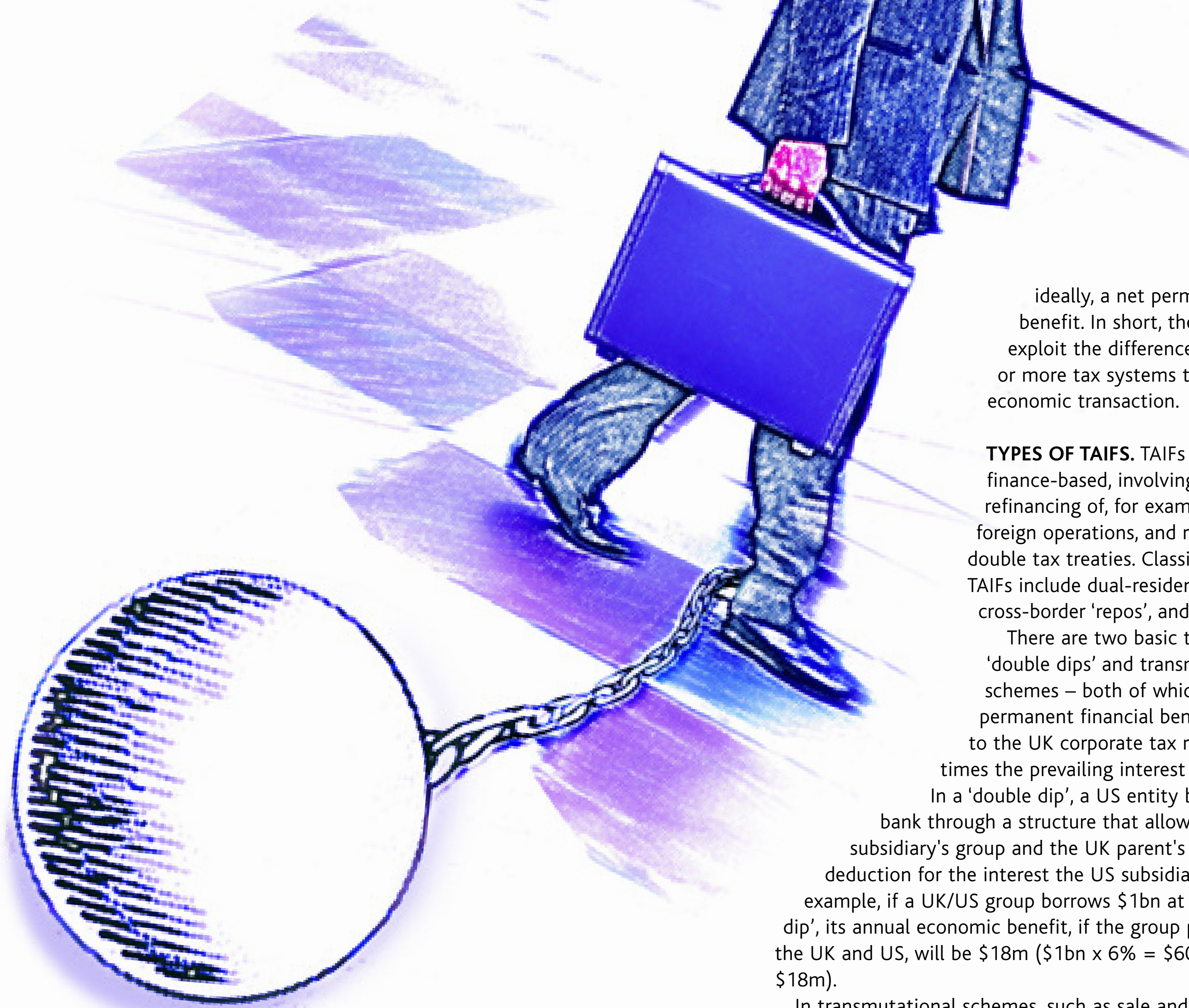
Executive summary

- Despite UK and US efforts to legislate against and regulate tax avoidance schemes, international schemes that use at least two tax systems can resist unilateral elimination.
- TAIFs involve the financing or refinancing of, for example, a UK group's foreign operations, and rely on one or more double tax treaties. Classic examples of TAIFs include dual-resident 'double dips', cross-border 'repos' and 'hybrid debt'.
- Amendments to the US/UK Treaty; changes in domestic law and greater co-operation between the UK and the US have led to the closure of 'hybrid' TAIFs, 'reverse hybrid' TAIFs, some 'double dips', some 'repos' and some third country 'pref stock' 'double dips' during the last 15 years.
- The US is developing regulations to further limit 'repos' and 'double dips'. The UK, US and Joint International Tax Shelter Information Centre (JITSIC) are now examining deferred subscription agreements, which were created to replace 'reverse hybrids.'
- The UK and US now have systems in place to eliminate abusive TAIFs quickly and effectively. In March 2004, the UK announced legislation requiring all scheme promoters to register a scheme with the Inland Revenue when first offering it to a company.
- Not all TAIFs are abusive, and it is unlikely they will all be closed down. Those that survive will grow out of a rational commercial position and will not be treaty-dependent.



No escaping the taxman

TAX SCHEMES, SUCH AS TAIFS, HAVE ENABLED COMPANIES TO AVOID TAX PENALTIES IN ONE COUNTRY WHILE EXPLOITING MORE FAVOURABLE CONDITIONS IN ANOTHER. BUT RECENT MOVES, SUCH AS TAX AUTHORITIES' REQUIREMENTS THAT SCHEME PROMOTERS INFORM THEM IMMEDIATELY OF A SCHEME'S SALE, MEANS THERE IS NO ESCAPING THE TAXMAN. **DAN BURT** REPORTS.

Tax advisers, like cosmologists, argue about whether their universe is boundless, or limited. Many believe that the international tax avoidance cosmos is contracting, and will become much smaller than it has been in the past quarter century. The UK and US have legislated, regulated and litigated against purely domestic tax avoidance schemes for the last 40 years, and hence there are few purely domestic high value US and UK schemes left.

However, international schemes have been far harder to stop since they use at least two tax systems to produce benefits for their users and, therefore, can resist unilateral elimination.

International schemes fall into two basic types – the practical and conceptual. Practical schemes arrange commercial activity within a group so that deductions arise in a high tax country and profits arise in low tax ones. They are practical because there is no argument about what a deduction or a receipt is – only about whether it is justifiable and where it arises.

