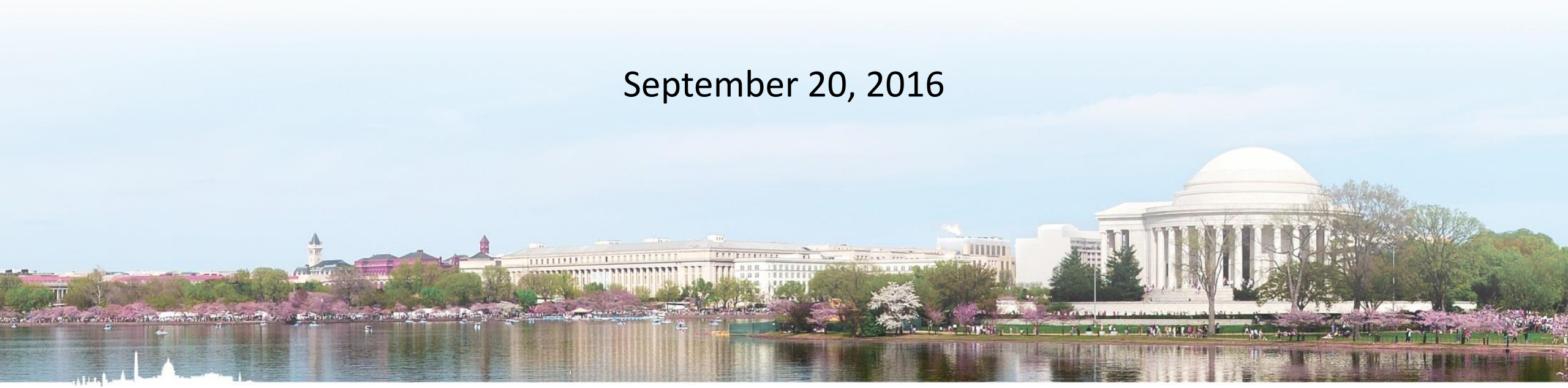
Practical Issues in Entity Classification and Claiming Tax Treaty Benefits for Transparent Entities

September 20, 2016



IBA2016 18–23 SEPTEMBER WASHINGTON DC

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Introduction

- Recurring theme in international tax planning
- Perceived opportunities for aggressive tax planning
- Inconsistent domestic approaches
- International attention (OECD BEPS)
- Likelihood of “consensus”?
- What to expect

Overview

- Outline of basic issue
  - Proliferation of choice
  - Domestic mismatches at the core of the issue
  - Tax treaty implications
  - Evolving domestic legal tests
  - Tax arbitrage
- Evolution of international (OECD) approach
  - BEPS Action Plan 2 and 6
  - Current EU developments (Anti Tax Avoidance Directive)
- Specific approaches
  - Practical examples and local developments

Outline of Basic Issue

- Proliferation of choice
  - Growing number of potential business vehicles
    - Creatures of national, state/provincial legislation
    - Differing commercial rationale / policy objectives
    - Increased flexibility in corporate law to enhance business/investment climate
  - Evolution of domestic legal “tests”
    - Differing local / national approaches to classification of domestic and foreign entities
    - No common set of rules for classification: different criteria in many jurisdictions
    - Limitation of liability; able to sue/be sued; shares?; transferability restricted? assets distinct from assets partners;
    - US Check the Box rules
    - Ultimately: simply based on election
  - Tax arbitrage opportunities
    - Double non-taxation, double deduction, extended deferral
  - Implications to tax treaty benefits
    - Lack of specific rules for hybrids (certain notable exceptions), although modern treaties deal with the issue

Evolution of International (OECD) Approach

- 1999 Partnership Report
- 2010 OECD Collective Investment Vehicle (CIV) Report
- BEPS Action Items / Reports
  - Public reactions
  - Possible outcomes / domestic adoption
- Result of the OECD Action Plan: EU Anti Tax Avoidance Directive
- EU State Aid discussion

