any cross-border transaction like the case study, the key objectives of US tax planning would be to maximise foreign tax credits (FTCs) (which can mitigate double taxation on such transactions) and, in relation to any debt or equity instruments, maximising the benefits of interest deductions whilst minimising any withholding taxes on dividend and interest payments. It was noted that tax treaties can play an important function in minimising tax burdens on cross-border cash flows.

The facts of the case study was used to illustrate the different tax burdens that would be borne depending on whether an instrument could be characterised as debt or equity and to demonstrate some of the advantages of 'pushing down' debt within the acquisition structure.

When considering US tax planning on transactions like the case study, the preferences of the parties to the proposed arrangement would also need to be taken into account. In this regard, it was noted that investors would typically prefer to receive equity treatment as FTCs may then be available to such investors. From the perspective of an entity looking to raise funds, the opposite would generally be the case with debt treatment being preferable as interest payable in respect of debt should be a deductible expense for the debtor.

Whilst traditionally the US tax authorities have sought in certain cases to recharacterise debt as equity, the point was made that this approach is changing, with there now being a trend towards recharacterising equity as debt. Cases such as *Pritired I LLC v United States* and *Hewlett Packard Co v Commissioner* were cited to highlight this changing trend. In these cases, the courts looked at not only the terms of the instruments involved (such as the expected maturity of those instruments) but the actual arrangements entered into by the parties to conclude that the instruments were debt. On the basis of that conclusion, FTCs were disallowed in these cases. It was noted that the arrangements in both the case of *Pritired* and *Hewlett Packard* were at the aggressive end of the tax planning spectrum. The case of *Pepsico Puerto-Rico Inc v United States* was also mentioned as representative of less aggressive tax planning and this case illustrated the tension that can arise where there is an asymmetrical treatment in different jurisdictions.

Finland

The discussion concerning Finland began with a summary of some proposed Finnish legislative changes. Under current Finnish law, debt-financed acquisitions are attractive owing to the availability of tax deductions for the debtor in respect of interest expenses. However, with effect from 1 January 2014, Finland is proposing to introduce interest deduction limitation rules (similar to those that already exist in Germany) which will reduce the attractiveness of debt-financed acquisitions. Broadly, these new rules will limit the deductibility of net interest expense (ie, interest expense exceeding interest income) to 30 per cent of 'Tax EBITDA' subject to a 'safe harbour' of €500,000. Any interest expense that is not deductible under these new rules can be carried forward with relief given in subsequent periods (subject to the application of these rules to those future periods). It was noted that these new rules will have a particularly pronounced effect on loss-making companies.

Although case law in Finland has historically been both flexible and favourable to the taxpayer, the point was made that tax anti-avoidance rules and transfer pricing rules were increasingly being used by Finnish tax authorities to challenge interest deductibility (it was noted that Finland does not, however, have a statutory thin capitalisation rule). Acquisition branch structures are being challenged applying an OECD functional analysis to deny the availability of interest deductions. Other areas that were being increasingly challenged include intra-group debt push-downs which are being challenged under general anti-avoidance rules. For this reason and in the context of the facts of the case study, it was suggested that consideration should be given to effecting debt push-downs prior to completion.

A further measure which was referred to in the context of recharacterising debt as equity was the OECD Transfer Pricing Guideline 1.65, which may in extraordinary circumstances allow the tax authorities to disregard the parties' characterisation of a transaction and recharacterise it in accordance with its substance. This guideline has been used in a few 'pilot' cases in which the Finnish tax authorities have sought to recharacterise both hybrid debt (debt that carries certain equity like features) and excessive shareholder debt as equity. Constitutional issues and a lack of foreseeability were flagged as two potential concerns with respect to the approach of the Finnish tax authorities and their reliance upon this guideline.

Austria

Important to the discussion regarding debt and equity financing in Austria is the fact that Austria imposes a one per cent stamp duty on equity contributions whilst there has been no stamp duty on debt or loan financing with effect from 2011.

Like Finland, Austria does not have a statutory thin capitalisation rule. Typically, the Austrian tax authorities require Austrian companies to have a 3:1 or 4:1 debt to equity ratio. However, shareholders tend to agree how to debt/equity finance a vehicle. Recharacterisation by Austrian tax authorities of debt into equity is generally only possible if the arrangement concerned has not been entered into on arm's length terms. The burden of proof in respect of recharacterisation lies with the Austrian tax authorities and it was noted that this has proved to be a hindrance to the tax authorities when challenging the characterisation of an instrument.

Another issue that often arises is where an Austrian company enters into a hybrid instrument with a foreign subsidiary. As a result of new legislation introduced as of 2011, payments made under hybrid instruments issued by an Austrian company will no longer be tax exempt under the participation regime if those payments are tax deductible in the source country. This applies to hybrid instruments as well as dividends which are tax deductible under foreign local law, subject to the provisions of the EU Parent Subsidiary Directive.

The case study was discussed against the background of the introduction in 2005 of a favourable tax regime (including a group tax regime) and the further introduction of new rules in 2011 that prevented an interest deduction being obtained where a participation interest was acquired, either directly or indirectly, from an affiliated company or a controlling shareholder. The purpose of the 2011 rules was to eliminate unacceptable intra-group structuring and to prevent the deductibility of artificially generated tax expenses relating to debt financed intra-group sales of group participations. In relation to these types of transactions, it was suggested that, as a practical matter, consideration should now be given to changing a loan for the acquisition of an intra-group participation into a loan for the funding of a dividend. Once the dividend had been paid, the shareholders would pay an amount equal to that dividend to the Austrian company as an equity contribution. The Austrian company would then use those 'new' funds to repay the loan in respect of the acquisition of the participation. This proposal would, however, still be subject to various Austrian anti-avoidance rules which would require further consideration.

Belgium

The discussion in the context of Belgium started with an overview of some basic Belgian legal principles. Debt and equity characterisation in Belgium is governed by the Belgian Civil Law Code. A particular Advanced Ruling of note relates to the tax treatment of profit participating loans (PPLs), and confirms that an instrument with equity features can be compatible with a debt characterisation. The features of an instrument dealt with by this ruling were highlighted, including the term of the instrument, payment of principal and interest, subordination, transferability and profit participating characteristics.

'Interest' amounts in respect of PPLs within this ruling were characterised as 'dividends' and, in this particular case, were exempt by virtue of the Luxembourg participation exemption regime.

Further developments have included the introduction of the 'notional interest deduction' rules with effect from 1 January 2006, which effectively replaced the coordination centre regime. The notional interest deduction rules provide for a deduction at a set rate calculated by reference to the 'adjusted statutory book equity' as at the end of the previous fiscal year. One of the most important adjustments relates to participations benefiting from the participation exemption regime and, in this regard, it was noted that this adjustment disincentivises the establishment of holding companies with high levels of equity. However, the Advocate General of the Court of Justice of the European Union has concluded that the notional interest deduction rules impose an unjustified restriction on the freedom of establishment of Belgian companies with foreign permanent establishments. As at the date of the conference, a preliminary ruling had not yet been issued.

Reference was also made to Belgium's thin capitalisation rules. Under new rules which took effect from 1 July 2012, the debt-to-equity ratio is 5:1 (the ratio was previously 7:1). The scope of 'tainted debt' has also been expanded to include loans directly or indirectly owed to group companies (in addition to debt ultimately owed to persons or entities established in 'tax havens', as was the limited scope under the old regime).

Finally, the case study was discussed in order to demonstrate how a 'double-dip' could be obtained using the notional interest deduction rules. The facts of the case study were modified in order to demonstrate how a 'double-dip' could be obtained using the PPL ruling and a Luxembourg company. The case study was also discussed in the context of debt push-downs, which are not easy to achieve in Belgium, lacking a tax consolidation regime.

Germany

The German position was discussed with particular reference to the case study with NewCo being established under German law.

The discussion in respect of Germany was prefaced by a brief discussion of various taxation rates. It was noted that the average rate of taxation in Germany is 30 per cent (corporate and trade income tax and the 'solidarity surcharge'). Where a shareholding exceeded ten per cent, withholding tax on dividends are imposed at the rate of five per cent or where the requirements of the 'super limitation-on-benefits clause' are fulfilled, the withholding tax rate is reduced to zero. Accordingly, the need to establish the 'substance' of intermediate holding companies in order to minimise withholding tax obligations and the effect this has on incentivising equity was also discussed.

In the context of debt funding to the German NewCo, it was noted that Germany does not tax the interest income of the shareholder and that the interest is, in principle, deductible, subject to the provisions of the interest barrier rules. The interest barrier rules set out circumstances in which the deductibility of interest will be limited. The interest barrier rules are also applicable to hybrid debts. On this basis, whether debt-financing or equity-financing is preferable will depend upon the profitability of the German NewCo. The interest barrier rules have been of particular concern in recent years as loss-making companies have been taxed on 'profits' that have effectively arisen as a result of the application of the interest barrier rules.

