International Taxation Conference

“Double Nontaxation”

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Agenda - Overview

- Framing the Issue (Scope and Context)
- Possible Policy Concerns
- Historical Attitudes (Treaties; Jurisprudence)
- Legislation, Including Some Recent Unilateral Actions
- OECD and EU Action Plans as Relating to Double Nontaxation
- General Considerations from a Source State's Perspective
- Certain Considerations for a Tailored Solution
- Example of Hybrid Debt
- Example of Separation of Low Margin Functions from High Profit Residual
- Concluding Remarks

Scope of Issue: When is Income Doubly Nontaxed and When Is this Unintended?

•**Important to define the issue and target the problem before taking actions that may have negative economic consequences nationally or globally**

•**In a broad sense, double nontaxation refers to a situation where, due to the interaction of the tax laws applicable to cross-border income flows, no or little tax is levied by either country on an item of income**

•**Compare "single tax principle": income taxed once (and only once)**

•**A country's double nontaxation policy may differ between its treatment of residents and its treatment of nonresidents**

- Residents:
  - Worldwide taxation of residents with foreign tax credit vs. exemption system
  - CFC rules (eg, measured by minimum rate of foreign tax)
  - No tax sparing vs. tax sparing
- Nonresidents: withholding tax and nexus policies

Scope of Issue: When is Income Doubly Nontaxed and When Is this Unintended? (Cont'd)

- **Not all double nontaxation is "unintended" (words of OECD) or inappropriate**
  - Which country's perspective? Possibly different views.
- **Different types and degrees of concern:**
  - Targeted tax relief (e.g., tax sparing; patent boxes)
  - General low/no tax regimes (tax havens and other countries w/o an income tax)
  - Definitional inconsistencies
  - Intentional tax arbitrage
  - Overall question of impact on domestic system/revenues or not
- **Distinction from "stateless income"**
  - US Treasury Secretary Lew's comment that "stateless income" is the target
    - Stateless income in this sense likely would not include income indefinitely deferred; but still may be concern, from both countries' standpoints.
  - Ireland's announced action to address stateless income is simply to require the payee to be resident (whether or not a tax haven)

Context of Issue

- **Residence taxation is preferred by economists and avoids source arguments, but has the drawback of mobility of residence and capital**
- **Thus, potential for double nontaxation may arise when treaty or other bilateral or multilateral relief (e.g., EU Directives) is given by a Source State**
  - Part of the agreed division of taxing rights under the agreement
  - The tax system/policies of Residence State may not tax the income, e.g., under a territorial system
  - Tax-favorable residence can be created
- **Also may arise due to domestic relief by the Source State**
  - E.g., domestic law exemptions on withholding tax
  - National tax systems attempt to address this in certain contexts (e.g. German earning stripping rules)
  - In theory within the unilateral control of the Source State
  - But economic competitive forces (relative costs of capital and technological assistance) may bind its hands

Possible Policy Concerns

- **Coherence of tax system**
  - Logical framework that operates consistently
  - In a global economy, this factor crosses borders
- **Efficiency of tax system/avoiding economic distortions**
- **Fairness/distribution effects**
- **Taxpayer morale/perceptions of unfairness**
- Affects overall system dependent on voluntary compliance
- **Revenue impact**
- **Magnitude of phenomenon has grown exponentially over the past 20 year**
  - Not just natural falling through the cracks but targeted use of inconsistencies in tax regimes as part of basic 1.0 tax planning
  - Ability to make income disappear increases incentives for deductible payments

Historic Attitudes

- **Evidence from Model Tax Conventions**
    - “Main purpose” of bilateral income tax treaties: avoiding “juridical double taxation” (Intro. to OECD Comm.). Cf. Intro to UN Model Convention.
    - “Liable to tax”: full (comprehensive) liability; exercise jurisdiction under accepted contacts; not just on local source, as diplomats
    - “Beneficial ownership” of withholdable types of income: nominee situations
- **Treaties with Countries that Do Not Tax the Income**
    - 1932 US-France treaty
    - Treaties with e.g. certain Mideastern countries (e.g., India-UAE)

Historic Attitudes: A Different View

- **1981 US (Proposed) Model Convention**
  - Source State relief unavailable for income “to the extent” that it is subject to “significantly lower tax” than similar income arising within the Residence State derived by its residents
- **Reflection of similar concepts in actual US treaties**
  - 1962 US-Luxembourg treaty: 1929 companies
  - Other US treaties in 1970s-80s targeting specific regimes, especially if treaty shopping: e.g., 1975 UK
- **Triangular provisions for branches**
  - E.g., 15% w/h tax if, by reason of a permanent establishment in a third country, income not taxed at at least 60% of the Residence State’s normal rate.
- **Regulations addressing fiscally transparent entities and domestic reverse hybrids (Regs. 1.894-1(d))**
- **But: consider effects of tax law on access to capital**
  - Portfolio interest exemption from US withholding tax