ATAD

- ATAD adopted by EU Member States on 21 June 2016
  - Implementation
    - 1 January 2019
    - 1 January 2020 (exit tax)
    - 1 January 2024 (earnings stripping)
  - ATAD on hybrid entities:
    - Limited to EU Member States, but Preamble underlines importance to include third countries, in line with BEPS Action Plan 2 (end of 2016)
    - Starting point ATAD on hybrids: avoid double deduction or deduction without inclusion
    - Hybrid qualification of p.e. is treated as separate issue
  - Article 2.9 ATAD, Definition

    ‘Hybrid mismatch' means a situation between a taxpayer in one Member State and an associated enterprise in another Member State or a structured arrangement between parties in Member States where the following outcome is attributable to differences in the legal characterization of a financial instrument or entity:

ATAD (ii)

(a) a deduction of the same payment, expenses or losses occurs both in the Member State in which the payment has its source, the expenses are incurred or the losses are suffered and in another Member State ('double deduction'); or

(b) there is a deduction of a payment in the Member State in which the payment has its source without a corresponding inclusion for tax purposes of the same payment in the other Member State ('deduction without inclusion').

- Article 9 ATAD:
  - If double non-taxation: only deduction in source state allowed (source of payment)
  - If deduction without inclusion: source state should refuse deduction
- Implications to tax treaty benefits
  - Lack of specific rules for hybrids (certain notable exceptions), although modern treaties deal with the issue

EU State Aid

- EU State Aid cases
  - Starbucks
  - Apple
  - Etc.

- Influence of use of hybrids on EU decision ? (Starbucks)
- Inconsistency between OECD transfer pricing models based on risk allocation and EU State Aid criteria
- Implications on future of US Check the Box rules?
- Other US measures to be expected?

Country- Specific Approaches / Current Developments

- Practical bilateral examples and the way these evolve:

  US/UK
  Argentina/Spain

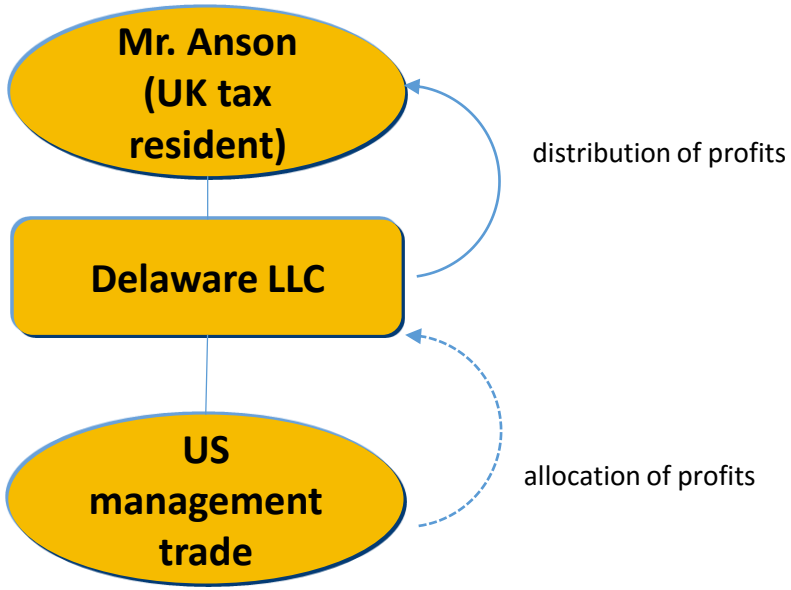
- Examples of recent bilateral developments:

  Netherlands/US (2012), Canada (2013) and Switzerland (2016)
  Canada/United States

Country-Specific Approaches

- United States / United Kingdom
- Argentina / Spain

Delaware Limited Liability Companies - *Anson*



- US – current income tax on all <u>allocated</u> profits as trading income regardless of distribution
- UK HMRC position – taxed only on "dividend" income when received. No credit allowed for US tax against UK tax on dividend income
- UK Supreme Court found that, based on the original findings of fact in the case, the profits were the same for the purposes of the US/UK DTA and credit was, in fact, available.
- "Look through" in the US and the UK.
- *George Anson v HMRC (2015) UKSC 44*

Delaware Limited Liability Companies - *Anson*

- UK HMRC *Business Brief 15/15*:
  - The decision is specific to the facts found in the case.
  - Where US LLCs have been treated as companies within a group structure HMRC will continue to treat the US LLCs as companies,
  - Where a US LLC has itself been treated as carrying on a trade or business, HMRC will continue to treat the US LLC as carrying on a trade or business.
  - HMRC also proposes to continue its existing approach to determining whether a US LLC should be regarded as issuing share capital.

