Bloomberg BNA

Daily Tax Report®

Commentary on the BEPS Discussion Drafts on Tax Treaty Abuse And Countering Avoidance Using Hybrid Mismatch Arrangements

BY TIM JARVIS AND AREDHEL JOHNSON

In July 2013 the Organization for Economic Cooperation and Development published its Base Erosion and Profit Shifting (BEPS) Action Plan; a public discussion draft was published March 14 on countering tax treaty abuse as part of the BEPS Action Plan, and it was followed by the publication of a public discussion draft on countering hybrid abuse March 19.

These public discussion drafts generate a number of significant issues. The first challenge for policy makers is to delineate between what is abusive and what isn't so as to protect genuine commercial arrangements while pursuing abusive ones. Further there may be disagreements between different states as to what is abusive and what isn't, particularly as tax competition becomes ever more prevalent.

The first challenge for policy makers is to delineate between what is abusive and what isn't so as to protect genuine commercial arrangements while pursuing abusive ones.

Then there is the overall question of implementation. It will be interesting to see if OECD member states can agree on a harmonized approach to implementation or if the proposals will be implemented piecemeal and inconsistently among various states. It is self-evident that global coordination is going to be important as jurisdictions that implement changes on a piecemeal basis may end up at a competitive disadvantage relative to other jurisdictions.

Here we provide an overview to the recommendations made in the BEPS public discussion drafts and set out some thoughts on issues that may arise in determining whether arrangements are abusive.

Tim Jarvis is a partner and Aredhel Johnson a senior associate in the Tax Strategy and Benefits practice at Squire Sanders.

Countering Treaty Abuse

The public discussion draft on countering treaty abuse contains a number of measures that are designed to prevent tax treaties from being used for inappropriate planning. These include:

- Amending the preamble to bilateral income tax treaties to include a statement that each treaty's purpose is to avoid creating opportunities for non-taxation or inappropriate reduced taxation. The implementation of this change will operate as a mini anti-avoidance rule. In other words, domestic courts will be able to strike down planning opportunities that may not have been envisioned at the time of writing because they don't accord with the spirit of the treaty.

- Making the entitlement to treaty benefits subject to a ''main purposes'' test. The plan is for a treaty to say ''. . . a benefit made under this Convention shall not be granted in respect of an item . . . if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining the benefit was one of the main purposes of any arrangement or transaction.'' The concept of a ''main purposes'' test is used in U.K. tax jurisprudence. What the U.K. courts repeatedly grapple with is the delineation of the boundary between a commercial arrangement that has been structured tax effectively and an arrangement that has one of its main purposes as being the creation of a tax advantage. No doubt this debate will be relevant here.

- Nearly all of the tax treaties that have been concluded by the U.S. contain a ''limitation of benefits'' clause. For example, the U.S.-U.K. treaty contains such a clause. In general, under a limitation of benefits clause, a non-individual person will be denied treaty benefits unless the person has a listing in the relevant contracting state or is, in turn, under the control of persons who are entitled to treaty benefits in the relevant contracting state. The use of a limitation of benefits article is designed to prevent persons who are resident outside the contracting states from creating a vehicle

 ISSN 0092-6884

that is resident in one of the contracting states merely to access treaty benefits.

So What Arrangements Will Be Caught?

At the simplest level, the proposed changes to tax treaties will combat the most extreme cases of treaty shopping.

For example, the Netherlands has a favorable tax treaty network whereas the Netherlands Antilles has a limited treaty network in its own right. Historically intellectual property has been licensed from the Netherlands Antilles to the Netherlands and from there, relying upon the Dutch tax treaty network, to end users with the objective of reducing or eliminating the effective rate of withholding tax. The Dutch tax treaty network enables royalties to be paid to the Netherlands at low or reduced withholding rates whereas, due to a domestic Dutch law exemption from withholding tax, royalties can be paid out from the Netherlands tax free. This type of arrangement should be caught by the anti-avoidance mechanisms discussed above.