By reference to the case study, it was explained how a debt push-down is possible by financing German subsidiaries (within the HoldCo group) with equity and a subsequent repayment of the equity by way of a loan from those German subsidiaries to USCo. These arrangements would be subject to transfer pricing rules and interest barrier rules. In the context of debt and equity characterisation, it was noted that the tax treatment usually follows the German GAAP treatment. An alternative proposal was discussed whereby German NewCo and ant German subsidiaries (within the HoldCo group) would form a tax group. The formation of a tax group would allow German NewCo to allocate the total income at this level so that the deduction of the interest may be more acceptable. A third structure involving leveraged dividends was also discussed, however, it was observed that tax audits tend not to accept these structures as the interest is not incurred as a consequence of the business itself but rather that the interest is incurred to finance dividend distributions.

Spain

The discussion started with a brief explanation of the advantages and disadvantages of the Spanish tax system in relation to acquisitions. Advantages include the deduction of goodwill and losses of domestic-foreign subsidiaries, very limited change-of-control provisions for the disallowance of tax credits, an extensive tax treaty network and tax-free waivers of intra-group loans. This is balanced by disadvantages which include the limitation on the use of net operating losses in 2013, the challenge of intra-group reorganisations, potential transfer taxes on the acquisition of real estate companies, arm's length rules and documentation requirements in respect of transfer pricing, and both specific and general anti-avoidance rules.

With regards to the financing of a Spanish subsidiary (within the HoldCo group), it was noted that there are 'safe harbour' rules in relation to the tax deductibility of interest and that tax grouping allows for the deduction of interest within a Spanish group. However, interest expenses derived from intra-group reorganisations are non-deductible unless the reorganisations resulted from a third party acquisition or when there is a real management of the interests in Spain. In addition, it was noted that interest paid to persons resident in an EU member state is generally exempt from Spanish withholding tax.

The Spanish tax characterisation of certain hybrid instruments, such as the joint account agreements, Brazilian 'juros' and perpetual loans was discussed, with emphasis made on the different tax, legal and even accounting rules at play.

In relation to the case study, the jurisdiction of incorporation and residence of NewCo will be influenced by tax haven anti-abuse provisions and the provisions of the EU Parent Subsidiary Directive. It was also noted that the new US-Spain tax treaty will provide further tax planning opportunities.

A potential 'optimal' Spanish structure was discussed. This structure involved the establishment in Spain of a limited liability NewCo which would acquire subsidiaries (Spanish and Latin American) from HoldCo. It is then proposed that the Spanish NewCo would elect to be within both the favourable Spanish holding company and tax grouping regimes which would confer certain Spanish tax benefits on the shareholders of Spanish NewCo as well as facilitating interest deductibility.

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What is the meaning of beneficial owner today?

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The term 'beneficial owner' has been included in Articles 10 (dividends), 11 (interest), and 12 (royalties) of the OECD Model Tax Convention on Income and on Capital (OECD MTC) since 1977. Article 10, paragraph 2, provides that dividends may be taxed in the contracting state of which the company paying the dividends is a resident and according to the laws of that state (source state). But if the beneficial owner of the dividends is a resident of the other contracting state (home state), the source state will be limited in its taxation rights. Article 11, paragraph 2 has a similar provision in connection with interest arising in the source state, and Article 12, paragraph 1 provides that only the home state is allowed to tax royalties arising in the source state if the recipient is the beneficial owner.

The concept of 'beneficial owner' has given rise to different interpretations by courts and tax administrations. Those interpretations range from the extremes of a formal to an economic approach. In a more formal approach, only nominees and agents disqualify as 'beneficial owner'. In an extreme economic approach, only the ultimate shareholders would be considered the beneficial owners of income and thus holding companies would be disregarded for beneficial ownership purposes. Given the risks of double taxation and non-taxation arising from these different interpretations, the OECD Committee on Fiscal Affairs has worked on proposals aimed at clarifying the interpretation that should be given to that concept in the context of the OECD MTC. As a result, the OECD released a public discussion draft entitled 'Clarification of the meaning of "beneficial owner" in the OECD Model Tax Convention' on 29 April 2011, followed by a revised public discussion draft entitled 'Revised proposals concerning the meaning of beneficial owner in articles 10, 11 and 12 of the OECD Model Tax Convention' released on 19 October 2012, which also discusses comments received on the first draft. It is expected that the OECD commentary to the OECD MTC in connection with the meaning of beneficial ownership will be updated in 2014.

When determining the meaning of the term 'beneficial owner' for a state, a number of questions are relevant. First, does its domestic tax law provide for a withholding tax on dividends, interest or royalties? To the extent this is not the case, the term will not be very relevant. But to the extent there is such a withholding tax, a second question is whether its domestic tax law provides for the term 'beneficial owner' or whether that term is included in an applicable double taxation convention (DTC). Third, given that including the term 'beneficial owner' in its domestic tax law or DTC is a way of addressing treaty shopping situations in general and conduit companies in particular, how relevant is the concept of 'beneficial owner' in dealing with those forms of tax avoidance? There are many ways of addressing treaty shopping situations and conduit companies for a state, including specific anti-abuse rules (SAARs), either in its domestic tax law or in a DTC, general anti-abuse rules and substance-over-form or economic substance approaches.

The panel, chaired by René Beltjens, Dominic Stuttaford and Barbara Worndl, discussed the meaning of beneficial ownership today in six OECD Member States, specifically Canada, Denmark, Germany, the Netherlands, the UK and the US, on the basis of recent case law and case studies. Although a more detailed overview with respect to each of those states is provided below, four aspects were remarkable:

- First, although both Germany and the US are familiar with the term 'beneficial owner', it does not play a prominent role for them in attacking tax treaty shopping situations.
- Secondly, both Canada and the Netherlands tend to have a formal approach to the term; however, for the Netherlands it is only relevant in relation to dividends whereas for Canada it is also relevant for interest and royalties.
- Thirdly, the UK has more of an anti-abuse approach to the term, in which the substance of the recipient may be relevant to a certain extent. This approach clearly tends more to an economic approach than to a formal approach.
- And finally, for Denmark the meaning of the term is rather in development given that a number of cases are currently pending before the court and new legislation in which the meaning of the term is crucial has been adopted as per 2013.

Barbara Worndl stated that in Canada, 'beneficial ownership' has been used by the Canada Revenue Agency (CRA) to attack the use of holding companies in treaty-friendly jurisdictions, together with general anti-avoidance arguments. Section 3 of the Income Tax Conventions Interpretation Act provides that if a term is not defined in a DTC, it has the meaning it has for purposes of the Income Tax Act. There is no definition of beneficial owner included in the Income Tax Act. When interpreting DTCs, Canadian courts have tried to determine what the contracting states intended when they entered into the DTC. For that purpose, courts take the most recent OECD commentaries to the OECD MTC into account, even if they have been amended after the conclusion of the DTC and the protocols thereto (dynamic or ambulatory approach), provided that they clarify (so they do not conflict with) the OECD commentaries in place at the time the DTC and its protocols were concluded.

The landmark *Prévost* decision (2009, dividends) and *Velcro* decision (2012, royalties), which both dealt with beneficial ownership, were discussed by Barbara Worndl. In *Prévost*, a Canadian company paid dividends to its sole shareholder, a Dutch holding company ('DutchCo'). On the basis of the applicable DTC, DutchCo could benefit from a reduction of the Canadian domestic withholding tax rate on dividends, whereas the shareholders of DutchCo could not. According to a shareholder agreement (which was not binding on DutchCo itself), DutchCo's two shareholders had to cause DutchCo to distribute at least 80 per cent of its earnings as dividends. The CRA contested that DutchCo was the beneficial owner of the dividends and denied entitlement to reductions of the withholding tax. The Tax Court of Canada decided that 'because [DutchCo] was not bound to the shareholder agreement, it had free use and enjoyment of the monies received as dividend', which decision was upheld by the Federal Court of Appeal. The *Velcro* decision was generally in line with *Prévost*. The issue in *Velcro* was whether a DutchCo was the 'beneficial owner' of royalties paid by a related Canadian company, and therefore entitled to a reduced rate of Canadian withholding tax under the applicable DTC, whereas DutchCo was contractually required to remit a specific percentage of all amounts received from the Canadian company to its parent company located in the Netherlands-Antilles, which company would not have been entitled to a reduced rate. The Tax Court of Canada ruled that DutchCo was indeed the beneficial owner of the royalties because it had possession, use, risk and control of the royalties and it retained *some* discretion as to the use of the royalties while in its possession.

In Denmark, the relevance of beneficial ownership only seems to increase given a number of recent cases and recent legislation. As to the latter, Anders Oreby Hansen discussed that due to negative media attention, a new act intends to remove Denmark as an intermediate holding jurisdiction. The act mainly affects international structures in which a Danish company is used as an intervening holding company to funnel dividends received from a foreign subsidiary to its foreign parent, and cannot be considered the beneficial owner (under the definition of the Danish tax authorities) of the dividends received from its foreign subsidiary. In that event, Denmark will impose dividend withholding tax on the otherwise tax exempt dividend distributions from the Danish company to the foreign parent that are made in or after 2013. This anti-abuse rule does not apply if the distribution of dividends from the Danish company is covered by the EU Parent/Subsidiary Directive. As to the interpretation of the term 'beneficial owner', the legislative history explicitly refers to the OECD public discussion draft released on 29 April 2011, which has later been revised.

