

# THE STATE ADMINISTRATION OF INTERNATIONAL TAX AVOIDANCE

OMRI MARIAN\*

*This Article documents a process in which a national tax administration in one jurisdiction is consciously and systematically assisting taxpayers to avoid taxes in other jurisdictions. The aiding tax administration collects a small amount of tax from the aided taxpayers. Such tax is functionally structured as a fee paid for government-provided tax avoidance services. Such behavior can be, and probably is, easily copied by other tax administrations. The implications are profound. On the normative front, the findings should fundamentally change our conceptual understanding of international tax competition. Tax competition is generally understood to be the adoption of low tax rates in order to attract investments into the jurisdiction. Instead, this Article identifies an intentional “beggar thy neighbor” behavior, aimed at attracting revenue generated by successful investments in other jurisdictions, without attracting actual investments. The result is a distorted competitive environment in which revenue is denied from jurisdictions the infrastructure and workforce of which support economically productive activity. On the practical front, the findings suggest that internationally coordinated efforts to combat tax avoidance are missing an important part of the tax avoidance landscape. Current efforts are largely aimed at curbing aggressive taxpayer behavior. Instead, this Article proposes that the focus of such efforts should be on curbing certain rogue practices adopted by national tax administrations.*

*To explain these arguments, this Article uses an original dataset. In November 2014, hundreds of advance tax agreement (ATAs) issued by Luxembourg’s Administration des Contributions Directes (Luxembourg’s Inland Revenue, or LACD) to multinational corporate taxpayers (MNCs) were made public. One hundred and seventy-two of the documents are hand-coded and analyzed. The analysis demonstrates that LACD cannot be reasonably viewed—as some have suggested in LACD’s defense—as a passive player in tax avoidance schemes of multinational taxpayers. Rather, LACD is best described as a for-profit manufacturer of tax avoidance opportunities.*

## INTRODUCTION

In November 2014, The International Consortium of Investigative Journalists (ICIJ) made public hundreds of leaked, privately negotiated advance

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tax agreements (ATAs).<sup>1</sup> These ATAs were issued by Luxembourg's *Administration des Contributions Directes* (Luxembourg's Inland Revenue or LACD), primarily to multinational corporate taxpayers (MNCs).<sup>2</sup> This Article analyzes an original dataset, generated from a hand-coded sample of 172 of these leaked ATAs. The analysis makes several important contributions—both descriptive and normative—to international tax law literature.

Descriptively, this Article demonstrates that our understanding of international tax competition, and the role of tax havens in such competition, is outdated. International tax competition is generally understood to be the adoption of favorable tax regimes, or explicitly low tax rates, to attract investment.<sup>3</sup> The analysis of LACD administrative practices shows a different pattern. LACD assisted multinational taxpayers to erode the tax base in jurisdictions *other than Luxembourg*, without attracting any real investment into Luxembourg. Luxembourg's tax administration served as a conduit, or intermediary agent, between the jurisdiction of the investor (residence jurisdiction) and the jurisdiction of the investment (source jurisdiction), eliminating the tax bases both at the source and the residence. In return, LACD earned what is best described as fees for tax-avoidance services.

This Article also shows how a jurisdiction can become a tax haven by *administrative practice*. While a formal definition of a “tax haven” is elusive,<sup>4</sup> it is generally understood that tax haven jurisdictions possess two important characteristics: low statutory tax rates and strict secrecy laws.<sup>5</sup> The results demonstrate how such features can be generated by opaque administrative practices, rather than by explicit statutory prescriptions. In fact, Luxembourg's tax laws look nothing like one might expect from a tax haven. Luxembourg's corporate tax rate is about 29%, higher than the rate in most industrialized jurisdictions.<sup>6</sup> It has anti-tax avoidance measures in place<sup>7</sup> and requires taxpayers who seek favorable administrative rulings to have a sub-

<sup>1</sup> Advance tax agreements are discussed further below. See *infra* Part II.B. Generally, however, they are assurances given by the tax administration to the taxpayer regarding the tax treatment of a particular transaction.