Many jurisdictions tax nonresidents on capital gains or certain capital gains. However many tax treaties reserve the taxing rights to the tax authorities of the jurisdiction in which the seller is resident. In other words, the treaty ''trumps'' the rights of the state in which the relevant asset is situated to allow imposition of tax on nonresident capital gains.

Therefore, if the seller is resident in a jurisdiction that has a participation exemption, and a special purpose vehicle is interposed into the group structure, it may be possible to eliminate charges to tax on capital gains altogether. This type of planning is potentially caught by the ''main purposes'' test and it may have the effect of making many existing structures ineffective.

The question is what is meant by "one of the main purposes of an arrangement"?

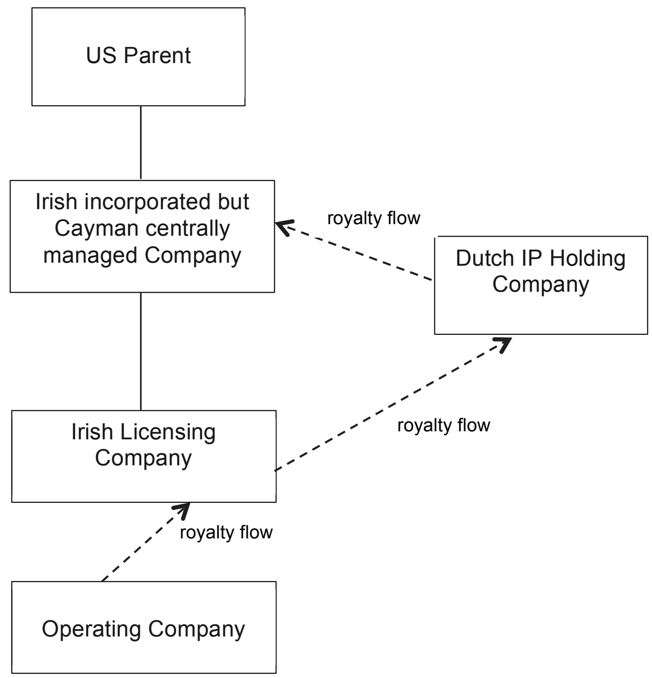
The Indian revenue authorities have sought to assess nonresidents for capital gains tax on the disposal of Indian situs assets, notably in the Vodafone litigation. The proposed reform would prevent ''treaty blockers'' being interposed into group structures to hold Indian situs assets in order to prevent the avoidance of Indian tax.

Similar issues can arise on inward investment into Latin America and Russia. Often inward investment into Latin America is structured using a Spanish holding company to avoid local tax on capital gains. Historically, investment into Russia has been structured using Cyprus and Luxembourg holding companies to mitigate Russia's taxing rights on capital gains.

The question, as alluded to above, is what is meant by ''one of the main purposes of an arrangement''? Say that an international group interposes an intermediate holding company into a group structure and it is a pure holding company. It may be reasonable to infer that the intermediate holding company was interposed to eliminate tax on capital gains.

However, say that the intermediate holding company is an operating company in its own right and the value of the operating activities is at least equal to that of the interests held in the subsidiary. This gives rise to the difficult question as to what time the existence of the subsidiary ceases to have as its main purpose the accessing of tax treaty benefits. Indeed the revenue authorities of the seller state and the state in which the shares are located may have different answers to these questions.

It is understood that many U.S. groups have used the ''Double Irish Dutch Sandwich'' structure as part of their planning.