Further, Anders Oreby Hansen presented a recent decision by the Danish National Tax Tribunal, dated 23 November 2012, which has been appealed before the court. It dealt with a Bermuda parent that indirectly held, via a double tier LuxCo structure, all the shares in a Danish subsidiary. The latter paid interest and dividends to its Luxembourg parent. Both LuxCos were not recognised as the beneficial owner of the income because they were stripped of all corporate powers and had no employees, although it did have offices. The beneficial ownership requirement was deemed to be in compliance with the EU Interest/Royalty Directive (Article 1, paragraphs 4 and 7) but not with the EU Parent/Subsidiary Directive because it does not contain such an explicit requirement: the general anti-abuse clause in Article 1, paragraph 2 was not incorporated in Danish law in relation to beneficial ownership. As a result, the decision was only in favour of the taxpayer in relation to dividends. Further, the tribunal seems to have decided in line with its earlier decisions dated 22 December 2010 (on interest; appealed) and 16 December 2011 (on dividends; appealed). Interestingly, substance was considered relevant by the tribunal in order to determine the beneficial ownership of the LuxCo.

Pia Dorfmueller argued that generally, beneficial ownership is not relevant in cases where Germany is the source state because the German tax authorities will invoke a SAAR in supposed treaty shopping situations. She stated that the term 'beneficial owner' is not included in German domestic tax law, but is provided for in DTCs concluded by Germany with Italy, Norway, Sweden, Australia and the US. According to those DTCs, the beneficial owner of dividends, interest or royalties is the resident who is the economic owner of the assets on which the dividends, interest or royalties are paid. Under German domestic tax law, the economic owner is the person exercising actual domination over an asset such that the person is typically able, in economic matters, to exclude the legal owner from control of the asset for the duration of its usual life. And further, a withholding tax on interest does not exist in Germany (unless the loan is secured by real estate), but there is one on dividends and royalties. Apart from a 1988 case, there are no cases dealing with beneficial ownership. The German SAAR referred to above limits the entitlement of a foreign company for (partial or full) relief from German withholding tax under a DTC or an EU Directive. Such entitlement is limited to the extent that:

- the shareholders of the foreign company are persons who would not be eligible for tax relief if they had directly received the income; and
- certain functional requirements are not met (harmful earnings).

In the Netherlands, a withholding tax on dividends solely exists so that the concept of 'beneficial owner' is in principle only relevant in that context. Paul Sleurink noted that Dutch domestic tax law does only include a definition of what is not a beneficial owner: Article 4, paragraph 7 of the Dutch Withholding Tax Act (dividend stripping rules) provides that the recipient is not considered the beneficial owner of the profit distribution if the following three requirements are cumulatively met:

the recipient paid a consideration (*tegenprestatie*) in cash or in kind;

- the payment of the consideration was part of a sequence of transactions;
- it is likely that:
    - an individual or company effectively benefited in whole or in part from the distribution, and such individual or company would have been entitled to a less favourable dividend withholding tax treatment than the recipient of the distribution would be in the case of direct receipt; and
    - this individual or company, directly or indirectly, retains a position in the shares, profit rights or profit sharing bonds that is comparable with his position in similar shares, or profit sharing bonds he or she had prior to the sequence of transactions.

If this provision applies, a profit distribution to an individual or company that can be considered the beneficial owner of the profit distribution would under all circumstances be subject to the domestic dividend withholding tax rate of 15 per cent.

The term 'beneficial owner' is included in virtually all DTCs the Netherlands entered into force after 1977. For those DTCs, the *Market maker* decision (1994) is relevant. This case clarified the meaning of the term 'beneficial owner' under the DTC concluded between the Netherlands and the UK in 1980. On the basis of the treaty's context, the Dutch Supreme Court ruled that a dividend recipient who does not own shares, but who receives dividends based on dividend coupons, is regarded as the beneficial owner of the dividends if he or she may freely dispose of: (i) the dividend coupons; or (ii) after the conversion of the coupons, of the dividend payments; and (iii) provided that he or she does not act as an agent or a nominee upon conversion of the coupons. Thus, 'substance' was not taken into account. And although at the time the *Market maker* case was decided the dividend stripping rules were not yet adopted, Paul Sleurink views it as questionable whether the negative definition of 'beneficial owner' in those rules would have influenced the tax treaty interpretation by the Dutch Supreme Court, whose approach can generally be characterised as autonomous, taking account of the (latest) OECD approach.

Furthermore, Paul Sleurink noted that international criticism of the use of conduit companies in the Netherlands led to the introduction of Article 8c in the Corporate Income Tax Act in 2002. It provides that if a company with intragroup activities (eg, intragroup financing activities) does not have sufficient equity to cover the risks relating to those activities, the income and expenses relating to those activities will be excluded from that company's tax base, and the Dutch tax authorities will not allow that company to claim a credit for foreign withholding tax and consider it as an agent, which might encourage the source state of the income to deny the benefits of an applicable DTC, for example, applying the local withholding tax rates instead of the lower DTC rates.

As to the UK, Dominic Stuttaford argued that 'beneficial ownership' is one of the treaty shopping weapons of the HM Revenue & Customs (HMRC), although it is not very clear what it means. In 2006, the English Court of Appeal ruled in *Indofood* that when determining whether an entity has beneficial ownership it is necessary to consider an international fiscal meaning rather than the narrow technical UK domestic law meaning. Thus, if recipients are bound in legal, commercial or practical terms to pass on the income, they will not be considered the beneficial owner thereof. And further, particular regard should be had to the 'substance of the matter'. This line of reasoning was considered consistent with the purpose of DTCs, being the avoidance of double taxation and the prevention of tax evasion. And thus, the Court adopted a more anti-abuse approach. As English courts generally do, the English Court of Appeal took a dynamic approach to the OECD commentaries on the OECD MTC: the 2003 OECD commentaries clarifying the term 'beneficial owner' were taken into account, whereas they were amended after the conclusion of the applicable DTC and the protocols thereto.

After *Indofood* was decided on, the HMRC published detailed commentary on beneficial ownership and guidance on *Indofood*. The guidance was supplemented in 2012 and lists a number of practical points to be considered when determining whether a claimant has beneficial ownership of the income in question. Substance of the claimant is also argued to be relevant, but it is not clear to what extent. Given the absence of a withholding tax on dividends, beneficial ownership is irrelevant with respect to dividend distributions made by a UK company.

Finally, Fred Gander concluded that in the US, inter alia, the domestic anti-hybrid regulations, domestic conduit financing regulations, and extensive limitation on benefits provisions in virtually all DTCs concluded by the US have taken the pressure off the concept of beneficial ownership as a means of addressing tax treaty shopping for purposes of avoiding US withholding taxes on dividends, interest or royalties. Nevertheless, beneficial ownership of income is determined under the provisions of section 7701(l) and any other applicable general US tax principles, including principles governing the determination of whether a transaction is a conduit transaction. For example, the partners of a partnership are considered the beneficial owners of the partnership's income. Nominees, agents and conduits are not, though. Further, benefits of the 2006 US Model Treaty apply to residents with respect to dividends, interest and royalties only if the resident is the 'beneficial owner' of the amount. The technical explanation of that treaty states that: '[t]he term "beneficial owner" is not defined in the Convention, and is, therefore, defined as under the internal law of the country imposing tax (i.e., the source country). The beneficial owner of the dividend for purposes of Article 10 is the person to which the income is attributable under the laws of the source State.'

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Distressed assets, tangible and intangible

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During the session, tax professionals from the US, Ireland, the Netherlands, Italy, Spain, Germany and the UK presented two case studies on distressed intangible and tangible assets and the tax implications various financial transactions between the real estate developer BigCo, investors, bank and investment fund SmartCo have in the respective tax jurisdictions.

The panel looked at the topic of distressed assets and, in particular, considered two case studies: the first involving a distressed situation in relation to real estate, and the second case study dealing with distressed debt secured over intangible assets.

Peter Maher led the panel discussion on the first case study which involved a company in country 1 developing a mega golf/shopping/residential/commercial/retail project funded by contributions of US$50m from investors in country 1 and borrowings of US$300m from a lender in country 2. Five years after the fundraising, the project is completed, but the underlying assets are only worth US$100m and the amount due and owing (principal and accrued but unpaid interest) to the lender in country 2 is US$400m.

The various panellists from the UK, the Netherlands, Italy, the US, Germany and Spain considered how the release of indebtedness by the lender would be treated in their countries from the perspective of the debtor and the creditor and how that treatment might differ if the debtor and creditor were connected. Each panellist also dealt with the most likely work out option in their jurisdiction from a tax perspective.

Dick Lipton led the discussion on the second case study which involved an investment fund making an unsecured loan to a publishing company in a different country. Arising out of plummeting share values, a private equity fund subsequently acquires all of the stock of the publishing company which it financed with US$25m of its own money and US$225m of newly issued publicly traded debt which was senior in priority to the unsecured note issued by the publishing company a year before to the investment fund.

Again, each of the panellists outlined the tax position in their countries for the publishing company, the investment fund and the private equity fund on the assumption that each was in their particular jurisdiction. The position of the publishing company and the investment fund was also considered in the context of the publishing company issuing equity to the creditor as a swap for the debt.