<sup>2</sup> See Leslie Wayne et al., *Leaked Documents Expose Global Companies' Secret Tax Deals in Luxembourg*, INT'L CONSORTIUM INVESTIGATIVE JOURNALISTS (Nov. 5, 2014, 4:00 PM), <http://www.icij.org/project/luxembourg-leaks/leaked-documents-expose-global-companies-secret-tax-deals-luxembourg>.

<sup>3</sup> See *infra* notes 140–45 and accompanying text.

<sup>4</sup> See Dhammika Dharmapala, *What Problems and Opportunities are Created by Tax Havens?*, 24 REV. ECON. POL'Y 661, 662 (2008) (“Although tax havens have attracted widespread interest (and a considerable amount of opprobrium) in recent years, there is no standard definition of what this term means.”).

<sup>5</sup> *Id.* at 662–63 (“Bank secrecy laws (another common feature) have attracted great attention, although they appear to be of declining significance owing to growing international efforts to promote information-sharing among the tax authorities of different countries . . .”).

<sup>6</sup> Comparative corporate tax rates can be obtained at the OECD Tax Database. See *OECD Tax Database*, OECD (May 2016), [http://www.oecd.org/tax/tax-policy/tax-database.htm#C\\_CorporateCapital](http://www.oecd.org/tax/tax-policy/tax-database.htm#C_CorporateCapital). For a comparison of the 2015 fiscal year, see *Corporate Income Tax Rates*, OECD (May 2016), <http://stats.oecd.org/Index.aspx?QueryId=58204>.

<sup>7</sup> Of particular relevance is Luxembourg's thin capitalization guidance. See *infra* Part III.B.3.

stantive presence in Luxembourg.<sup>8</sup> Nonetheless, during the sample period, Luxembourg enabled taxpayers to eliminate their tax liabilities through administrative rulings. Luxembourg did this by issuing binding yet unpublished agreements without reviewing taxpayers' submissions<sup>9</sup> and without asking taxpayers for information where information was obviously missing.<sup>10</sup> At the same time, Luxembourg ignored its own administrative guidance,<sup>11</sup> binding intergovernmental legal procedures,<sup>12</sup> and well-established principles of international tax law.<sup>13</sup>

This Article labels Luxembourg's administrative behavior as "arbitrage manufacturing." Arbitrage manufacturing can generally be described as a process in which a jurisdiction issues a regulatory instrument to a taxpayer who resides outside the jurisdiction, in respect of an investment located outside the jurisdiction, in return for a fee. This regulatory instrument is designed to synthetically generate differences between the tax laws of the jurisdictions of source and residence. The taxpayer can then take advantage of the manufactured differences and eliminate most of its tax liability on the profitable activity.

On the normative front, the processes are disconcerting. Any country that has an income tax can copy Luxembourg's behavior. The expected result is a distorted form of tax competition.<sup>14</sup> Proponents of tax competition view "interjurisdictional competition as a beneficent force that . . . compels public agents to make efficient decisions."<sup>15</sup> Competition based on arbitrage-manufacturing, however, is unlikely to discipline public agents in the way envisioned by efficiency-based arguments. Moreover, skeptics of tax competition warn that "in their pursuit of new industry and jobs, state and local officials will hold down taxes . . . to such an extent that public outputs will be provided at suboptimal levels."<sup>16</sup> Arbitrage manufacturing, in all likelihood, is expected to generate such undesirable outcomes.

In addition, the findings shed light on the role of tax havens in tax competition.<sup>17</sup> Here too scholars are divided.<sup>18</sup> The traditional view of tax

<sup>8</sup> LUX. MINISTRY OF FIN., LUXEMBOURG MINISTRY OF FINANCE POSITION PAPER ON TAX TRANSPARENCY AND RULINGS (Oct. 12, 2014) [hereinafter POSITION PAPER ON TAX TRANSPARENCY], [http://www.mf.public.lu/publications/divers/gov\\_position\\_rulings\\_101214.pdf](http://www.mf.public.lu/publications/divers/gov_position_rulings_101214.pdf) ("In order to be able to be granted a ruling, it is mandatory for companies to demonstrate to the Luxembourg tax authorities that they have appropriate economic substance and are genuinely active in Luxembourg . . .").