A practical scheme's key benefit is tax deferral – not permanent tax avoidance. Such schemes have become much less useful in the face of increasingly comprehensive anti-avoidance rules – there are few unpicked cherries, and the cost of picking them is often prohibitive.

Of more interest to treasurers are conceptual international tax avoidance schemes such as tax advantaged international financings (TAIFs). A conceptual scheme organises direct or indirect commercial relationships to exploit definitional peculiarities in one or more national systems, or differences between two or more national systems, to produce a deferral or, ideally, a net permanent economic benefit. In short, these schemes exploit the differences in the way two or more tax systems treat the same economic transaction.

TYPES OF TAIFS. TAIFs generally are finance-based, involving the financing or refinancing of, for example, a UK group's foreign operations, and rely on one or more double tax treaties. Classic examples of TAIFs include dual-resident 'double dips', cross-border 'repos', and hybrid debt.

There are two basic types of TAIF – 'double dips' and transmutational schemes – both of which produce a permanent financial benefit roughly equal to the UK corporate tax rate (30% today), times the prevailing interest rate.

In a 'double dip', a US entity borrows from a bank through a structure that allows both the US subsidiary's group and the UK parent's group to claim a deduction for the interest the US subsidiary pays. For example, if a UK/US group borrows $1bn at 6% using a 'double dip', its annual economic benefit, if the group pays taxes in both the UK and US, will be $18m ($1bn x 6% = $60m x 30% = $18m).

In transmutational schemes, such as sale and repurchase agreements, meanwhile, a payment that the payor country 'regards' as a deductible item, e.g. interest, rent or royalty, the recipient country 'sees' as either a capital receipt which is non-taxable, or as a dividend carrying underlying tax credits with it.

In a repo, for example, a US company 'sells' stock in a US subsidiary to a UK company subject to a promise to buy the stock back in, say, five years, and pays dividends from the subsidiary to the purchaser. US law treats repos as loans and the subsidiary's dividends as interest payments on a debt. But the UK treats the dividends as dividends, which carry a tax credit. The economic result is the same as in the 'double dip', though it is achieved through the use of tax credits.