In conclusion, co-chair Peter Maher said that what was obvious from the contribution of the panellists is that:

- the tax position in some countries is highly dependent on the accounting treatment whereas in other countries it is less so;
- some countries have well developed tax rules relating to cancellation of indebtedness and debt for equity swaps whereas other countries have limited tax rules; and
- the tax treatment in the various jurisdictions of the different transactions discussed varied considerably.

Recent cross-border mergers and acquisitions and restructuring transactions

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Thomas Meister *Walder Wyss & Partners, Zurich*
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The aim of the panel was to provide an overview and discussion of selected recent high profile and interesting cross-border M&A and restructuring transactions. The transactions discussed involved various jurisdictions and were presented in a case study format.

Tyco/Pentair cross-border combination transaction

The Tyco/Pentair cross-border combination has been one of the most recent notable US related transactions. It involved a distribution to the public by a publicly traded Swiss corporation (Tyco) of a Swiss subsidiary (SwissCo) with significant US operations, followed by the acquisition of a public US target (Pentair) by the now public SwissCo. This was a business driven combination with significant tax structuring considerations.

Pentair was a publicly traded US corporation engaged in the valves and flow control business, mostly in the US but increasingly outside the US. Tyco was a publicly traded Swiss corporation engaged in valves and flow control, ADT home security, and commercial fire and security businesses.

The transaction was initiated by a non-taxable Tyco spin-off of valve/flow business, which entailed spin-off of Tyco's 100 per cent Swiss subsidiary running valve/flow business (SwissCo) to Tyco Public. SwissCo next acquired Pentair, this being structured as a non-taxable reorganisation transaction and was preceded by SwissCo establishing two US SPVs, that is, the acquisition company and its subsidiary which was then merged with Pentair (Pentair survived), with issuance of shares in SwissCo to Pentair Public. As a result of the transaction, Tyco's historic shareholders own more than 50 per cent of the combined company and Pentair historic shareholders own 47.5 per cent.

A number of US tax rules were taken into account when planning the transaction. In order to assure tax neutrality of the Tyco spin-off of valve/flow business, it was necessary to provide sufficient corporate business purpose and there was a requirement for active businesses at Tyco and SwissCo. Section 355(e) did not apply at the Tyco level because Pentair Public acquired less than 50 per cent of SwissCo (it would have mattered if Tyco had undertaken certain restructuring steps to form SwissCo).

The next step, that is, the acquisition of Pentair by SwissCo, was structured as a tax-free stock-for-stock exchange. It was not taxable to Pentair Public under the anti-inversion rules of section 367(a) because they acquired less than 50 per cent of SwissCo (and other requirements were met).

After the transaction, SwissCo is considered as a foreign corporation for US tax purposes – anti-inversion rules of section 7874 do not apply because Pentair Public owns less than 60 per cent of the combined company.

From the Swiss perspective, the spin-off of SwissCo was tax neutral for dividend withholding tax provided that distribution was made out of qualifying contributed surplus/share premium of SwissCo. As regards income tax, the spin-off resulted in income recognition on the part of shareholders (including corporate shareholders) holding shares in Tyco as a business asset. For individual shareholders of Tyco holding shares as a non-business asset, spin-off was income neutral. As regards further steps in the transaction, the merger of SwissCo's subsidiary with Pentair with issuance of SwissCo shares to Pentair shareholders was considered as a share-for-share exchange (so-called 'quasi merger'). This meant that there was no distribution by SwissCo and that there was an increase of qualifying contributed surplus/share premium of SwissCo equal to the fair market value of Pentair – it substantially increased the Swiss dividend withholding tax free distribution capacity of SwissCo.

Inversions of US publicly traded companies into Ireland

One can observe inversion of US publicly traded companies into Ireland. For instance, the following companies have been re-domiciled in Ireland as part of mergers with existing Irish companies:

- Eaton Corporation – through its acquisition of Cooper Industries in a US$11.8bn cash and stock deal (for details, please see below);
- Alkermes Inc – through the acquisition of the drug formulation and manufacturing business unit of Elan in a US$1bn deal; and
- Jazz Pharmaceuticals – through its acquisition of Azur Pharma in a US$500m deal.

The section 7874 US Anti-Inversion Rule was an issue in all the above transactions. Section 7874 applies where:

- NewCo acquires substantially all of the properties held directly or indirectly by USCo;
- after the acquisition, at least 60 per cent of NewCo stock by vote or value is owned by former shareholders of USCo by reason of their prior ownership of USCo stock; and
- the expanded affiliated group of which NewCo is part does not have 'substantial business activities' in NewCo's jurisdiction.

If section 7874 applies, then the following applies:

- where former shareholders of USCo own more than 80 per cent of NewCo – NewCo is treated as a domestic US corporation for all US tax purposes; and
- where former shareholders of USCo own between 60 per cent and 80 per cent of NewCo – NewCo is treated as a surrogate foreign corporation, that is, the taxable income of USCo and its over 50 per cent US affiliates, for a ten-year period following the inversion, may not be less than the inversion gain for such year.

There are a number of reasons for which the inversion into Ireland takes place, including the possibility of applying US GAAP, the fact that Ireland is a common law jurisdiction, as well as a friendly tax environment (eg, low income tax rate), access to EU directives, tax treaty network, tax incentives, no tax on capital gains, no CFC rules, limited transfer pricing, no thin cap rules, etc.

One of the good examples of inversion of a US public company into Ireland is the Eaton Corporation/Cooper Industries transaction. At the preparatory stage, a new holding structure was set up for Eaton, where New Eaton holds shares in EU Sub-HoldCo, which then holds shares in another EU Sub-HoldCo. The latter holds shares in US Merger-Sub established in order to merge with Eaton US. In the merger procedure, EU Sub-HoldCo and US Merger-Sub deliver New Eaton shares to Eaton shareholders. Acquisition of Cooper Industries takes place once the Eaton structure is ready. Under a scheme of arrangement under Irish law, existing shares in Cooper Industries are cancelled and Cooper Industries issues new shares to New Eaton, in return for which New Eaton issues shares and pays cash to Cooper shareholders.

Debt push downs in Austria

In case of acquisitions of Austrian targets by US investors, the US acquirer usually sets up an Austrian acquisition vehicle (AcquiCo) in order to buy the target. The goal of the structure is to have the interest on the acquisition financing taken up at the level of AcquiCo to reduce operating profits of the target. The Austrian group taxation rules allow such debt push down for tax law purposes (such an effect would not be possible in the case of a corporate merger of AcquiCo with the target). The double use of expenses and the double use of losses becomes an option if check the box election is made in the US in order to treat the Austrian AcquiCo as a look through entity.

The above-mentioned benefit of deducting interest expenses on acquisition financing and certain other benefits (eg, good will deduction) apply only in the context of an acquisition from a third party (ie, they shall not apply in case of intra-group reorganisations).

Glencore International/Xstrata combination

Glencore/Xstrata is a transaction involving two listed companies, that is, Glencore International plc, a Jersey law public company being tax resident in Switzerland, and Xstrata plc, an English law public company which is a tax resident in Switzerland. This means that both companies are incorporated under foreign law but they are Swiss tax residents. In the pre-combination structure, Glencore owns over 33 per cent of the shareholding in Xstrata.

The following facts and tax issues have been taken into account in connection with the combination:

- Glencore has substantial qualifying contributed surplus/share premiums, while Xstrata has modest qualifying contributed surplus/share premiums – since there is a Swiss withholding tax of 35 per cent on distributions other than stated nominal share capital or qualifying contributed surplus/share premium, the goal was to preserve/increase (with no dilution) the qualifying contributed surplus/share premium;
- a legal merger would not allow for a substantial increase of the share in stated nominal share capital or qualifying contributed surplus/share premiums of the surviving company (dilution effect); moreover, if by operation of the exchange ratio the merger would lead to an increase of the share of the Xstrata shareholders in available stated nominal share capital or qualifying contributed surplus/share premiums, a constructive distribution would be assumed, triggering the 35 per cent Swiss dividend withheld tax charge – as a consequence, legal merger was not attractive from a Swiss tax perspective;
- quasi merger (share-for-share exchange without dissolution of Xstrata) would allow for a substantial increase of the share capital and qualifying contributed surplus/share premiums of the offering company (up to the fair market value of the shares held by the tendering shareholders of Xstrata); moreover, quasi merger would not result in effective or constructive distribution being assumed for Swiss dividend withholding tax purposes – as a consequence, quasi merger was attractive from a Swiss tax perspective.

The post-combination final structure is that Glencore (renamed Glencore Xstrata plc) holds 100 per cent of the shareholding in Xstrata. Before that, Xstrata shares are split into A and B shares, where B shares are then exchanged for new Glencore shares (so shareholders of Xstrata other than Glencore and its related entities could become shareholders in Glencore). The applied transaction scheme results in a final structure where there are no minority shareholders in Xstrata, Xstrata is not directly listed and where an extra qualifying contributed surplus/share premium is created, which means that Swiss withholding tax free distribution capacity is increased (re-load of qualifying contributed surplus/share premium).