<sup>9</sup> See discussion *infra* Part II.C.

<sup>10</sup> See discussion *infra* Part III.B.2.

<sup>11</sup> See discussion *infra* Part III.B.3.

<sup>12</sup> See discussion *infra* Part III.B.4.

<sup>13</sup> See discussion *infra* Part III.B.2.

<sup>14</sup> See discussion *infra* Part IV.

<sup>15</sup> Wallace E. Oates & Robert M. Schwab, *Economic Competition Among Jurisdictions: Efficiency Enhancing Or Distortion Inducing?*, 35 J. PUB. ECON. 333, 333 (1988).

<sup>16</sup> *Id.* at 334.

<sup>17</sup> See discussion *infra* Part IV.

<sup>18</sup> See Dharmapala, *supra* note 4 (summarizing the academic debate on the role of tax havens in global economy).

havens is a negative one<sup>19</sup>: Tax havens are “parasitic” in the sense that they poach revenue from other jurisdictions,<sup>20</sup> and they commercialize their jurisdictions<sup>21</sup> by allowing taxpayers from non-haven economies to “rent” residence.<sup>22</sup> This results in an intensifying tax competition that “forces non-haven countries to set lower tax rates than they otherwise would, thereby reducing the supply of public goods.”<sup>23</sup> On the other hand, the new view of tax havens is more sanguine. Under this view, tax havens are “benign”<sup>24</sup> participants in the global economy. These small-size jurisdictions can offer no economies of scale opportunities to investors. Therefore, tax havens can only meet their revenue needs from mobile capital, which they attract by offering low, or no, taxation on returns from such capital.<sup>25</sup> Moreover, tax havens may actually benefit the global economy, as they mitigate some of the distortive effects of high taxes imposed by industrialized economies.<sup>26</sup> In the process, tax havens also improve the welfare of their own citizenry.<sup>27</sup>

Arbitrage manufacturing supports the traditional view of tax havens. The process of arbitrage manufacturing described herein eliminates most of the tax base in the jurisdiction where the economic activity takes place. Whatever little revenue left to be collected is diverted from the jurisdiction of economic activity to the jurisdiction that issues the arbitrage instrument (where no activity takes place). Arbitrage manufacturing is not designed to attract mobile investment that generates revenue. It is designed to poach revenue—generated by immobile investment—from other countries and represents a classic example of rent seeking.

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<sup>19</sup> *Id.* at 662.

<sup>20</sup> See Joel Slemrod & John D. Wilson, *Tax Competition with Parasitic Tax Havens*, 93 J. PUB. ECON. 1262 (2009) (developing a model of parasitic tax competition); see also GABRIEL ZUCMAN, *THE HIDDEN WEALTH OF NATIONS 1* (2015) (suggesting that tax havens “steal the revenue of foreign nations”).

<sup>21</sup> See Ronen Palan, *Tax Havens and the Commercialization of State Sovereignty*, 56 INT’L ORG. 151 (2002) (portraying tax havens as benefiting from a business model of sovereignty commercialization).

<sup>22</sup> *Id.* at 163.

<sup>23</sup> Dharmapala, *supra* note 4, at 671.

<sup>24</sup> Slemrod & Wilson, *supra* note 20, at 1261 (“[P]revious literature has modeled tax havens as a *benign phenomenon* that helps high-tax countries reduce the negative impact of their own suboptimal domestic tax policies.” (emphasis added)).

<sup>25</sup> See Adam H. Rosenzweig, *Why Are There Tax Havens?*, 52 WM. & MARY L. REV. 923, 948–57 (2010) (explaining the process by which small countries, with little tax base of their own, engage in competition for mobile capital in order to meet their minimum revenue needs).