Depends on specific LLC agreement

- Drafting issues
- Delaware/State law crucial
- Clearance from HMRC may be possible
- Practical experience over last 12 months

Lending into the UK by partnerships

- UK HMRC approach to partnerships in the context of DTAs

  "Where a partnership is treated as transparent, claims may be made by a partner who is resident in a country with which the United Kingdom has a double taxation agreement in respect of his share of partnership income as if he had received that income direct."

- WHT on UK source interest
- Need for gross payment directions
- HMRC is willing to entertain any application for relief at source from partnerships. Likely to give relief in this way chiefly where:
  - HMRC is able to obtain satisfactory assurances about the membership of the partnership.
  - Small and fixed number of participators, such as corporations engaged in a joint venture
- Difficult with broadly held partnerships where interests are freely assignable
- Currently, partnerships are not eligible for DTT Passports.
- Consultation on extending DTT passport scheme to partnerships.
- Practical issues

Compare to Lending into US by Partnerships

- Many lenders rely on “portfolio interest exemption” rather than treaties to avoid US withholding on interest
- For payments of dividends, interest, rents, royalties to non-US partnerships, whether withholding is done on the partnership or by the partnership depends on whether the partnership is a “withholding foreign partnership” that has assumed primary withholding responsibility
- Treaty benefits are generally self-executing with IRS Form W-8BEN/W-8BEN-E – no clearance from tax authority necessary
- FATCA further complicates withholding

BEPS Action 2

- Proposed new Article 1.2 to OECD Model Treaty :
  - “Article 1
  - PERSONS COVERED
  - 1. This Convention shall apply to persons who are residents of one or both of the Contracting States.
  - ***2. 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.”***
- Revised proposed OECD Model Treaty commentary : *“The paragraph not only ensures that the benefits of the Convention are granted in appropriate cases but also ensures that these benefits are not granted where neither Contracting State treats, under its domestic law, the income of an entity or arrangement as the income of one of its residents.”*
- Very similar to existing Art. 1(8) US/UK DTA and Art. 1(6) of New US Model Tax Treaty (2016)

Impact of BEPS Action 6 on investment fund Partnerships

- Investment fund partnerships using holdcos with treaty benefits
  - LOB/PPT
  - Potential fund restructurings?
  - Looking through multiple layers of feeders (transparent/opaque)
- New US Model Treaty – revised LOB provisions
  - Fiscal transparency taken into account in “equivalent beneficiary” rules
  - Biggest divergence between new US Model and BEPS relates to permanent establishments (BEPS Action 7)

Transparent entities: Spain

- Spanish tax system foresees tax transparency for Spanish tax entities in very limited cases:
  - Inheritance in abeyance, joint proprietorships and contractual partnerships ("sociedades civiles") without commercial purpose (1).
    - Personal Income Tax Rules apply unless all interestholders are subject to Corporate Income Tax.
    - Nonresident taxpayers, permanent establishment and application of Tax Treaties.
  - Spanish Economic Interest Groupings ("Agrupaciones de Interés Económico " – AIE-), European Economic Interest Groupings ("Agrupaciones Europeas de Interés Económico" – AEIE-) and Temporary Joint Ventures of Enterprises ("Uniones Temporales de Empresas"):
    - Corporate Income Tax rules to determine taxable base.
    - Transparency tax regime applicable to resident interestholders (and nonresident in case of AEIE).
    - Corporate Income Tax at the level of the Spanish entity in case of nonresident interestholders and treatment of distributions as a dividend for tax purposes (exception: tax transparency leading to potential permanent establishment in case of AEIE).