THE REVENUES FIGHT BACK. In the US, the Internal Revenue Service (IRS) began complaining publicly about the growing marketing and use of corporate tax shelters back in 1994. It challenged questionable schemes in court, and won significant victories, but soon came to believe the tax shelter industry had grown so large that litigation could not dismantle it. It needed new tools to cope with 'abusive tax shelters.'

Congress introduced anti-hybrid legislation in the spring of 1997 to override US tax treaties which allowed foreign-owned groups to use 'hybrid' TAIFs. These allowed a US subsidiary to borrow from its non-US group and claim interest deduction in the US. The non-US group, meanwhile, did not pay tax on receipt of the interest because its country treated it as a dividend.

Promoters responded to these anti-hybrid rules by shifting to 'reverse hybrid' TAIFs, but the IRS issued regulations to stop the use of these in 2001.

The UK has also attempted to reduce the use of TAIFs such as the 'Principal First Loan' which exploited the fact that the US relieved interest on an accruals basis, but the UK taxed interest on an arising basis. In 1996, the UK changed the taxation of corporate debt to an accruals basis. The UK attempted to further reduce the use of TAIFs by changing its tax credit rules in 2000 to limit offshore mixing, and by modifying the Controlled Foreign Company rules.

History of TAIFs

The use of TAIFs grew proportionately with the growth of UK investment in the US as of the late 1970s. UK groups investing in the US were using 'double dip' dual resident structures as early as 1977. The UK and IRS tried to shut down 'dual resident' companies by introducing legislation to end this practice in 1986 (US) and 1987 (UK). These laws ended the use of 'dual resident' companies for 'double dips' but did not end the practice.

TAIF activity diminished after 1987, but only for a few years. Their use saw a vast increase in the early 1990s due to developments in:

- Regulation – In 1995, the US first suggested its now notorious 'check the box' rules, which allowed US companies, partnerships and trusts to elect how they would be taxed, regardless of the legal form in which they operated. These rules apply to foreign entities for US purposes, e.g. a UK limited subsidiary of a plc may elect to be completely disregarded and treated as if it did not exist for US purposes. These 'check the box' rules gave rise to a flood of TAIFs, and a new industry to create and sell them.
- Politics – The US congress responded to a growing anti-government mood in the US in the 1990s by assaulting IRS audit practices. Congress drastically reduced the audit capabilities and will of the IRS to audit.
- Economics – The US boom that began in 1992 attracted large amounts of inward direct investment into the US. Much of this investment took the form of foreign acquisitions in US industries.
- Commerce – This economic growth was paralleled by growth in all parts of the US' and UK's financial services industries. Banks, investment banks and law and accounting firms boomed and the latter expanded and promoted themselves as 'one-stop shops'. They started providing and promoting tax plans and high fees and high overheads led some to promote more and more questionable schemes.

These four developments converged to produce very fertile fields for TAIFs. In 1996-2000 there were at least six different TAIFs on offer – 'hybrid' TAIFs, 'reverse hybrid' TAIFs, 'repos' – both internal and external, 'check the box' 'double dips', Irish and Luxembourg 'pref stock accumulators' and, as of 2001, deferred subscription agreements.

'CONGRESS PASSED A NEW LAW TO WHEEDLE OUT MANY, IF NOT ALL, OF THE TREATY-BASED SCHEMES CURRENTLY IN USE WHICH MIGHT ARGUABLY BE CALLED 'ABUSIVE'.

The US and UK have also added a number of anti-hybrid and anti-repo rules to the new US/UK Treaty which came into effect on 1 May 2004. The Treaty contains an anti-hybrid rule in Article 1.8, removing Treaty protection, and hence all benefits, for certain TAIFs using hybrids – deferred subscription agreements, for example.

Both the Inland Revenue and the IRS have emphasised that the purpose of double tax treaties is to eliminate the double taxation of income, not to permit double non-taxation. This doctrine establishes a clear test for the concept of 'treaty abuse'; it underlines the US anti-hybrid rules and the UK-US Treaty's Article 1.8; and will support the IRS in any court challenges to TAIFs.