<sup>26</sup> Qing Hong & Michael Smart, *In Praise of Tax Havens: International Tax Planning and Foreign Direct Investment*, 54 EUR. ECON. REV. 82, 92 (2010) (concluding that “[w]hile income shifting to tax havens may reduce revenues of high-tax jurisdictions and increase tax base elasticities, it tends to make the location of real investment *less* responsive to tax rate differentials”).

<sup>27</sup> See James. R. Hines, *Do Tax Havens Flourish?*, 19 TAX POL’Y & ECON. 65, 79–85 (2005) (finding that tax havens are doing better than comparable non-havens in terms of economic growth).

This Article also offers several observations.<sup>28</sup> Arbitrage manufacturing has real implications for international efforts to combat tax avoidance.<sup>29</sup> Current anti-avoidance efforts are largely aimed at coordinating the domestic tax laws of multiple jurisdictions, with the hope of preventing taxpayers from taking advantage of differences between national tax laws.<sup>30</sup> However, any jurisdiction can insert itself between the source and residence jurisdictions and create synthetic arbitrage opportunities through unpublished administrative rulings. The results demonstrate that Luxembourg's tax administrators functionally partnered with taxpayers from other jurisdictions to form a for-profit venture of arbitrage manufacturing.<sup>31</sup> Luxembourg's revenues were directly related to the amount of taxes saved by the taxpayers in other jurisdictions. Since the interests of the taxpayers and the tax haven jurisdiction are aligned in such context, there are good reasons to expect other jurisdictions to engage in similar behaviors. This suggests that internationally coordinated efforts to combat tax avoidance should shift some of their focus away from tax schemes designed by taxpayers to tax-reducing administrative practices.

The rest of the discussion is structured as follows: Part I briefly describes the LuxLeaks scandal (the affair in which the documents became public) as well as the data collected from the leaked documents. It also addresses some sampling issues and provides a few sample descriptors. Part II explains LACD's administrative practices as gleaned from the sample. Such practices enable arbitrage manufacturing to take place. Part III explains the substantive aspects of Luxembourg's arbitrage manufacturing practices by focusing on one clear example: conduit financing with debt-equity arbitrage. Part IV models a simple numerical presentation of Luxembourg's arbitrage manufacturing in order to demonstrate the profound effect the practice had on tax collection in other jurisdictions. Part V discusses some of the normative implications that the findings have for our understanding of tax competition as well as the role of tax havens in the global economy. This Article concludes with a discussion of the implications that the findings have for current international efforts to combat tax avoidance.

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<sup>28</sup> See discussion *infra* Part IV.C.

<sup>29</sup> This article only addresses tax havens in the context of tax avoidance, which refers to schemes that reduce taxes by presumably legal tax planning. This Article does not discuss tax havens in the context of *illegal* tax schemes, commonly referred to as tax evasion.

<sup>30</sup> See discussion *infra* Part V.C.

<sup>31</sup> At least one commentator portrayed Luxembourg's relationship with taxpayers as a for-profit partnership. Allison Christians, *Lux Leaks: Revealing the Law, One Plain Brown Envelope at a Time*, 76 TAX NOTES INT'L 1123, 1123 (2014) (referring to Luxembourg's tax ruling practice as a "public/private partnership of tax authorities and tax advisers for multinational corporations").

## I. SAMPLING AND DATA

A. *The LuxLeaks Affair*

Most of the ATAs were leaked to the ICIJ by a former employee at the PwC's Luxembourg office.<sup>32</sup> Publically dubbed "LuxLeaks,"<sup>33</sup> the leak allegedly exposed a systemic practice by which LACD aided MNCs to dramatically cut their tax bills in jurisdictions other than Luxembourg. Following the leak, MNCs were blamed for "channel[ing] hundreds of billions of dollars through Luxembourg and sav[ing] billions of dollars in taxes . . . ."<sup>34</sup> News reports suggested that MNCs were "helped" by LACD who "rubber-stamped tax-avoidance on an industrial scale."<sup>35</sup> The revelations triggered a special review by the European Parliament,<sup>36</sup> as well as fierce public criticism characterizing Luxembourg as a "global tax haven."<sup>37</sup> LuxLeaks eventually materialized into an investigation by the European Commission into the tax ruling practices of all EU member states.<sup>38</sup>