(1) Contractual partnerships with commercial purpose where transparent until 2015.

Transparent entities: Spain

- Nonresident entities qualify as transparent in Spain if their legal nature is identical or substantially similar to the one of Spanish transparent entities:
  - Tax rulings on different types of partnerships (Dutch CV V0886-15, German KG V1631-14, UK LLP V6306-14 and UK LP V0012-2011).
  - LLCs and Spanish / US tax treaty. (Competent Authority Agreement signed in 2006 and binding ruling V1545-16).
- Special rules in connection with CIVs:
  - Nontransparency of Spanish CIVs and application of Treaty benefits.
  - CIVs based in tax havens attribute positive income to Spanish resident interestholders (NAV differences).
  - Nontransparency of EU CIVs of Directive 2009/65/CE (UCITs) and application of Treaty benefits (and EEE equivalent).
  - Rest of CIVs: depends on the legal nature of the CIV.

Transparent entities: Argentina

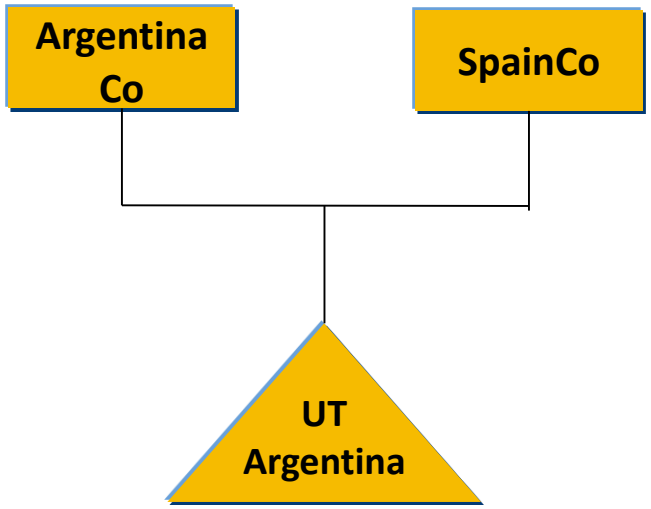
- Business entities with legal personality are deemed either taxable or transparent entities for income tax law purposes, depending on the type of entity under private law, and regardless of the nature of the income obtained and the characteristics of the members.
- The classification as taxable entity is mandatory.
- Not frequently used as vehicles to carry out business activities.
- Fully transparent entities. Statutory joint ventures (Uniones Transitorias) and other forms of contractual joint ventures.
  - frequently used for carrying out specific projects, services and supplies of a limited duration.
  - considered as transparent entities with respect to income tax and the tax on assets.
  - treated as independent legal entities, for certain purposes including labor law, social security contributions and for VAT and turnover tax.

Transparent entities: Argentina

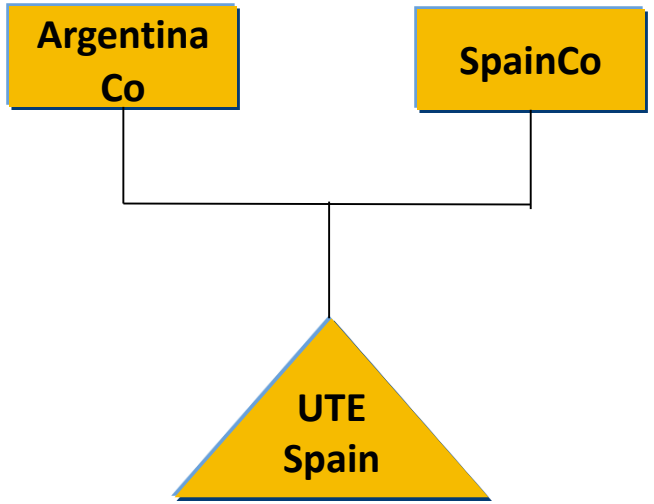
- Income reporting entities
  - filing of tax returns for information purposes.
  - Items of income and deductible expenses are offset at the entity`s level.
  - A net amount is attributed to the members in proportion to their participation.
  - Income taxation at the members level depends on their condition for income tax law purposes.
- Domestic vs. foreign entities: location of the effective place of business.
- Foreign resident members with a PE (mandatory for joint ventures): same treatment as local corporations.
- Foreign resident members without a PE: subject to withholding income tax.
- Application of tax treaties. Included in the definition of “person” (except DTT with Germany).