Under the structure an IP right, such as a brand name, is placed in an Irish incorporated but a Cayman centrally managed company. The IP is licensed to a Dutch IP Holding Company, which sublicenses to an Irish Licensing Company. Currently the structure produces the following effects (but it may be subject to challenge on main purposes grounds):

- The royalty flow moves profit from the operating company to the Irish Licensing Company, where it is subject to 12.5 percent tax in Ireland.
- However, the profit flows from the Irish Licensing Company to the Dutch IP Holding Company, thereby creating a tax deduction in Ireland and the Netherlands/Ireland treaty is relied upon to eliminate Irish withholding tax.
- Apart from a ''turn,'' the profit is transferred out of the Dutch IP Holding Company to the Irish incorporated company but Cayman centrally managed company and the Dutch IP Holding Company isn't subject to withholding tax under its domestic law on the royalty flow.
- The royalties received by the Irish incorporated but Cayman centrally managed company aren't taxed under Cayman law. In addition Ireland doesn't tax the Irish incorporated but Cayman centrally managed company because, under Irish tax law, the company is treated as being solely tax resident in Cayman. Further, because the Irish Licensing Company is ''checked open'' for U.S. tax purposes, the licensing activities of

   ISSN 0092-6884

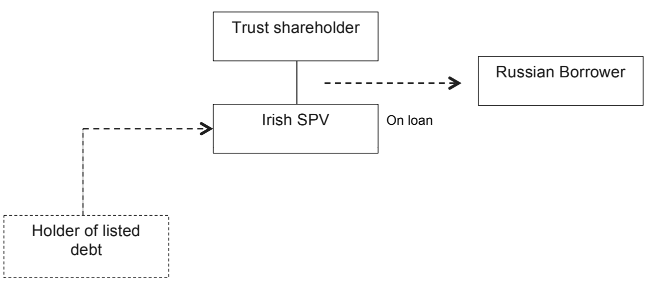
the Irish Licensing Company are attributed to the Cayman company, making it ''active'' and thereby avoiding Subpart F treatment under the U.S. controlled foreign corporation regime.

The ''main purposes'' test drives a ''coach and horses'' through the Double Irish Dutch Sandwich structure. This is because it should be possible to conclude that the Dutch IP holding company has been interposed into the structure solely—or at least mainly—to access the favorable terms of the Netherlands-Ireland tax treaty. It may also be possible to challenge this arrangement under the limitation of benefits rules on the grounds that the Dutch IP Holding Company isn't under the control of Dutch residents.

Could Relatively Benign Capital Markets Arrangements Be Caught by These Proposed Changes?

The U.K. has a relatively benign set of rules for allowing companies to raise finance on the debt capital markets. For example, if a U.K. company issues paper that is listed on a recognized stock exchange, interest can be paid on the paper without withholding tax.

However, many jurisdictions don't have as benign a regime for withholding tax mitigation for capital markets issues as the U.K. For example, Russian issuers don't appear to have an equivalent to the U.K.'s listed loan rules to rely on. This has led many issuers to use a structure that relies on Ireland's tax treaty network and Ireland's equivalent to the listed loan exemption.



Under the structure the Irish SPV issuer issues debt securities that benefit from the listed loan exemption from withholding tax in Ireland. The proceeds of the funding are lent on to the Russian borrower and the Ireland-Russia treaty allows the interest to be paid gross from Russia to Ireland.

However, it appears that the Irish SPV will have as one of its main purposes the obtaining of benefits from the Ireland-Russia treaty. The policy question is whether this type of arrangement is inherently abusive. It is being put in place to facilitate a genuine capital markets transaction and it is only being put in place because the ultimate borrower doesn't benefit from a relatively ''capital markets friendly'' tax system such as that in the U.K.