In its own defense, Luxembourg forcefully asserted that its administrative tax ruling practices were legal, from both domestic and European law perspectives.<sup>39</sup> In an odd turn of events, the President of the European Com-

<sup>32</sup> *Luxembourg Whistleblower Says He Acted out of Conviction*, THE GUARDIAN (Dec. 15, 2014, 6:16 PM), <http://www.theguardian.com/world/2014/dec/15/luxembourg-tax-avoidance-whistleblower-conviction>. The whistleblower, Antoine Deltour, was selected to be Tax Person of the Year for 2015 by the influential Tax Notes International. *Tax Analysts Announces Person of the Year Features for 2015*, TAX ANALYSTS (Oct. 10, 2016, 3:05 PM), <http://www.tax-analysts.org/for-the-press/press-releases/tax-analysts-announces-person-year-features-2015/181076>; see Teri Sprackland, *Antoine Deltour — The LuxLeaks Whistleblower*, 80 TAX NOTES INT'L 967 (Dec. 21, 2015).

<sup>33</sup> See Leslie Wayne & Kelly Carr, *'Lux Leaks' Revelations Bring Swift Response Around the World*, INT'L CONSORTIUM INVESTIGATIVE JOURNALISTS (Nov. 6, 2014, 6:00 PM) <http://www.icij.org/project/luxembourg-leaks/lux-leaks-revelations-bring-swift-response-around-world>.

<sup>34</sup> James Kanter, *Hundreds of Companies Seen Cutting Tax Bills by Sending Money Through Luxembourg*, THE NEW YORK TIMES (Nov. 5, 2014) (quoting Wayne et al., *supra* note 2), [http://www.nytimes.com/2014/11/06/business/international/hundreds-of-companies-seen-cutting-tax-bills-by-sending-money-through-luxembourg.html?\\_r=0](http://www.nytimes.com/2014/11/06/business/international/hundreds-of-companies-seen-cutting-tax-bills-by-sending-money-through-luxembourg.html?_r=0).

<sup>35</sup> Simon Bowers, *Luxembourg Tax Files: How Tiny State Rubber-Stamped Tax Avoidance on an Industrial Scale*, THE GUARDIAN (Nov. 5, 2014, 4:01 PM), <http://www.theguardian.com/business/2014/nov/05/sp-luxembourg-tax-files-tax-avoidance-industrial-scale>.

<sup>36</sup> See Amanda Athanasiou, *European Parliament Begins 'Lux Leaks' Review*, 77 TAX NOTES INT'L 939 (TA) (Mar. 16, 2015).

<sup>37</sup> See James Kanter, *Jean-Claude Juncker Breaks Silence Over Luxembourg Tax Issues*, THE NEW YORK TIMES (Nov. 12, 2014), [http://www.nytimes.com/2014/11/13/world/europe/jean-claude-juncker-luxembourg-corporate-taxes.html?\\_r=0](http://www.nytimes.com/2014/11/13/world/europe/jean-claude-juncker-luxembourg-corporate-taxes.html?_r=0).

<sup>38</sup> European Commission Press Release IP/14/2742, *State Aid: Commission Extends Information Enquiry on Tax Rulings Practice to All Member States* (Dec. 17, 2014).