NYSE/Euronext/Deutsche Börse combination

By cross-border combination under a new Dutch holding company, NYSE-Euronext (a US publicly traded corporation) and Deutsche Börse (German publicly traded corporation) were expected to create the world's largest exchange group by revenue, the shares of which were to be listed on the New York, Frankfurt and Paris stock exchanges. The combination was very advanced (approval of shareholders, tax rulings in place) when it was called off in February 2012 due to competition objections from the European Commission.

A number of tax issues had to be taken into account when planning the transaction, including the choice of holding company jurisdiction, tax residency questions (board composition, board meetings, etc), German roll-over facility, dividend withholding tax and the issue of US tax-free merger.

The planned structuring for the transaction included the following main steps:

- incorporation of Dutch HoldCo by independent Dutch Foundation ('Stichting');
- incorporation of US MergerCo by Dutch HoldCo; and
- shareholders of NYSE-Euronext and/or Deutsche Börse were to receive shares in Dutch HoldCo (Deutsche Börse brought under Dutch HoldCo through an exchange offer; NYSE-Euronext brought under Dutch HoldCo through a merger of US MergerCo into NYSE-Euronext).

After combination, HoldCo would have dual headquarters for the combined group in NYC and Frankfurt. Responsibilities of Dutch HoldCo board members (17 directors) would be limited to strategic matters and there would be no Dutch resident board members. There would also be a very limited number of board meetings in the Netherlands. Nevertheless, the Dutch tax authorities agreed that HoldCo should be considered as having Dutch residency provided that it would not be considered effectively managed in Germany (which was to be confirmed by the German tax authorities) or the US (under an analysis of US tax law and the Dutch-US tax treaty).

As regards the German CIT roll-over facility, in order to apply this to exchange of Deutsche Börse shares for Dutch HoldCo shares, the latter should value the Deutsche Börse shares in its balance sheets at tax book value, which is in general not possible under Dutch tax law (Dutch Holdco shall value assets it receives at fair market value). However, in the case at hand, using tax book value would have no adverse Dutch tax consequences because Dutch participation exemption would apply to the future sale and transfer of Deutsche Börse shares. The Dutch tax authorities agreed with the use of tax book value to accommodate the German roll-over facility.

Distressed transactions in the Spanish market (2012)

In 2012, there was an increase in the number and value of transactions on distressed debt in Spain. The forecast for 2013 is a growth of this type of operations caused, inter alia, by favourable evolution of price gap, sentiment of decrease of risk in the market and moving towards the end of the financial sector recapitalisation. Distressed assets are usually acquired so far by specialised investment funds.

In terms of Spanish taxes, structuring of the transactions should take into account the following factors:

- the nature of the distressed debt (senior loans, consumer loans, etc);
- the future plans of the buyer: loan-to-own or loan-to-trade;
- the strategy of retail: investments made through arrangers versus investments directly made by specialised funds;
- reorganisation of the debt into a marketable asset: the use of 'aggregating vehicles'; and
- potential permanent establishment issues usually in connection with collection function.

The typical structure for a transaction is to use investment vehicles being tax residents in the EU, such as Luxembourg Soparfi or Irish 'Super-QIF' structures. Contractual arrangements (such as participation loan agreements) are not often used so far as purchases made by funds, as opposed to arrangers. It is worth mentioning that structuring the debt in tradable portfolios using trusts as aggregators is not advisable in Spain, as trusts are not recognised in Spain (Spain did not sign the Convention of the Hague on trusts).

One of the issues with Spanish tax is proper qualification of income derived from distressed assets, that is, whether it should be qualified as interest income or capital gain. However, an exemption is available in case of EU resident investors for interest and qualifying capital gains, so the discussion becomes more theoretical than practical. In any case, the tax residency of ultimate investors, GAAPs and beneficial ownership issues should be observed. Moreover, potential permanent establishment issues should be taken into account in the event there is a collecting agent in Spain.

As regards the Spanish market for distressed assets, it should be pointed out that a Spanish bad bank has been established – the SAREB – which has €50.8bn of assets (loans to developers and real estate property) and equity of €4.8 bn (9.4 per cent on total assets). It has 28 investors, including 55 per cent of the shareholding kept by private investors such as Spanish banks, foreign banks, and Spanish and foreign insurance companies. The average haircuts with respect to assets contributed were 46–49 per cent in the case of loans to developers and 63–66 per cent in the case of assets acquired by enforcement (developments in progress, land and houses).

In order to efficiently organise the future sales of assets, tax arranged pools of distressed assets (*Fondos de Activos Bancarios* – FAB) have been ruled out. FAB is a specialised fund, consisting of a separate estate with no legal personality (represented by a securitisation asset management company). It is subject to a tax regime similar to mutual funds (one per cent CIT) but there is an exemption available for capital gains and dividends obtained by foreign investors (including tax havens). Moreover, indirect tax exemptions apply for transfers from SAREB to FAB or from FAB to FAB.

Executive compensation and mobile employees

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Hypothetical fact pattern

Ann is a UK national tax resident. On 1 December 2012, she joins the executive team of US Group, a US public company. Ann spends her first month at the US headquarters. On 2 January 2013, she is relocated to France where she works for US Group's French subsidiary. She then moves to Switzerland on 2 January 2015 where she becomes a member of the board of directors of US Group's Swiss subsidiary. In each year, she spends 25 per cent of her time in the UK on matters for the UK subsidiary, and 30 days in the US.

Ann receives an annual salary of €1.2m and is entitled to an annual discretionary bonus. She also receives a sign-on bonus on 1 December 2012. She receives all of her compensation from US Group, with the French subsidiary reimbursing US Group for 75 per cent of her salary and bonus, and the UK subsidiary reimbursing for the remaining 25 per cent.

Ann receives 20,000 non-qualified stock options on 1 December 2012 under US Group's stock option plan, which vests in 20 per cent increments at the end of each of the five-year anniversaries of the commencement of Ann's employment.

On 1 July 2015, Ann relocates to US Group's headquarters in New York City. She sells her London flat prior to moving to the US and leases an apartment in Manhattan.

Shortly afterwards, US Group is subject to a takeover and Ann is entitled, under the change of control provisions in her employment contract, to a cash payment. Ann moves to Bermuda on 15 December 2015 and resigns on 24 December 2015.

General compensation considerations

In France, social security charges can be up to 45 per cent for employers. If, as in Ann's case, the employee earns more than €250,000, this is reduced to 26 per cent. Employees pay a basic rate of 22 per cent, which is reduced to nine per cent on the uncapped portion of compensation. Most inpatriates can avoid social charges, however, because they remain covered under their home social security system.

Income tax is set at a marginal rate of 45 per cent. There is also a CHR tax for high earners, with a four per cent rate being applicable to Ann on the basis that she earns more than €500,000. There is, however, a special income tax inpatriate regime, under which significant portions of Ann's employment income can be carved out, provided her contract of employment is appropriately drafted.

Investment income is subject to social surtaxes, amounting to 15.5 per cent. Ann can reduce her liability for investment income by moving her investments to a capitalisation vehicle which does not distribute and will not generate taxable income whilst Ann is in France.

Income derived from dividends and interest are subject to withholding tax. This triggers burdensome responsibilities for taxpayers with investment income in non-French bank accounts, as in Ann's situation; she will be required to file a monthly return and send a monthly payment to the tax authorities. In light of these onerous duties, Ann should negotiate tax assistance in her employment contract.

If Ann moves to Belgium instead of France, income tax will be applied to everything she obtains in her professional activity, irrespective of the payor or the form of the compensation, be it cash remuneration, stock options, etc. Tax rates range from 25 per cent to 50 per cent, with income of over €36,000, as in Ann's case, being subject to 50 per cent tax. Ann will, however, fall within the scope of the special expat regime whereby as a non-Belgian national, she will be deemed to be a non-Belgian tax resident so will only be taxed on her Belgian-source income. This regime will apply even if Ann would be considered a Belgian tax resident under the normal rules.

With regards to the income Ann receives from the UK subsidiary, the way in which it is taxed will depend on Ann's residence and domicile status. Under the new statutory test for residency, an individual is deemed a UK resident if he or she satisfies either the 'automatic residence' test or the 'sufficient ties' test. A UK domicile will be taxed on an arising basis on their worldwide income as and when it arises. A non-UK domicile, however, can be taxed on the remittance basis: they will only be taxed on their offshore income/gains if they remit them into the UK. As a UK national, Ann is likely to be a UK domicile so will be taxed on an arising basis on her worldwide income.

The taxation of the income Ann receives whilst in the US will, similarly, depend on Ann's residence status. US residents are taxed on a worldwide income basis, whereas non-US residents are taxed on a source basis. Residency status is based on an individual's immigration status or physical presence in the US. Ann will not be a US resident in the years up to 2015 as she is not physically present in the US for at least 31 days in the year and at least 183 days over a three-year period. As such, in the years up to 2015, Ann will only be charged US tax on her US-source income. From 2015, however, Ann will satisfy the physical presence test and, as a US resident, will be taxed on her worldwide income.