Historic and More Recent Attitudes--Jurisprudence

- **Canadian courts:** commenting on double nontaxation as acceptable
  - Canadian cases involving nonresidents; e.g. *MIL* and *Velcro* (GAAR cases)
  - Canadian case involving resident: e.g., *Hausman*
- **US courts:** commenting on tax arbitrage/“double dipping” (mixed)
  - E.g., *Coleman* (leasing); *Laidlaw* (debt); *PepsiCo Puerto-Rico* (debt)
- **Danish courts:** cases commenting in terms of beneficial ownership
- **Spanish courts:** eg., *Roche* case (permanent establishment)
- **French courts:** e.g., *RBS* case (hybrid instrument)
- **Swiss courts:** e.g. Case 2C_708/2011, Oct. 5, 2012 (foreign PE not respected, to avoid double nontaxation)
- **Indian courts:** e.g., *Meera Bhatia v. ITO* (UAE). See also *Azadi Bachao Andolan*.
- **Other countries**

Legislative Action

- **Countries with blacklisted countries (generally tax havens) resulting in higher domestic law withholding taxes**
- **Countries with general antiavoidance rules**
- **US IRC   894(c) regarding “fiscally transparent entities”; OECD Partnership Report**
- **Danish legislation on payments to hybrid entities**
    - Precursor of BEPS initiative
    - Response of PEFs: use Luxembourg intermediary company
- **German legislation**
    - Tightened dual consolidated loss (DCL) rules
    - Added subject-to-German-tax requirement for shares attributed to a German PE
    - Further proposal made to disallow 95% exemption for deducted amounts

Legislative Action (Cont'd)

•**Certain legislation catalyzed by OECD BEPS Action Plan (July 19, 2013) suggesting additonal unilateral measures: e.g. France and Mexico**

•**France's Draft Finance Bill for 2014 (Art. 9) includes (as of November12, 2013):**

- Provision conditioning deductibility of interest on loans received from related parties on the taxpayer demonstrating that the lender is subject, during the same FY, to an income tax (on the interest received) of at least 25% of the standard income tax that would be due of a French taxpayer receiving the income.
- Proposed for FYs ending on or after Sept. 25, 2013.

•**Australia July 2013 Scoping Paper, Risks to the Sustainability of Australia's Corporate Tax Base**

•**US: Senator Baucus Discussion Draft released November 19, 2013**

- E.g., would deny deduction of interest owing to a related entity if any provision reduces the tax by 30% or more from the statutory rate, or to any related hybrid entity

Legislative Action (Cont'd)

- **Mexico's Federal Government presented to the Congress on September 8, 2013, the 2014 economic package, including:**
  - Provision that a payment by a Mexican taxpayer of interest, royalties or technical assistance to a foreign entity that controls or is controlled by the taxpayer would not be deductible if
    - (i) the entity receiving the payment is transparent, unless the owners are subject to tax on the payment and the payment is equivalent to an arm's length amount,
    - (ii) the payment is nonexistent for tax purposes in the country of the foreign entity, *or*
    - (iii) the foreign entity does not consider the payment as taxable income under applicable taxation provisions.
  - Further, payments to any person whose income is subject to preferential tax treatment would not be deductible unless demonstrated that equivalent to an arm's length amount.
  - Further, payments made to a related party generally would not be deductible if such party is also able to deduct the amount.
  - An earlier proposal made on September 8, 2013 would have resulted in disallowance of a deduction if the recipient were not taxable on the income at a rate at least equal to 75% of the rate that would have applied to a Mexican recipient (i.e., 22.5%). See France, supra.

Prior OECD and EU Work Regarding Double Nontaxation

- **OECD projects have increasing focused on concerns relating to shifting income to low tax countries and exploitation of inconsistencies in legal systems to achieve double non taxation**
- **Projects have included:**
  - "Harmful tax competition" among countries;
  - Business restructuring to migrate functions;
  - Mismatches in classification of financial instruments and entities;
  - Transfer, ownership and pricing of intangibles; and
  - The need for transparency and information exchange.
- **Similarly, EU Projects have included:**
  - Action Plan of December 6, 2012
  - Hybrid Mismatches
  - CCCTB
  - EU Code of Conduct on Business Taxation

OECD BEPS Initiatives Addressing Double Nontaxation

- **Tax administration themes addressing double nontaxation**
  - Cooperation of tax authorities in view of global economy
  - Collection and sharing of information
  - Facilitate action in unison, both unilaterally in parallel and multilaterally
    - Attempt to counter propensity to bestow tax benefits to attract companies ("harmful tax competition")
    - Change attitude of taxpayers, esp.multinationals: transparency
    - Consistency in approach should reduce risks of double taxation