<sup>39</sup> See Ministère des Finances, Grand-Duche de Luxembourg, *The Ministry of Finance Comments on the Practice of Advance Tax Decisions* (Nov. 6, 2014), [http://www.mf.public.lu/actualites/2014/11/lux\\_fisc\\_eng\\_061114/index.html](http://www.mf.public.lu/actualites/2014/11/lux_fisc_eng_061114/index.html) (asserting that "[t]he advance tax decisions issued by the Luxembourg tax administration are compliant with national, European and international law. Their legality is not contested."). In a Wall Street Journal article, the Luxembourg Finance Minister asserted that Luxembourg "fully complies with global standards and isn't a tax haven." See Matthew Karnitschnig & Robin Van Daalen, *Business-Friendly Bureau-*

mission, Jean-Claude Juncker, also defended Luxembourg's practices at the same time that the Commission under his charge continued its investigation.<sup>40</sup> In the periods relevant to the leaked ATAs, Juncker served as the Minister of Finance and later as the Prime Minister of Luxembourg. Juncker insisted that the reason for the dramatic reduction in tax rates achieved by MNCs is not Luxembourg's fault, but rather the "insufficient tax harmonisation in Europe."<sup>41</sup> In tax jargon, Juncker's defense refers to what is known as "international tax arbitrage." International tax arbitrage is the ability of MNCs to exploit differences (that is, the lack of legal convergence or "harmonisation") between the tax laws of jurisdictions involved in a cross-border transaction.

A simple example can illustrate how international tax arbitrage might work. Until recently, Ireland defined the tax residence of corporations based on the place of management.<sup>42</sup> The United States defines the tax residence of corporations based on the place of incorporation.<sup>43</sup> Before Ireland changed its law, a corporation could incorporate in Ireland but locate its management in the United States, thereby creating an entity that is "foreign" from the point of view of both Ireland and the United States. If such a tax arbitrage scheme is successful, no country asserts tax jurisdiction over the corporation.<sup>44</sup>

Juncker's defense portrays Luxembourg as a benign participant in taxpayers' tax avoidance plans. Obviously, Luxembourg's tax laws are not completely harmonized with those of other jurisdictions. Taxpayers, the argument goes, simply exploited legal differences in their tax planning.

Contrary to Juncker's assertion, Luxembourg was not a passive player in the tax arbitrage process. Rather, Luxembourg is best described as a manufacturer of synthetic arbitrage opportunities. When the tax laws of the residence and the source jurisdictions are harmonized, there are theoretically no

*crat Helped Build Tax Haven in Luxembourg*, WALL ST. J. (Oct. 21, 2014, 10:44 PM), <http://www.wsj.com/articles/luxembourg-tax-deals-under-pressure-1413930593>.

<sup>40</sup> See Kanter, *supra* note 37.

<sup>41</sup> See Bruno Waterfield, *Juncker Defends Luxembourg's Tax Arrangements as Legal*, THE TELEGRAPH (Nov. 12, 2014, 4:00 PM), <http://www.telegraph.co.uk/news/worldnews/europe/eu/11225662/Juncker-defends-Luxembourgs-tax-arrangements-as-legal.html>.

<sup>42</sup> See Ryan, O'Shea, and Fahy, 7170 T.M., *Business Operations in the Republic of Ireland*, at Part V.B (BNA).

<sup>43</sup> I.R.C. § 7701(a)(4) (2016).

<sup>44</sup> Indeed, a recent investigation by the Senate's Homeland Security and Governmental Committee, Permanent Subcommittee on Investigations found that a subsidiary of Apple Inc., Apple Operations International (AOI), engaged in such arbitrage. Between 2009 and 2012, AOI was able to accumulate \$30 billion in profits without Ireland or the U.S. asserting tax jurisdictions over such profits. These profits remained untaxed. See *Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.): Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. and Governmental Affairs*, 113th Cong. 9 (2013) (Statement of Sen. Carl Levin, Chairman, Permanent Subcomm. on Investigations and Thomas R. Carper, Chairman, Comm. on Homeland Sec. and Governmental Affairs) ("Apple Operations International, which from 2009 to 2012 reported net income of \$30 billion, but declined to declare any tax residence, filed no corporate income tax return, and paid no corporate income taxes to any national government for five years.").

tax arbitrage opportunities for taxpayers. Luxembourg, however, functioned as a jurisdictional conduit between the source and residence jurisdictions, thereby creating arbitrage opportunities that would not have been available had an investor invested directly in the source jurisdiction.