Special payments

Ann receives her sign-on bonus on 1 December 2012 during her time at the US headquarters. As discussed, at that time she is not a US resident so it is necessary to consider whether the sign-on bonus is US-source income. The case law in this area is uncertain, but it may not be appropriate to tax the bonus according to the compensation sourcing regime (ie, based on the location where the services are performed) as Ann is not required to perform any extra work in order to qualify for the bonus, she need only be present at work. In relation to the change of control payment, Ann must pay an additional 20 per cent tax on any payment of compensation contingent on a change in control of US Group if this and other payments that are contingent on the change in control equal or exceed three-times Ann's average compensation from US Group over the preceding five years (or, if less, Ann's total period of employment). By contrast, a different tax situation will result if Ann's employment is terminated and she receives a severance payment. In that case, the severance will be sourced like other compensation based on the location of the services within and outside of the US during the relevant period over which the severance accrued. The severance payment will be exempt from 409A restrictions and potential tax penalties if paid in a lump sum shortly after Ann is terminated.

If Ann was a UK resident upon receiving her sign-on bonus, such bonus would be subject to UK tax. Under the double tax treaty between the US and the UK, the US is entitled to tax the bonus as Ann was working at the US headquarters. There is an exception, however, where the employee is present in the US for less than 183 days in a 12-month period, the bonus is paid by an employer who is not a US resident, and the remuneration has not been charged back to a permanent establishment held by the employer in the US. In this case, however, the exception will not apply since it seems clear that the US is funding Ann's sign-on bonus, and it will therefore be subject to US taxation.

By comparison, the sign-on bonus will not be taxable in France; French residency is based on the date of arrival, and the bonus was paid before Ann arrived in France in January 2013.

Stock options

Under the new tax regime in Switzerland, options are taxed at exercise. Therefore, for the six months from January to June 2013 when Ann is working in Switzerland, she must pay tax if she exercises her options.

The situation is more complicated in France. For qualified options and restricted stock units, employees can benefit from a deferral of tax until the shares are sold. Mobile employees such as Ann, however, will generally be under non-qualified plans and will be taxed when they exercise their options, not when they sell their shares. As such, if Ann exercises her options whilst in France, she will be taxable, although the level of tax will be reduced if Ann is under the special income tax inpatriate regime. If Ann exercises her options after leaving France, she will be taxable on the French-source portion.

In the US, stock options must comply with the conditions under 409A in order for Ann to have a whole period of years to decide when to exercise the option. If the conditions are not complied with, there must be a single calendar date of exercise and delivery of the shares, and Ann will not be able to choose that date. The conditions are that:

- the exercise price cannot be less than the fair market value of the stock on the date of grant. For a public company such as US Group, the fair market value is the value on the principal market on which the stock is traded; and
- the option cannot include a deferral feature, that is, anything that would allow Ann to delay US income tax beyond the exercise date of the option.

In Belgium, the employee can choose the moment of taxation. Ann may opt to be taxed upon grant under a beneficial tax regime. The tax paid, however, will not be recoverable, even if she never exercises the option. Most employees, therefore, choose to be taxed upon exercise of the option at the normal tax rate.

With regards to the UK, under the tax treaty, there is an apportionment of gains according to the time spent in the various countries. If Ann was resident in the UK when the option was granted, HMRC would seek to charge tax on exercise. If, however, she spent only 25 per cent of her time over the period from grant to vesting in the UK, HMRC would charge tax on only 25 per cent of the gain.

Special tax issues

FATCA and FBAR

The FATCA rules target offshore tax evasion of financial assets by US tax residents by imposing an individual obligation to report any specific foreign financial assets if they exceed a certain threshold. Ann will only fall within the scope of FATCA in 2015 when she becomes a US tax resident. From this date, Ann will need to report, among other items, her UK pension scheme since it is funded by a foreign financial institution. Her options are exempt as they are issued by a US entity, but otherwise would be subject to reporting. The FBAR rules, by contrast, cover a more narrow set of accounts, for example, Ann's equity income will not need to be reported regardless of the status of the issuer.

Swiss caps on compensation

A new article has been incorporated into the Swiss constitution concerning the compensation of the board of directors and the executive management of listed companies incorporated in Switzerland.

As a member of the board of directors of US Group's Swiss subsidiary, these rules will be of concern to Ann.

Shareholders will be given a binding vote on the compensation of board members and executive directors. This is likely to have a significant impact on Ann's compensation as it will, for the first time, be subject to shareholder approval. In addition, she will no longer be entitled to receive any golden parachute payment or bonuses for acquisitions and sales. This will, again, hugely impact Ann given the size of her annual bonus. As well as this, Ann's appointment on the board of directors will be subject to an annual shareholder election.

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The service permanent establishment: the latest trends in relation to the taxation of cross-border service

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Introduction

The last panel of the conference gave a most interesting insight into the concept of service permanent establishment ('Service PE') and its implementation. Beyond the specific issues related to the Service PE, the panel showed in a quite a revealing way how the rules of the game concerning the allocations of the taxing rights between residence and source country are being redefined in the globalised world and how this impacts on the general concept of permanent establishment as such.

Stefano Petrecca, one of the co-chairs of the panel, explained in his introduction that the concept of PE is becoming more and more important in a globalised world. The Service PE was developed as an extension of the classical PE definition according to Article 5 of the OECD Model Tax Convention on Income and on Capital ('OECD MC'). According to Article 5 OECD MC, a source country can basically only tax a foreign enterprise if such enterprise carries on its business through a fixed place of business or a dependent agent in the source country. The Service PE allows conceptually the source country to broaden its taxing rights by taxing a foreign enterprise which is providing services through its employees in the source country for a certain period of time, even if the classical requirements of a PE (fixed place of business or agent) are not fulfilled.

The Service PE was first introduced in the UN Model Double Taxation Convention ('UN MC') mainly at the request of the developing and emerging economies. Although the expression 'Service PE' is not specifically used in the wording of Article 5 paragraph 3 letter b UN MC, this relevant clause reads as follows:

> 'The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.'

Although the Service PE is not foreseen in the OECD MC, the 2008 update of the OECD MC Commentary foresees the possibility of including such a clause in a double taxation treaty.

PE definition in domestic law and in double taxation treaties of specific countries

After Stefano Petrecca's presentation, the different speakers of the panel explained the PE concept in domestic and in international treaty law of their respective countries (Austria, France, Germany, Italy and Switzerland) and to what extent the Service PE was relevant in their country. Without going into the details of each country, the panel showed that there is a rather wide range of PE definitions at the domestic level:

- Switzerland has a narrow PE definition, since Swiss tax law foresees only the physical PE with a fixed place of business.
- The Italian domestic definition corresponds substantially to the OECD definition foreseeing the classical trias: the physical PE, the agency PE and the construction site PE, whereby the latter constitutes a PE after a period of three months.
- The Austrian domestic definition is in some aspects broader than Article 5 of the OECD MC: it does foresee the classical trias (six months or more for the construction site PE). Under Austrian tax law, a Service PE is taxable as well (even if the classical requirements of PE are not fulfilled). Accordingly, income from trade and business earned from commercial or technical consultancy services are taxable in Austria under a Service PE. It seems, however, that this clause is not very relevant in practice, since a double taxation treaty will apply in most cases. A further activity taxable under a Service PE is the leasing of personnel income (income from trade and businesses earned from temporary provision of employees for work performed in Austria).
- Germany has a broad domestic definition of PE. The domestic PE definition is not only relevant in the international context, but also in the national context for the local taxes such as the trade tax (*Gewerbesteuer*). In the domestic context, Germany also considers warehouses, purchasing and sales agencies and preparatory/auxiliary activities as a PE. Construction sites also qualify as PEs after a six-month period.
- In France, the domestic definition of PE has mainly been developed by case law and is to a large extent in line with the OECD MC. Under French domestic tax law, a Service PE is not taxable. However, French tax law foresees that if a double taxation treaty allocates the taxing rights to France, France can tax such income even if the domestic tax law does not foresee the taxation of such income (this, however, applies only if French tax law does not specifically exempt such income). Hence, a Service PE will be taxable in France if a double taxation treaty concluded by France has a clause with a Service PE.

All the above-mentioned countries have concluded double taxation treaties which in some cases do foresee a Service PE clause.

- Italy has concluded double taxation treaties with a Service PE clause with the following countries: Azerbaijan, China, Israel, Indonesia, Jordan, Kazakhstan, Lebanon, Malta, Pakistan, Saudi Arabia, Sri Lanka, Uganda and Vietnam. According to Stefano Petrecca, there are no specific court cases in Italy concerning a Service PE. It seems, however, that the Italian tax authorities are investigating certain foreign internet companies with respect to a possible PE in Italy.
- Some treaties concluded by Germany foresee a Service PE clause (eg, China, Philippines).
- Austria has concluded several tax treaties with a Service PE clause: Albania, Czech Republic, Greece, Hong Kong, New Zealand, Saudi Arabia, Singapore and Vietnam. Clemens Philipp Schindler presented the practice developed by the Austrian and Czech tax authorities with respect to the double taxation treaty concluded with the Czech Republic. Since the Czech Republic is a neighbouring country of Austria, it is not surprising that Service PE issues arise under this double taxation treaty. One of the issues was the calculation of the relevant period. In order to exceed the required six-month period stated in the treaty, the service must be provided for more than 183 days (within any 12-month period). Further, the 183 days are not calculated per project, but rather by the sum of all working days on all services provided in Austria combined, which must exceed 183 days. In another case, it was confirmed that if there is a fixed place of business in which the services are provided, then the PE qualifies as a physical PE and not as a Service PE. In one case where a distributor of merchandise was using his own car for carrying out his activity, it was concluded that since there was no taxable event according to the Austrian domestic tax law, then the application of the double taxation treaty was not required. This was the case despite the fact that according to the double taxation treaty, such activity would

have qualified as a Service PE. With respect to restaurants on international trains, the Austrian Ministry of Finance took the position that the providing of ready-made food and beverages qualifies only as a supply of goods and not as a qualifying service for a Service PE. In a further case, the Austrian Ministry of Finance considered that the leasing of personnel does not qualify as a qualifying service for a Service PE under the tax treaty, even though such activity would qualify as Service PE under Austrian domestic tax law.