Sample case: Temporary Partnership ("Unión Temporal de Empresas")

UT Argentina



UTE Spain



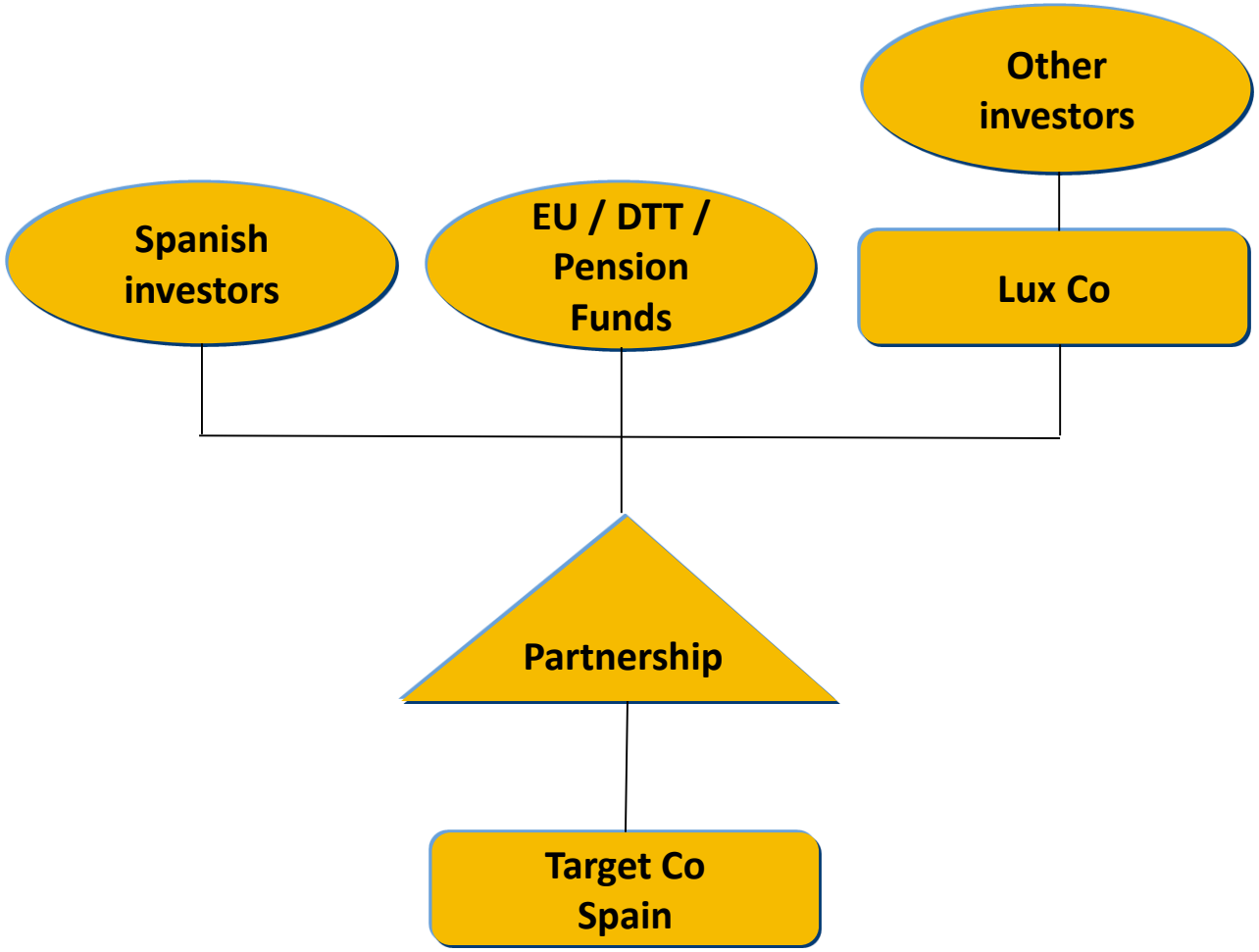
Description

Construction project to be developed by ArgentinaCo and Spain Co through a Unión Temporal de Empresas in Spain and in Argentina.