OECD BEPS Initiatives Addressing Double Nontaxation (Cont'd)

- **Broad themes for substantive rules addressing double nontaxation (largely from Source State perspective)**
  - Discouraging "preferential" tax regimes (tax haven type regimes)
  - Combating erosion of the tax base via e.g. arbitrage using mismatches in classification, shareholder loans and management fees; caps on interest deductibility; cash box IP companies
  - Taxing "where value is created" (where operational, incl. distribution, functions are) rather than where contracts stipulate or funding is transferred; recognition of integrated nature of firms
  - Addressing economic but nonphysical nexus (remote sales, etc.); review of treaty permanent establishment definition; digital commerce generally
  - Rules addressing tax treaty shopping (e.g., treaty country entities as conduits)
  - Expansion/tightening of rules requiring home country taxation of generally passive income of foreign affiliates (CFCs) on a current basis

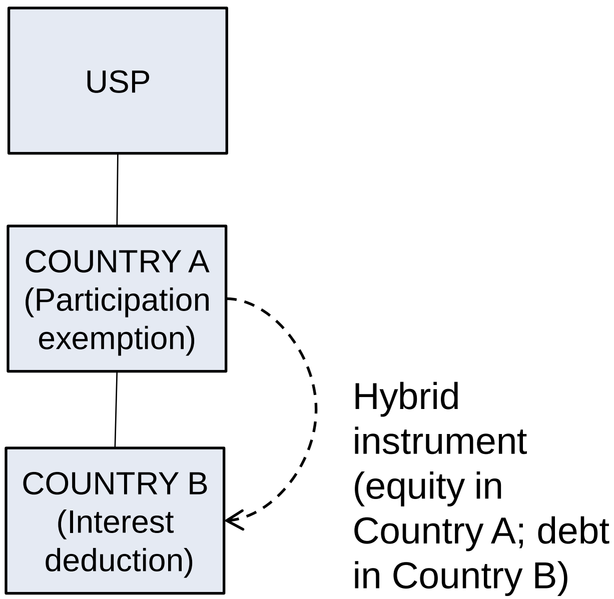
General Considerations from a Source State's Perspective

- **Is there a serious policy concern from its standpoint?**
  - Is the tax treatment in question inconsistent with the Source State's current domestic rules?
  - If not, is the concern a revenue concern or other concern described above?
- **Is unilateral action viable or appropriate?**
  - Can the problem be adequately targeted, without harmful overkill?
  - Can the proposed solution be complied with and administered adequately?
  - Will the proposed solution avoid negative trade/fiscal consequences? (Economists view local labor as bearing the largest burden of source taxes.)
  - Is the proposed solution consistent with treaty obligations?.
- **Is a GAAR a "second best" but defensible solution?**
  - Suffers from administrability, overinclusiveness and underinclusiveness
  - But it does have the benefit of avoiding the one size fits all problem

Certain Alternatives if a Tailored Solution Is Required by a Source State for Deduction or No W/H Tax in Certain Situations

- **Alternative of testing by reference to purpose**
  - Similar difficulties as a GAAR
  - Might be included as an alternative basis
- **Alternative of testing by reference to:**
  - (i) Low Residence State tax rates in the absolute (e.g., French approach),
  - (ii) Special Residence State regimes (e.g., foreign branches, deemed deduction)
  - (iii) Low Source State withholding tax (e.g., US IRC 163(j)), or
  - (iv) Types of transactions likely to involve intentional arbitrage (e.g., hybrids)?
- **Limited to related party situations? E.g. US IRC 163(j)**
- **Possible exception for treaty countries?**
  - Consider treaty shopping
  - Treaty countries may have regimes that encourage unwanted effects
  - Reduced treaty rates may be the actual concern (e.g., US IRC 163(j))
- **Alternative of not referencing how the Residence State taxes; jurisdiction based on nature of the transaction (commissionnaire issue)**

Example of Hybrid Loan-Equity



- Hybrid instrument –
  - Intended outcome under current law is tax deduction for interest expense in Country B with no corresponding taxable income in Country A
  - Intentionally structured between related parities to preserve income from deduction for group.
  - The tax policy concern has arisen because of affirmative use of such structures. But difficulty of a rule based on intention. Yet objective rules will be difficult (issues of scope, interchangeability, foreign law references and coordination, etc.)