- France has concluded double taxation treaties which foresee a Service PE clause with the following countries: China, Kazakhstan, Philippines and Chile. According to Edouard Milhac, these treaties do not give rise to specific issues in this respect. The French tax authorities are much more concerned in finding ways to tax the internet industry (see below).
- Switzerland has also concluded several double taxation treaties which provide for a clause for a Service PE, for example, with China, India, Kazakhstan, Philippines, Thailand and Vietnam.

The PE issues from the viewpoint of a multinational corporation

Patrick J Brown gave the view of a multinational corporation confronted with PE issues in its day-to-day business. He explained that even a rather standard practice for multinational companies, such as sending engineers or other technical personnel from the home country to be on location at the site of a foreign customer to install or overhaul equipment that the customer has purchased (eg, a powerplant, a locomotive, etc) gives rise to PE implications for which there are no certain answers. The secondment of employees also raises PE issues, since the legal form is becoming less relevant. As a consequence of a more economic approach, the topical question then is whether the seconded employee is doing business for the subsidiary or for the parent company. If the employee is performing work in connection with the business of the parent company, the latter may have a PE in the host country. In cases, however, in which the business of the parent company and of the affiliate are the same or similar, the question for which entity the employee is performing work might not be so easy to answer. Documentation will play an important role in such cases if investigations by the tax authorities of the host country are initiated. A further question in connection with secondments is the handling of the costs of the employee. If the employee is paid by the subsidiary, does such an arrangement differ from the one by which the employee is performing services in their capacity as employee of the parent company and the parent company is compensated by the subsidiary (eg, at cost plus)?

In order to limit the consequences of having a foreign PE, many US multinationals have been setting up so-called ‘employment companies’, whereby the parent company transfers the relevant employees in a domestic affiliate. This employment company then sends the employees abroad and concedes a PE in the host country. As a consequence, the employment company is ‘walled off’ from the major operating entities in order to avoid having significant profits pulled into any PE that is created. Can the host country challenge such a set up and tax a higher income than the effective income of the employment company? According to Patrick J Brown, it seems that the latest OECD developments concerning PE would allow this. The developments of the last decade at the OECD level would have given rise to more uncertainty in this area, whereas multinational companies would need clear rules. Also, the concerns articulated by some tax authorities to the effect that companies persistently stop just short of the defined PE status would be out of touch and go against the business case. The trend to decentralisation of decision-making within multinational groups would also lead to PE issues. The co-chair Patricia A Brown agreed with the need for clearer rules for multinational companies, although she wondered if multinational companies only asked for clearer rules if these were in their own interest.

The development of the digital world would also give rise to PE issues according to Patrick J Brown, even in cases where there is no physical presence of an employee in the host country. He mentioned as examples the overhaul of equipment, for example, via software upgrades or monitoring via cameras. Would such services constitute a PE? Hence, the broader question would be whether the new economy has fundamentally changed the business world and whether under this assumption the existing rules concerning PE would have to be changed. Or is the new economy just an excuse for trying to change the existing allocation of taxing rights between the country of residence and the source country?

At any rate, it seems that physical presence should still be relevant for a PE definition, as this will still be of vital importance in international business transactions.

Latest developments at the OECD level

The latest OECD development with respect to PEs was also subject to the critical view of Christoph Kromer. From a German point of view, the revised draft of the OECD-Permanent Establishment Paper, dated 19 October 2012, continues the trend of softening the requirements for establishing a PE. The two main areas of concern are:

- The widening of the notion 'at the disposal of' requirement. Accordingly, an employee who has a security card for the premises of the client's office building would be sufficient to fulfil the requirement. Also an employee having a home office would constitute a PE of their foreign employer if the home office were used on a regular and continuous basis. Even contractual access rights without an actual presence would be sufficient to fulfil the 'at disposal of' requirement. This would mainly be aimed at construction companies which would sub-contract all or part of a project (eg, building of a power plant, airport etc) to sub-contractors in the country of the client. In such cases, the activity of the sub-contractor would be attributed to the foreign main contractor and the sub-contractor would create a PE of the main contractor (so-called sub-contractor PE).
- The time requirement for the existence of a business is watered down to such an extent that even 'one-shot-businesses' would constitute a PE thereby increasing the risk of a double taxation.

Reconceptualisation of the PE concept for the digital world

The redesigning of the PE concept does not only take place at the level of the OECD. As Edouard Milhac explained, France is in view of the developing digital world trying to reconceptualise the PE definition in order to give the source country more taxing power. In January 2013, the so-called Colin and Colin Report was issued which, based on an analysis of the business model of the digital industry, tries to deduct new rules for its taxation. According to the report, the digital industry relies heavily on the exploitation of data created from the regular and systematic monitoring of internet users. Hence, the added value for the internet firm is not created by the firm itself but by the clients/users themselves. This fact is a radical departure from the classical theory of the firm and would constitute the main explanation for the huge value of internet firms. Since the 'free work' performed by the internet users contributes to a large extent to the profit of these firms, a part of this profit should also be taxable in the country where the users are located. It is expected that France will try to promote this new alternative for source country taxation at the OECD level.

Concluding remarks

As Martin Busenhard mentioned in his summarising remarks, the digital world makes it more difficult to make a fair allocation of the taxation rights between residence and source country. The Service PE according to the UN Model Convention would not allow dealings with the problems arising in connection with the digital industry, since it is still based on the classical way of doing business. The rise of the emerging markets and the huge amounts flowing from these countries makes it understandable that these countries also want a share of these profits and are thereby trying to extend the taxation rights of the source country. The current Service PE discussion would be very illustrative in this respect. However, the Service PE discussion does not only take place in the global context of a confrontation between developed countries and emerging countries, but also within integration processes such as in the European Union. Workers moving freely within the European Union and performing services will increasingly lead to issues concerning taxation rights, whereby Member States will understandably try to protect their tax basis. The Service PE still raises many questions and it is as yet unclear where the discussion will end.

Patricia A Brown mentioned in her concluding remarks that the post-World War II consensus which had been built up among a limited number of countries was now being challenged by numerous new countries which had in a first phase taken over the OECD MC without really being aware of the consequences. The PE discussion which should have happened at that time was now taking place. Thus, uncertainty will prevail until a new consensus for the allocation of taxing rights between the source residence and the source country is found.

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Tax and morality

'Governments are keen to make tax a moral issue. But morality is an elusive concept, which cuts both ways.'

UK Chancellor George Osborne caused something of a stir when, in his 2012 Budget speech, he announced that 'I regard tax evasion, and indeed aggressive tax avoidance, as morally repugnant.' Whilst of course all governments will loudly oppose tax avoidance, this was a level of inflammatory rhetoric which was new. Also new was his equating, at least in moral terms, of evasion (ie, knowingly breaking tax laws in order to pay less) with aggressive avoidance (ie, working within the law, although possibly taking a robust view of how it might be construed, to deliver an advantageous tax result).

This is not the place for a long discussion on the theory of jurisprudence. Many learned professors have written many lengthy books dealing with philosophical questions such as why must one obey the law, and whether there are any circumstances in which one might properly not do. What is abundantly clear from both theory and history, though, is that there are occasions when laws are passed which do not meet any widely accepted standard of justice. In turn, many philosophers will then accept that there comes a point when it may be moral for a citizen to break the law. In extreme cases, most commonly associated with oppressive legislation passed by totalitarian regimes, it may even be arguable that in order to act morally, a citizen must break the law.

Morals themselves are subjective. Many believe that there are higher principles derived from a deity or deities, and they look to their religion for guidance: God says thou shalt not kill, so don't. Others may take the view that morals are principles which assist in the formation of a successful society: killing people is wrong not because of some inherent higher law, but because people living in a society where they are constantly afraid of being violently attacked will not be able to function as effectively as people who feel safe, meaning that the society as a whole will be less prosperous.

Most people, of most cultural backgrounds, in most countries will happily sign up to the premise that indiscriminately killing someone is morally wrong, regardless of their view on the derivation of morals. But other, highly significant, moral questions are far from universally resolved, whatever Western liberals such as myself would like to think. Should citizens be free to criticise their governments? Should homosexual acts between consenting adults be permitted? Should women have the same rights as men? Is abortion ever acceptable?

This slight digression into jurisprudential and moral philosophy was intended to highlight two points which will be useful as we come to tax. First, there are surprisingly few principles which can truly be considered universal morals; and secondly, the proposition that the letter of the law must always be obeyed – never mind its spirit – is most certainly not one of them.