Issues to consider:

- Section 5 Argentine Spanish Tax Treaty provides special rules for PE consisting of (i) building sites, construction or installation projects; (ii) service projects; and (iii) mining, oil and gas exploration activities lasting more than six months.
- Argentine UT is transparent to Spain Co. Profits attributable to PE, as the case may be.
- Spanish UTE is only transparent to SpainCo. Subject to Spanish CIT and dividend withholding in connection to ArgentinaCo.

Spain: Use of partnerships or direct investment in club deals



Issues to consider:

- Flexible structure to directly invest in Target Co. (qualifying investors) or through intermediate structures:
  - To avoid potential treaty-shopping issues
  - To ensure intermediate taxes are credited by investors in their respective jurisdictions
  - To allow controlling power by general partner

Action 2 BEPS: Argentina

- Associated status for BEPS purposes. Non Government public comments on final report and possible implementation
- Significant measures consistent with BEPS are already in force.
- DTT with Austria, Spain, Switzerland and Chile were reviewed and drastically terminated as, in the view of former Argentine authorities, in some cases their application resulted in base erosion (e.g. double non taxation).
- Addressing dual residence entities under a treaty setting would require to resort to MAPs with a doubtful and lengthy outcome, unless arbitration is contemplated. Unlikely in the short term.

Action 2 BEPS: Spain

- Deep CIT Reform in 2015 (pre-BEPS conclusions).
- 2015 CIT Reform introduced anti-hybrid rules aimed basically at tackling hybrid instruments (equity-like instruments treated as a debt for accounting purposes and generating potentially tax deductible financial expenses), not hybrid entities.
- Difficult to crystallize in Spain double-nontaxation through hybrid entities:
  - Transparency is not common under Spanish tax regulations.
  - Introduction of a switch-over clause (CIT 2015 Tax Reform) whereby dividends coming from deductible expenses in the other country or taxed below 10% nominal rate (unless resident in a treaty jurisdiction) are not exempt.
  - Not application of the benefits of tax treaties to entities which are not resident in the other country within the meaning of the treaty. Assessment of tax residence lies in hands of the country where the entity is potentially a tax resident.

Action 2 BEPS: Spain

- Spanish-US Tax Treaty (similar to BEPS proposed 1.2 to Model Treaty):
  - Competent authority mutual agreement 2006 (LLCs): *" income received by an LLC, or other entity, whether organized within or without the US, that is treated for U.S. federal tax purposes as a partnership or disregarded as an entity separate from its owner, will be treated as income derived by a resident of the United States to the extent that income received by the LLC or other entity is subject to U.S. tax as the income of a U.S. resident"*.
- New Protocol signed January 14 2013 (not yet in force):
  - New Art. 1.6: An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State is considered to be derived by a resident of a Contracting State if the item of income, profit or gain is treated under the laws of the residence state as an item of income, profit or gain of a resident (Standard US tax treaty rule).
  - Protocol's fiscal transparency rule is more restrictive as it applies only if the entity is organized in the United States, Spain or a jurisdiction that has a tax information exchange agreement in force with the source state.

Action 6 BEPS: Argentina

- Treaties signed since 2013 incorporate several rules to deal with treaty abuses.

- DTT Argentina-Spain (2013). MoU expressly refers to the application of domestic anti-avoidance rules and includes a broad application of the beneficial ownership requirement.