A few days ago Congress passed a new law intended to wheedle out many, if not all, of the treaty-based schemes currently in use which might arguably be called 'abusive.' It requires the US Treasury to report by 30 June 2005 on all TAIFs which might be considered as treaty abuses, and is likely to lead to a substantial tightening of the US anti-abuse rules. This law's requirement for 'specific recommendations to address all inappropriate uses of tax treaties' puts a significant burden on the US Treasury to challenge questionable schemes of which it is aware, and which it has the power to close without legislation.

TAX AVOIDANCE DISCLOSURE RULES. Arguably, the two biggest and most innovatory steps the UK and the US have taken to reduce the use of TAIFs were to require advance warning of new schemes and to form a four country anti-TAIF team.

Moves in this direction started in 1995 when the IRS concluded that its biggest problem in combating TAIFs was that it learned about them too late. The IRS depended primarily upon its auditors to uncover new TAIFs, and audits generally lag the filing of corporate tax returns by two years or more.

The IRS thought it could eliminate this time lag by requiring taxpayers to disclose certain types of schemes in advance, and heavily penalising those who did not. Congress passed an anti-tax shelter law in 1997, allowing the IRS to issue regulations that required tax shelter 'promoters' – including banks, lawyers, and accountants – to register certain schemes before selling them. The IRS regularly publishes notices identifying certain transactions as abusive tax shelters.

These rules worked, although tax advisors fought them. For example, it was a US protective tax shelter filing two years ago which alerted the IRS to the deferred subscription agreements the UK and US are now investigating.

The UK followed the US's lead in developing an early warning system for tax schemes in March 2004 (see *News*, page 14, March, *The Treasurer*), when it announced legislation requiring the disclosure of tax avoidance schemes (DOTAS). The DOTAS rules apply very broadly to almost all TAIFs, whether realised through loans, stock, or derivatives. They require the promoter to register a scheme with the Inland Revenue when first offering it for use to a company. The promoter then receives a number, which must be attached to the tax return of any company using that scheme. If the promoter does not need to register the scheme, because, for example, it is a non-UK company or a law firm covered by the exception for legally privileged material, then the company using the scheme may have to register it instead.

The DOTAS rules are much broader than the US tax shelter rules, and will affect many more transactions. While they were aimed at the worst kinds of financings and, in particular, personal income tax avoidance structures, they will cover almost all TAIFs. The Inland Revenue is likely to scrutinise any registered scheme which it sees being used repeatedly and appears bold. It plans to change the law to eliminate schemes if it feels they are objectionable.

Six months ago, the UK and US complemented their tax avoidance early warning systems by setting up a rapid reaction team to make use of this information. The US, UK, Canada and Australia formed the Joint International Tax Shelter Information Centre (JITSIC) – a multinational tax 'taskforce' with international tax specialists from all four governments, which is based in Washington DC. Its goal is to use the US and UK tax avoidance early warning systems to find and jointly, or unilaterally, shut down abusive TAIFs.

SOX REQUIREMENTS. The two most recent developments that will reduce the use of TAIFs are the Sarbanes-Oxley Act (SOX) and the IRS' success in imposing penalties for using TAIFs. SOX has made it more difficult for accounting firms to continue to sell TAIFs to their audit clients because SOX requires this type of non-audit service to be approved by the client company's finance committee. Boards are now reluctant to use the TAIFs that their auditors propose.

Finally the US has taken the lead in imposing penalties on companies which use particularly daring schemes. In August 2004, a Federal District judge in Long Term Capital Holdings v. United States upheld penalties the IRS had levied against a taxpayer which had used a questionable international scheme to avoid tax on $100m in capital gains. This was despite the fact that the taxpayer had obtained ostensibly independent legal opinions that the scheme 'worked'.

Will TAIFs survive?

The US and UK clearly believe that cheap tax-advantaged financing is not right. But not all TAIFs are abusive, and it is unlikely that they will close down all of them. Those that survive will grow out of a rational commercial position, and will not be Treaty dependent.

If a TAIF meets the following criteria it is likely to be acceptable in the US and UK:

- **It is not primarily dependent on the UK-US Treaty for its benefits;**
- **There are good 'organic' business reasons to implement the scheme, regardless of the tax advantages;**
- **Independent second opinions from a respected QC on the UK side, and a reputable law firm unconnected to the promoter on the US side are obtained before entering the TAIF.**

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