### B. Data Collection

The leaked ATAs were made available by the ICIJ in two batches. The first, which included 548 documents issued to 340 MNCs, was made public in November 2014. This batch was leaked by Antoine Deltour, a former employee at PwC's Luxembourg office. Naturally, the documents leaked by Deltour contained mostly documents drafted or submitted by PwC.<sup>45</sup> The second and significantly smaller batch of documents made public in December 2014 included ATAs as well as other documents issued to thirty-three MNCs. Another former PwC employee was apparently involved in the second leak.<sup>46</sup> Multiple tax advisory firms were involved in the second batch of documents. All the documents leaked by the ICIJ are publicly available online.<sup>47</sup>

It is difficult to tell what the exact size of the database is. While the ICIJ states that the first batch of leaked ATAs contains 548 documents, the exact number of documents in the second batch has not been explicitly stated by the ICIJ. Moreover, the number of documents in the first batch is not accurate for the purpose of this study. Not all of the leaked documents are ATAs. Some of the documents consist of tax returns, tax preparation materials, and other documents contained in PwC's client files. Such documents are excluded from the sample. On the other hand, multiple ATA submissions contain previously issued ATAs as attachments. Attached ATAs are coded as separate cases, thus increasing the sample size.

For this Article, 172 ATAs were randomly selected for coding. The documents were selected based on their order of appearance in the online database, which is arranged alphabetically according to the name of the taxpayer sponsoring the submission.<sup>48</sup>

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<sup>45</sup> Some documents attached to the PwC submission, particularly copies of past ATAs, were drafted by other tax advisory firms.

<sup>46</sup> *Secret Agreement Between PwC & Whistleblower Revealed*, LUXEMBURGER WORT (Apr. 30, 2016, 12:06 PM), <http://www.wort.lu/en/business/luxleaks-trial-secret-agreement-between-pwc-whistleblower-revealed-5724838b1bea9dff8fa76f2d>.

<sup>47</sup> The International Consortium of Investigative Journalists, EXPLORE THE DOCUMENTS: LUXEMBOURG LEAKS DATABASE (Dec. 9, 2014 4:00pm), <http://www.icij.org/project/luxembourg-leaks/explore-documents-luxembourg-leaks-database>.

<sup>48</sup> One caveat is that the dataset only contains ATAs submitted in English; however, the majority of the ATAs are issued in English. During the coding we came across eleven non-English rulings: nine in French and two in German (the exclusion of which reduces the potential sample size from 183 to 172). Since non-English rulings represent just about 6.00% of the full sample, a sample of English-only rulings is still suitable for a non-generalizable exploratory analysis intended to identify administrative practices.

### C. Sampling Problems

The ICIJ database, and hence the original dataset, suffer from several inherent shortcomings. To begin, the majority of the submissions were drafted by PwC Luxembourg. In fact, the sample contains only two documents submitted to LACD by firms other than PwC: one by KPMG and the other by Loyens & Loeff. Under such circumstances, the dataset is clearly not a good sample of the entire population of ATAs issued by LACD. At best, it can be viewed as a sample of ATAs issued to taxpayers advised by PwC Luxembourg. As such, the sample cannot be used for generalizable statistical inference.

Instead, the sample is used to perform a descriptive exploratory analysis of recurring administrative practices by LACD. The sample is appropriate for this purpose. Even if the sample is understood to describe the practices of PwC alone, the findings are still valid. PwC is the largest tax advisory firm in Luxembourg.<sup>49</sup> PwC Luxembourg employs 660 tax professionals,<sup>50</sup> more than any other tax advisory firm in Luxembourg.<sup>51</sup> Thus, the findings cover a significant part of Luxembourg's tax advisory market. Moreover, studies in organizational sciences have shown that path dependence plays a significant role in the operations of elite firms that compete for the same clientele.<sup>52</sup> For example, Rostain and Regan provide a detailed account of such practices in the U.S. tax-advisory industry during the tax-shelter era of the late 1990s.<sup>53</sup> They describe an institutionalization process in which a "lax regulatory environment and a highly competitive market for professional services" led to a "widespread and *systemic* episode of professional wrongdoing."<sup>54</sup> It is therefore expected that PwC's practices are, at minimum, reminiscent of practices of other large tax advisory firms in Luxembourg and representative of Luxembourg's common tax advisory practices.