Neutralizing the Effects Of Hybrid Mismatch Arrangements

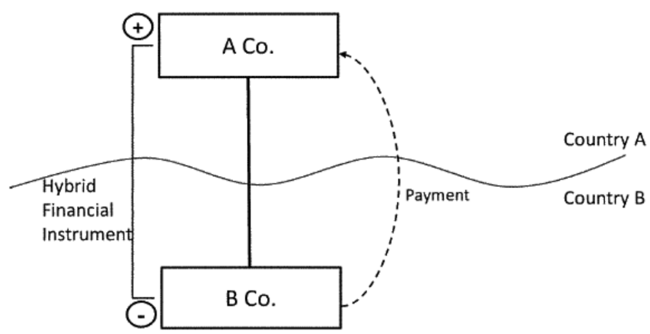
The BEPS public discussion draft on hybrids sets out different ways in which hybrid mismatch arrangements may be challenged. The public discussion draft focuses on hybrid instruments, hybrid entities and reverse hybrid arrangements. The public discussion draft targets arrangements that are designed to generate either double tax deductions or arrangements that generate a tax deduction and a tax-free receipt or equity-type return (or equivalent mismatches).

This section provides an overview of the arrangements that are targeted by the public discussion draft and considers the impact of some of the proposed arrangements on transactions in the market. This section also discusses the ways in which the public discussion draft initiates a discussion as to how innocent transactions can be protected from being caught.

Hybrid Instruments

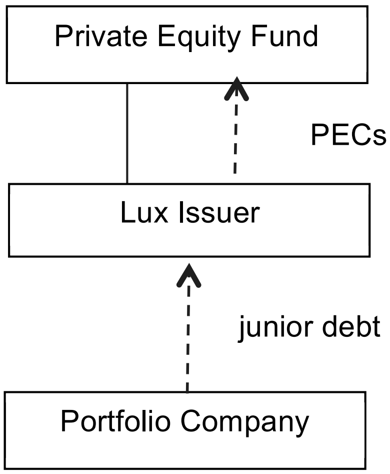
A hybrid instrument is an instrument under which either the instrument or a payment under the instrument is treated as debt in one jurisdiction but as equity in the other (and/or there is a mismatch in the tax treatment of the different types of payment between the two jurisdictions).

A diagrammatic representation of a hybrid instrument is set out below.



A hybrid instrument might cover a preference share financing where the issuer jurisdiction treats the instrument as debt and the investor's jurisdiction treats the instrument as equity.

Hybrid instruments such as preferred equity certificates are often used by Luxembourg issuers in private equity financing. A typical structure could work as follows:



Under the structure, the portfolio company takes a deduction for the junior debt in accordance with local transfer pricing rules. However the Luxembourg issuer is funding with PECs. These instruments are treated as debt under Luxembourg law, thereby eliminating tax on the interest income received by the Luxembourg company. However, the private equity fund treats the PECs as equity.

When you look at the overall economics the portfolio company has achieved a tax deduction, subject to local law transfer pricing, and the fund has crystallized an equity-type return. Going forward, the denial of a deduction for PECs instruments is likely materially to affect the economic return from private equity funds.

The public discussion draft goes on to make the point that the hybrids proposal will cover not just the hybrids themselves but specific payments made under the terms of a hybrid instrument, if those payments give rise to mismatches. For example, the rules will catch the following:

- a deduction claimed by an issuer for the premium paid on converting a mandatory convertible note, if the holder of the note treats the premium as an exempt gain;

- where an issuer of debt claims a deduction for the valuation of an embedded option in an optional convertible note while the holder ignores the value of the option component; and

- where an issuer bifurcates an interest-free shareholder loan into its equity and debt components and then accrues the equity component over the life of the loan while the holder treats the entire amount as a loan for the principal sum.

The changes discussed above will impact on cross-border loan note fundings where different national tax and accounting systems currently create favorable tax mismatches.