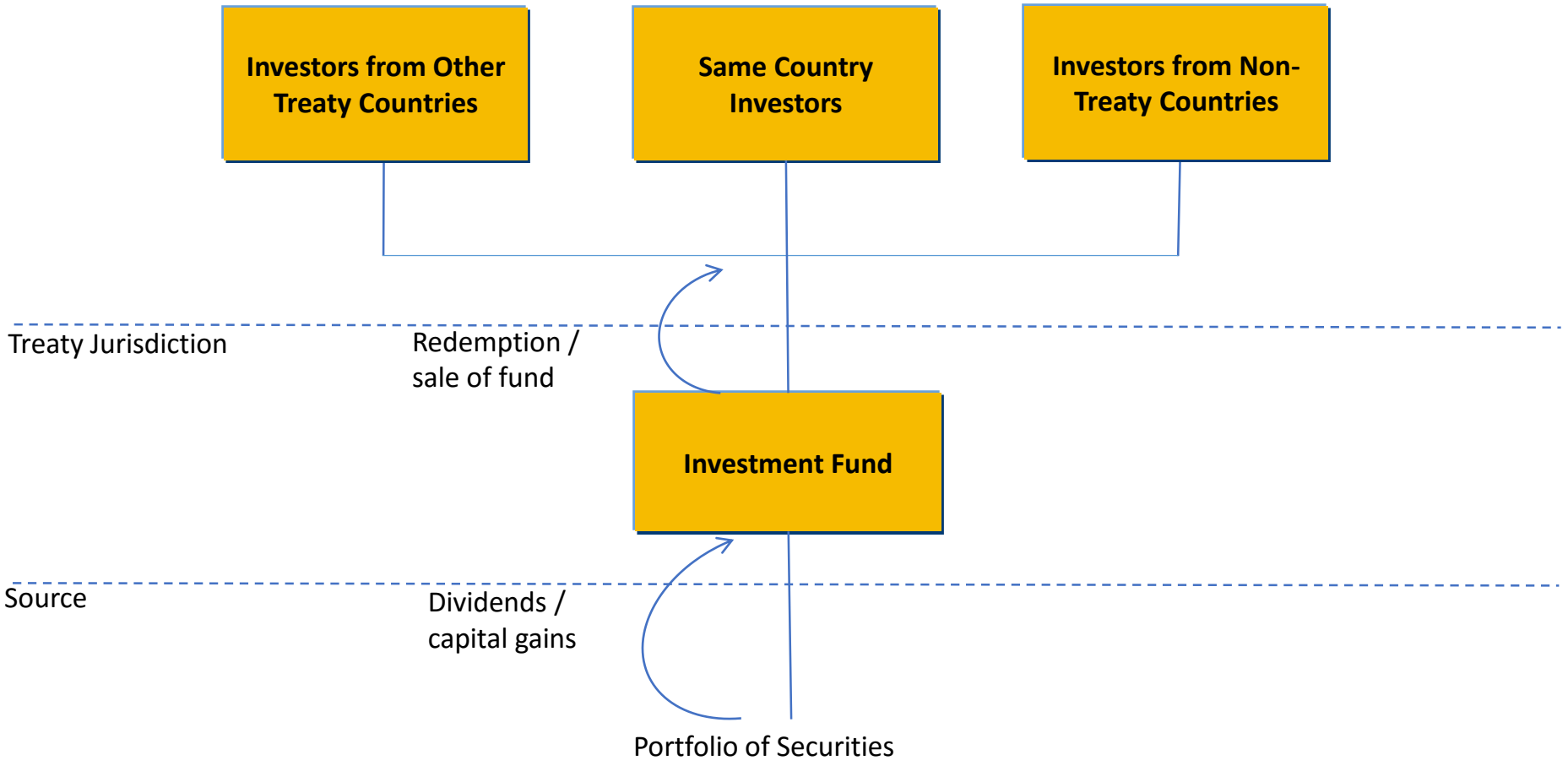
- DTTs with Chile and México (2015) contain a LOB provision, combined with a PPT standard.

Action 6 BEPS: Spain.

Investments through UCITS vs. other transparent entities.

Art. 14.1.i Spanish Nonresident Income Tax Law:

1% withholding tax on dividends paid to EU UCITS and equivalent CIVs in the EEE, but not to CIVs based in rest of the world.



THANK YOU

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