Review of Some Alternative Approaches for Debt

•**Suppose Source State concern is w/r/t deductible payments *to* hybrid entities where the income is not taxed locally *and* is not picked up currently under CFC rules in a group parent Residence State**

•**Or suppose concern also is w/r/t deductible payments *by* Source State hybrid entity where the income is not taxed locally *and* is not picked up currently under CFC rules in a group parent Residence State**

•**Or simply w/r/t deductible payments made to low tax destinations**

•**Approach 1: Adopt earnings stripping rules (such as US IRC 163(j), which defers related party interest deduction to the extent of no withholding tax if total interest deductions exceed a % of EBITDA)**

- Advantage of avoiding need to consult foreign law; and tied to withholding tax reduction so rationale is clearly related to Source State revenues; if limited to related parties, focuses on potentially uneconomic overleverage.
- May be thin cap (e.g., debt equity ratio test) as well

Review of Some Alternative Approaches for Debt (Cont'd)

•**Approach 2: Denial of deduction if Residence State taxation is below specified level (e.g, France)?**

- How measure effective tax rate? At what point? Proof?
- Is this treaty compatible or impermissible discrimination?

•**Approach 3: Denial of reduced/0% withholding tax rate if Residence State taxation is below normal level therein by reason of special regime (e.g. `1981 US Model Treaty and various treaty precedents)?**

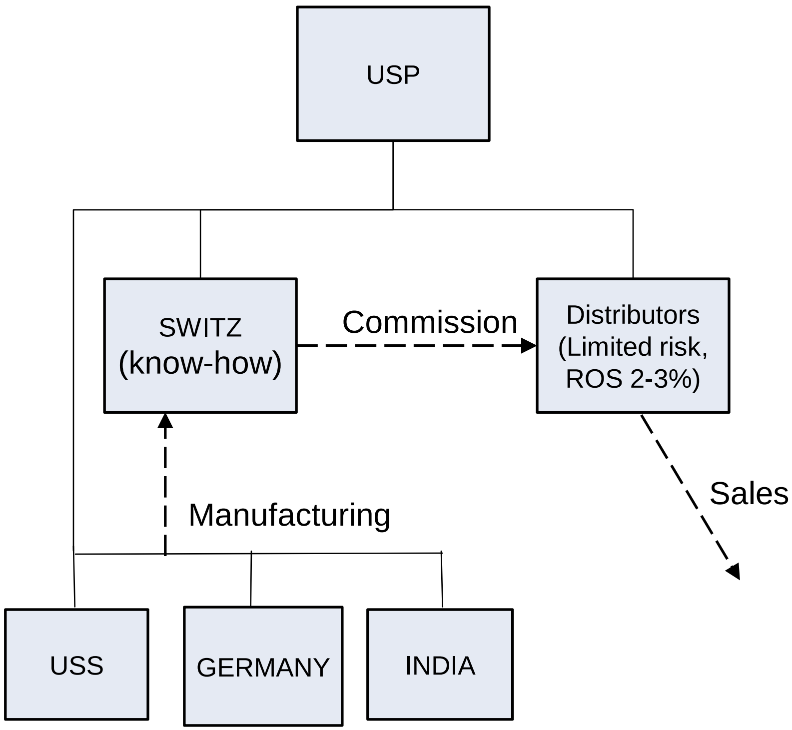
- Or denial of deduction?

•**Approach 4: Denial of reduced/0% withholding tax rate if certain hybrid or other indicia of double nontaxation are present?**

- Or denial of deduction?
- E.g. US "domestic reverse hybrid" regs recast purported interest payment as dividend, thus generally having both results.

- **Approach 5: Agree on consistent treatment- eg, US-UK CA Agt re DCL rules**
  - **Avoids double taxation risks/competing antiavoidance rules**

Example of Separation of Low-Margin Functions from Group's Offshore Residual Profit Center



is this *unintended* double nontaxation?

- Assume SWITZ holds know-how/tradename/ IP, and contracts with affiliates to perform routine manufacturing (for which it makes a "substantial contribution") and distribution.
- SWITZ retains the residual profit from the manufacturing know-how.
- Issues re transfer price to the distributor (contractually protected from a loss by the principal) and royalties from distributor and manufacturers.
- Issues re royalties (similar for BEPS as debt); other issues re sales etc.
- Is it proper to deemphasize contractual terms and legal allocation of risks?
- Is a distinction between use of a related vs. an unrelated contract manufacturer or distributor appropriate?

Concluding Remarks

•**Ultimately, each Source State necessarily has a great deal of discretion regarding what kind of provisions it believes are necessary**

•**One would hope the discretion is exercised circumspectly**

- Considering the complicated fact patterns and competing considerations, such that no broad rule can be bought to bear;
- Considering, more broadly, the interaction of local taxation and local economic growth;
- And considering the benefits for all of a global consensus in dealing with cross-border tax issues.