It follows from this that even tax evasion, with the breach of the law that it necessarily involves, is not inherently morally repugnant. What if a tax is so unfair as to itself be immoral? In the extreme case of the UK's attempts to impose stamp duty on its increasingly rebellious American colonies, this perception gave us the Boston Tea Party in 1773. Back home in the UK, in 1990, the 'community charge', a widely loathed local tax where a fixed amount was paid per head by each individual regardless of means, was instrumental in bringing about the downfall of prime minister Margaret Thatcher as middle-class pensioners marched in protest through central London.

That said, particularly in democracies, it is possible to take a contractual view of the authority of law. Citizens choose to live in the country in question and accept its legislative machinery in return for the benefits they obtain through living there. They must therefore obey the law whether they like it or not. The Boston Tea Party is the classic example of what can happen when this is not the case: the aggrieved people subject to the UK stamp duty did not have votes they could exercise in relation to its imposition, hence the well-known slogan 'no taxation without representation'. They felt entirely morally justified in refusing to pay the tax. The community charge example shows that sometimes a measure can be so unpopular as to be perceived to lose its democratic legitimacy even when adopted in accordance with the constitution of a democracy.

Fortunately, in mature democracies, tax measures commanding as little popular consent as the community charge are rare, although the imposition of new austerity-driven taxes in a number of European states is clearly in danger of raising the same issues. It follows that it can probably be said that most of the time, in most countries, tax evasion – the deliberate non-payment of taxes, contrary to law – can be said to be reprehensible. This is doubly the case where the country in question is a democracy with open borders, so that if a measure does become sufficiently unsupported, a mechanism exists (however remotely) for it to be changed by popular will – and of course if an individual hates a measure enough, they can always emigrate. Furthermore, for all the discussion above around stamp duty and the community charge, the moral position is surely different – and worse – for a surreptitious tax evader under-declaring his or her income than someone openly refusing to pay a tax on principled grounds.

What, however, of avoidance, whether it be aggressive or otherwise? Avoidance is of course a famously difficult concept to define, but in loose terms it must encompass using the law to achieve a tax result which the legislators who introduced the law in question would not have considered acceptable if they had been aware of it at the time. What are the moral questions here?

Most importantly, the law is not being broken – that is the distinction between avoidance and evasion. We do not therefore need to get into the questions of whether the law must always be obeyed, and how law derives its legitimacy, which have been considered above. We cannot use the same arguments to conclude that avoidance is immoral that we can use in relation to the great majority of evasion. Is there also some moral duty to uphold the spirit of the law as well as its letter?

The author's view is that there is no such duty. Once you take away the question of breaking the law, you are left with citizens being able to conduct their affairs as they see fit. That does not, of course, imply the adoption of an amoral stance: any given taxpayer may well have their own moral scruples which may lead them to reject a given avoidance opportunity.

Tax policy itself is in significant part a matter of highly subjective judgments with moral components. Should tax rates be more progressive, or flatter? Is it right, through social security contributions, to tax earned income at higher rates than unearned income? Should capital gains be taxed at a different rate to income? Is there a level of taxation which cannot be justified regardless of the circumstances? (Currently, despairing French people might care to recall that the UK's top rate of tax on unearned income in the 1970s was a rather magnificent 98 per cent. At least one good thing came of this, in that the Rolling Stones were inspired to record *Exile on Main Street* whilst in tax exile, ironically in France). At an even higher level, should tax policy be used as an instrument to drive behaviour? Especially where the desired behaviour reflects a government's own moral preferences, such as giving tax breaks to encourage marriage? None of these questions has an easy answer. None indeed has a right answer. Most importantly for the purposes of our discussion, there is no widespread consensus on the issues.

Consider a taxpayer who passionately believes that government tax policy is wrong and that they are unfairly over-taxed as a result. They may even believe that the policy is immoral (certainly one could find plenty of support for the proposition that a 98 per cent rate amounted to legalised theft). They realise that there is a defect in the relevant legislation which enables them to greatly reduce their overall tax rate, so they do this. A person who agrees with the government's policy may well consider what the taxpayer is doing to be morally reprehensible (and if that person is not hypocritical, they might therefore feel obliged to refuse the avoidance opportunity if it was offered to them). But the avoider will feel morally entirely justified: they will see themself as escaping an unfair tax. Most can probably agree that it is immoral to avoid a fair tax, but not whether any given tax is fair.

Take a different, more specific, example. The UK has a fiendishly complex set of rules dealing with the taxation of life assurance policies. They are intensely formulaic, and frequently give rise to tax outcomes at variance from the economic results of transactions. These rules were utilised in the sale of a marketed avoidance scheme which generated tax losses to order, without the need for any corresponding economic loss. This scheme was upheld by the UK courts in the case of *Mayes*: invited by HMRC to find against the taxpayer on the basis that this outcome was contrary to the purpose of the legislation, the court held that the results of the legislation in question were so irrational that it was impossible to discern a purpose behind the law.

Then, in a later case, Joost Lubler (a Dutchman resident in the UK) stumbled into these rules inadvertently and inflicted a very large taxable profit on himself despite making a material commercial loss. In finding against Mr Lubler 'with a heavy heart', an unusually outspoken tax tribunal noted that this was 'an outrageously unfair result', and 'more repugnant to common fairness... than to permit other taxpayers to avoid tax on undoubted income'.

Where is the morality here? A piece of law has made it to the statute book which, apparently by deliberate design, often delivers tax results wildly different from economic outcomes. For sure the taxpayer in *Mayes* deployed quite a convoluted series of steps to obtain his tax loss, but his scheme worked by the letter of the law. As the court found, it could not try and go beyond that letter of the law to underlying purpose or policy because none was apparent. Had we reached a point where, morally, the government deserved to see the law abused by Mayes? Is there a Darwinian argument that bad law will only evolve if taxpayers do abuse it? No number of Joost Lublers is likely to turn policymakers' eyes to the need to change a law, but one *Mayes* tends to get their attention.

It simply is not possible to dismiss all tax avoidance as objectively morally repugnant. Tax policy is a matter of balancing competing factors in a highly subjective way. It is not reasonable to say to a person who feels that they are over-taxed that they are acting objectively immorally by engaging in avoidance. A person may only feel morally obligated not to avoid tax if they feel the system as it applies to them is entirely fair in both conception and execution. One suspects that if one asked Mr Lubler for his views as to the morality of the UK tax system, as he faces bankruptcy due to an enormous tax bill arising from a loss making transaction, one might get a fairly colourful response. Morality in tax is a double-edged sword, and the more complex a tax system becomes (and in particular the greater differentials in rates it delivers), the harder it becomes for governments to preach from the moral high ground. Likewise, even if tax laws are widely seen as fair, any perception of uneven enforcement will undermine the moral authority of the system.

Consider the following examples:

- A business based in a single country is trying to compete with multinationals who are able to reduce their overall effective tax rates to close to zero using legitimate transfer pricing methods. The business utilises an aggressive loss generation scheme to reduce its own tax rate (and hence cost of capital) to a comparable level.
- A property fund observes that competitors are using schemes to avoid land transfer taxes. It starts to do this too, as otherwise its returns will instantly be several percentage points lower than those of its competitors, and it may well fail in consequence.
- A UK resident and domiciled owner of an investment property in the UK realises that their resident but non-domiciled colleague who also owned such a property, but through an offshore trust structure, has just sold it free of capital gains tax. They think it is unfair that they should be subject to capital gains tax on an exactly equivalent transaction, and they employ a loss creation scheme to put them on the same footing as their colleague.
- A very highly paid worker in the financial sector undertakes a scheme in conjunction with their employer to reduce the effective rate of tax on their bonus from 47 per cent to 15 per cent. They want to secure the tax saving in order to be able to buy the new model Ferrari Enzo out of their bonus.

These are all cases of aggressive avoidance in the pure technical sense. However, whatever one's view as to where the line should be drawn, they should surely not be lumped together as morally identical. And to dismiss all these behaviours as equivalent, and morally repugnant, is as unhelpful as it is inaccurate and simplistic.

Most people can probably agree that evasion is morally wrong almost all the time, on the basis of jurisprudential arguments around the authority of law. There is then a category of avoidance which borders evasion, involving advisers taking fairly extraordinary views of the meaning of law in order to permit the sale of tax products in which they have a significant financial interest: much of this activity can confidently also be described as morally reprehensible most of the time.

However, avoidance which does not overly strain the law is a very different beast. Any discussion of its morality also requires consideration of the morality of the policy behind the tax being avoided, and indeed of the wider tax system. That is not a matter on which any consensus is ever likely. This led in the UK to a very famous judicial conclusion:

> 'No man in this country is under the smallest obligation, moral or other, so as to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow – and quite rightly – to take every opportunity which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is, in like manner, entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the Inland Revenue.'

Or in summary: if the law says you are taxed, you are taxed. If it doesn't, you aren't. Morality does not come into it. Personally, I find it hard to disagree. The UK Government, unsurprisingly, does not, which is why we are getting a General Anti-Abuse Rule which will overturn this excellent judgment. Morally, all tax policy will thus henceforth be deemed to be fair. That's us told.

I B A P U B L I C A T I O N

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