Tax Profile

May 2013
Number 5

CCH
a Wolters Kluwer business

CURRENT INTERNATIONAL TAX ISSUES IN CROSS-BORDER CORPORATE FINANCE AND CAPITAL MARKETS

—Jack Bernstein, Aird & Berlis LLP

In February I had the pleasure of organizing and co-chairing a very successful two-day conference for the International Bar Association Tax Committee in London. We had 43 renowned international tax speakers from the United Kingdom, the United States, Australia, India, Germany, France, Spain, Luxembourg, Netherlands, Ireland, Italy, and Canada. There were several U.K. government speakers as well as speakers from financial institutions and multinational corporations as well as from private practice. The following are some of the highlights of the various panels.

Use of Finance Companies by Multinationals[1]

Examples of Group Finance Structures

Marcel Buur of Loyens & Loeff, London, presented the group finance structures which are most used in Europe.

There is the simple Luxembourg structure in which the parent company establishes a Luxembourg finance company granting loans to group affiliates. Whereas the finance income generated in the Luxembourg 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 Luxembourg company is financed primarily through Preferred Equity Certificates ("PECs") or Preferred Equity Share Certificates ("PESCs") which are considered as debt from a Luxembourg 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 2–5%.

A special U.K.-Netherlands structure is used by U.K. 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 form a U.K. perspective and that the Cooperative and the Dutch BV are treated as one single taxpayer. Finally, Marcel Buur referred to the Belgium-NID structure which became less attractive and less used today than in past years.

Taxation of Offshore Income of Financial Institutions[6]

The panel was chaired by Dr. Matthias Geurts, of Noerr in Frankfurt, and the remaining panellists were Avv. Prof. Gugliemo Maisto, of Maisto Associati in Milan; Peter Blessing, of Shearman and Sterling, in New York City (who has since moved to KPMG); and Pano Pliotis, of GE Capital EMEA, in London.

The panel started with the presentation by Dr. Matthias Geurts with a case decided by the German Supreme Court on a hedged tax sparing credit (Supreme Tax Court judgment I R 103/10 of June 22, 2011). A German corporation 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% on the gross income against the German tax due on the net income.

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.

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 of importance 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 (i.e., the loan) are in different jurisdictions. Therefore acceptance also for tax purposes might only be granted in cases where the basis and the hedging instrument are in the same jurisdiction. Additionally these type of transactions shall be market priced, documentation should be available, they should have hedging purposes and be part of a regulatory risk management. On this grounds until the hedge relationship is given both legs should be booked through the p&l or — avoiding the volatility within the p&l — one single "frozen" position should be shown.

III. Presentation on Transfer Pricing, Guarantee Fees, GAAR and Foreign Tax Credits

A. Transfer Pricing and Guarantee Fees

Prof. 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 of the group 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% to its parent that was subsequently recharged to the financed overseas companies of the group at the same rate.

According to Prof. Maisto there should be no markup 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 markup.

B. GAAR and Foreign Tax Credit

The other case presented by Prof. Maisto was a case decided by the Italian courts using general anti-avoidance rule ("GAAR") in a situation related with the double use of foreign tax credits in two different jurisdictions involving a repossession agreement between a U.K. bank and an Italian bank.

Prof. Maisto finished his presentation with an overview of the state of the art in what concerns the inclusion of income of banking financial activities in the radar of the CFC rules in seven major European jurisdictions and with an example of a restructuring operation of an Italian parent company with one subsidiary in Ireland and another in France to avoid Italian CFC rules that otherwise would be applicable to the profits of the French subsidiary.

IV. Presentation on an Overview of U.S. Anti-Deferral Legislation — Subpart F and the Active Finance Exception

Pano Pliotis made a very clear explanation on the basic framework of the well-known U.S. Subpart F rules created to prevent deferral of tax on passive income earned and retained by CFCs outside the United States. 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-U.S. 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. 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 means that at least 70% of the CFC's gross income derives from lending or finance transactions with non-U.S. unrelated customers. For fully regulated CFC banking entities with substantial deposit funding the 70% 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 his exposition with the presentation of some critical issues that arise in connection with this exception.

V. Additional Issues Relating to Offshore Operations of Financial Institutions, Particularly from a U.S. Perspective

The presentation by Peter Blessing addressed the proposals for international tax reform in the United States, 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 U.S. tax net and use of credits for excess foreign taxes paid thereon to reduce U.S. tax payable in respect of passive income.

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 U.K. 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. 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.

Peter Blessing 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 United States against the profits of a U.S. 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 United States, and particularly as they related to group relief, under regulations issued pursuant to section 909 of the IRC.

Notes:

[1] The reporter for this panel who prepared this summary was Leonard Toenz, ALTENBURGER LTD legal + tax, Zurich.

[2] The reporter for this panel who prepared this summary was Flavio Mifano, Tax Partner, Mattos Filho, Brazil.

[3] The reporter for this panel who prepared this summary was Mathew Herrington, McDermott, Will & Emery LLP, United Kingdom.

[4] The reporter for this panel who prepared this summary was George N. Kerameus, KPP Law, Athens.

[5] The reporter for this panel who prepared this summary was Niamh Keogh (William Fry), Ireland.

[6] The reporter for this panel who prepared this summary was Bruno Santiago, Marais Leito, Galvão Teles Soares da Silva & Associados (Lisbon/Portugal).

[7] The reporter for this panel who prepared this summary was Luigi Falvene (DLA Piper), London (Legal Director).

[8] Section 177A(1) of the *Income Tax Assessment Act 1936* (ITAA 1936).

[9] Section 177D(a) of the ITAA 1936.

[10] Section 177D(b) of the ITAA 1936.

[11] *RCI Pty Ltd. v. FCT*, [2011] FAFC 104.

[12] *Futuris Corporation Ltd. v. FCT*, [2010] FCA 935 (upheld on appeal [2012] FCAFC 32).

[13] *FCT v. AXA Asia Pacific Holdings Ltd.* , [2011] FCAFC 4.

[14] Part 7 of the *Finance Act 2004*, as amended by section 108 of the Finance Act 2007.

[15] The reporter for this panel who prepared this summary was Scott D. Newman of K&L Gates, New York.

[16] The reporter for this panel who prepared this summary was Amelia O'Beirne of Mason Hayes & Curran Solicitors, Dublin.

[17] The reporter for this panel who prepared this summary was Jessica Kemp of Travers Smith, London.