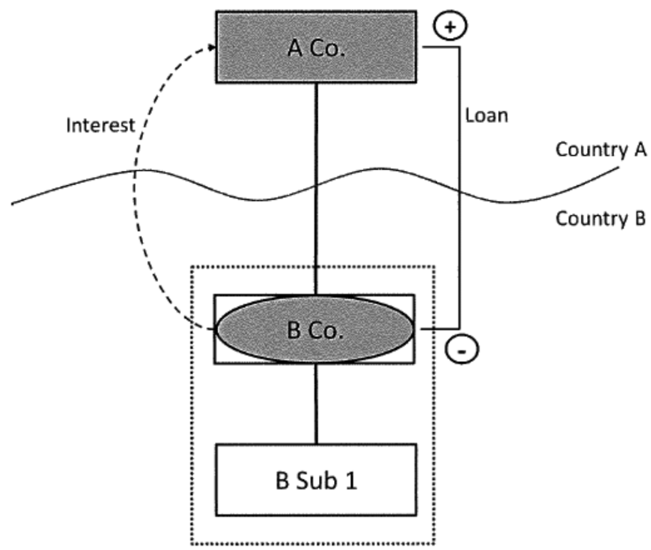
The public discussion draft doesn't expressly cover financing arrangements using leases. However, leasing arrangements that produce ''double dips'' would appear to be within the spirit of the draft.

For example, say that State A gives depreciation allowances for leased equipment by reference to legal form, whereas State B gives depreciation allowances on leased equipment by reference to economic substance. In this instance a leasing company based in State A could finance lease equipment to a lessee in State B and there would be a ''double dip''; State A would give tax relief on the legal form whereas State B would give tax relief on the economic substance (i.e., on the equipment treated as acquired).

Arrangements of this type fall within the spirit of the anti-hybrids proposal because the transaction is classified differently in two different states. Therefore it is likely that this type of arrangement would be targeted upon the implementation of the public discussion draft.

Hybrid Entities

The public discussion draft indicates that hybrid entities are to be combated. An example of a typical hybrid entity structure is set out in the graphic.[1]



Structures of this type have been routinely used by U.S. groups as part of acquisition structures. In the example B Co. is ''checked open'' vis a vis the U.S. but it is treated as a corporation in its jurisdiction of incorporation. In consequence, A Co. isn't taxed on the interest payment from B Co. in the U.S. (because they are treated as part of the same legal entity) whereas B Co. has the benefit of an interest deduction, which it can surrender down to (or consolidate with the profits of) B Sub 1.

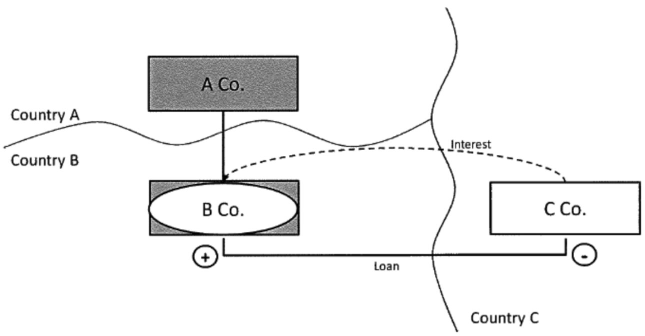
It will be interesting to see how this anti-hybrid rule proposal is implemented in practice. For example, the U.K. currently has anti-hybrid rules that may be more limited than those in the public discussion draft. Under the U.K.'s rules a tax deduction would only be blocked at the level of B Co. if the amount that B Co. borrows from A Co. exceeds the amount B Co. could have borrowed from a third-party lender. Therefore it will be interesting to see whether the public discussion draft results in a more stringent outcome than that currently created by U.K. law.

[1] This paper uses the OECD's diagrammatic representation of what is a hybrid. The OECD may use a different type of diagrammatic representation from that which is used in the U.S.

   ISSN 0092-6884

Reverse Hybrids

An example of a typical reverse hybrid is set out below.[2]



Reverse hybrids have often been used by U.S. groups as part of their group structuring. The structuring would typically use a Netherlands limited partnership, or CV. Under Dutch law the CV (which corresponds to B Co. in the example above) is treated as a ''see-through'' entity. However, for U.S. tax purposes B Co. would be treated as opaque. B Co. would then make a loan to C Co. The interest paid by C Co. to B Co. wouldn't be subject to tax in the Netherlands (as B Co. is entered as tax transparent). It is likely that C Co. would be ''checked open'' for U.S. tax purposes, with the consequence that B Co. would become an ''active company'' vis a vis the U.S., thereby blocking a CFC apportionment.

It is likely that the implementation of reforms of this type will have a material effect on how U.S. groups structure their international operations.

Hybrids and Tax Treaties

A public discussion draft has been issued to consider the interaction between hybrids and tax treaties.

It is proposed that tax treaties should be amended to include the following article:

> for the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.

If this change is implemented it would impact radically on how tax treaties are interpreted relative to hybrids. Say that a U.K. company borrows from a U.S. limited liability company. The U.K. treats the LLC as a corporate entity relying on the U.K.'s rules on entity classification. However, under U.S. tax law, the LLC is ''checked open.'' Under the revised proposal the LLC would only be able to access the benefits of the treaty to the extent that its income is treated for tax purposes as the income of U.S. residents.

The commercial consequences of this change will need to be thought through. Self-evidently the majority of tax treaty claims relate to routine commercial transactions, such as cross-border funding arrangements and the licensing of intellectual property. As part of making a tax treaty claim, if the public discussion draft is implemented, it will be necessary to carry out due diligence to determine whether the payee is a hybrid. It may be the case that this will result in longer time periods for the processing of tax treaty claims as a consequence.

Designing the Anti-Hybrid Rules

The public discussion draft initiates a debate as to how the anti-hybrid rules can be implemented without their becoming unduly burdensome.

The document indicates that certain types of arrangement will be outside the scope of the proposed reforms:

- Accounting and regulatory capital based products are to be excluded. Therefore, if an instrument is structured so that it is debt for tax purposes, and it is to be treated as equity for accounting or for regulatory capital purposes, then this won't by itself activate the rules so long as there is no tax based mismatch.

- The public discussion draft indicates that arrangements that bring about a timing mismatch will also be excluded. However, this gives rise to a debate (which the document doesn't explore) as to when a timing mismatch crosses the line and becomes avoidance.

- Certain jurisdictions have attempted to address mismatches in the funding of equity and debt by giving notional interest deductions for equity investments (such as Belgium). The public discussion draft indicates that just because a company resident in a jurisdiction that gives a notional interest deduction for equity invests in the share capital of a company within another jurisdiction (which doesn't give such a deduction), this won't activate the rules. The instrument is still equity vis a vis the two jurisdictions, it is merely the case that the investor jurisdiction treats the equity more favorably than the issuer jurisdiction.

- Self-evidently the note doesn't address questions of tax arbitrages due to countries having different tax rates.

The public discussion draft has started a debate as to how to prevent innocent transactions being caught by the anti-hybrid rules. The draft considers a ''bottom up'' or a ''top down'' approach.

Under a bottom up approach transactions that raised the most significant concerns from a tax policy perspective would be identified. The hallmarks of relevant transactions would be instruments held by related parties (including persons acting in concert) and arrangements that have been put together as part of a structured financing. The policy objective behind a targeted rule would be to avoid unintended or accidental mismatches caused by innocent commercial transactions from being targeted by the rules.

The other approach being considered is top down. It would start with a broad anti-hybrid rule that would target all hybrid mismatches other than those that fall within certain defined exceptions. This approach may give rise to a greater due diligence burden than the bottom up approach. This is because unless a transaction falls within a safe harbor it will be necessary to carry out due diligence to assess whether the transaction is caught by the rules.

[2] This paper uses the OECD's diagrammatic representation of what is a reverse hybrid. The OECD may use a different form of diagrammatic representation from that used in the US.

The Future

The BEPS public discussion drafts raise many complicated issues and, if implemented in full, they will bring about a radical sea change as to how international business is transacted. The public discussion documents will therefore be followed very closely by policy makers and practitioners in the next few months.

  DTR ISSN 0092-6884