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<sup>49</sup> PwC Luxembourg prides itself as being "the largest professional services firm in Luxembourg with 2,700 people employed from 58 different countries." See *About Us*, PwC LUXEMBOURG, <http://www.pwc.lu/en/about-us/index.jhtml> (last visited Dec. 5, 2016).

<sup>50</sup> See *Tax Services*, PwC LUXEMBOURG, <http://www.pwc.lu/en/tax.html> (last visited Dec. 5, 2016).

<sup>51</sup> For example, per the International Tax Review, PwC's 660 tax professionals are comparable to other Big Four accounting firms: Deloitte employs about 400 professionals in Luxembourg while EY employs about 200 tax professionals (EY touts its 200-strong practice as one of "Luxembourg's largest tax practices"). See International Tax Review, *World Tax Market Overview: Luxembourg*, WORLD TAX 2016, <http://www.itrworldtax.com/Jurisdiction/78/Luxembourg.html> (last visited Oct. 2, 2016, 11:28 AM).

<sup>52</sup> See, e.g., Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L. Q. 347, 348-49 (1996) (explaining that economic efficiencies and behavioral biases lead to standardization in legal practice of corporate contracting).

<sup>53</sup> See TANINA ROSTAIN & MILTON C. REGAN, JR., CONFIDENCE GAMES: LAWYERS, ACCOUNTANTS, AND THE TAX SHELTER INDUSTRY (2014).

<sup>54</sup> *Id.* at 4 (emphasis added). For a summary of this institutionalization process, see *id.* at 332-37.

Another problem with the database is that it only covers a specific time period. The sample covers ATAs issued between March 7, 2003, and September 29, 2010. It is possible that the practices identified are particular to this period. Legislative and economic considerations may create certain tax planning needs and opportunities that are not available in other periods. This may be particularly true in this case, since 140 ATAs (81.40% of the sample) were issued in 2009 and 2010, during the height of the global financial recession. Therefore, the practices identified herein arguably are particular to an environment of a financial crisis and not representative of standard tax planning behavior.

However, the limited timeframe covered by the database is not harmful to the validity of the results: very few of the ATAs in the sample were driven by financial loss considerations. Moreover, recent initiatives to combat tax avoidance have been driven in part by global financial recession.<sup>55</sup> In that sense, ATAs that were issued during the recession period, just before demands to act on tax avoidance took shape, seem especially relevant. In addition, the small part of the sample that does seem to be driven by financial losses provides a unique opportunity to observe administrative behavior at times of exigency. When tax structures executed under the assumption that profits will be generated are faced with a reality of financial losses, taxpayers scramble and revisit their planning schemes. Administrative responses to taxpayers' requests to change previously issued ATAs are particularly telling of the relationship between taxpayers and the tax administration.

An additional reason for which the limited sample period is not problematic is that the chief administrator in charge of the ATA process throughout the sample period also oversaw the process for the two decades preceding the sample period.<sup>56</sup> It is, therefore, reasonable to expect that the practices he employed in LACD during the sample period are similar to practices he employed in non-sample periods.

#### D. Coding and Variables

##### 1. The Contents of ATAs

An advance tax ruling, or ATA, "is a procedure that allows taxpayers to achieve certainty concerning the tax consequences of a contemplated transaction. Before carrying out a transaction, the taxpayer turns to the tax authorities for a binding ruling on the tax consequences of the transaction."<sup>57</sup>

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<sup>55</sup> See Yariv Brauner, *What the BEPS?*, 16 FLA. TAX REV. 55, 64 (2014) (discussing the financial crisis as one of the factors inducing current coordinated efforts to combat tax avoidance).

<sup>56</sup> See discussion *infra* Part II.A.

<sup>57</sup> Yonatan Givati, *Resolving Legal Uncertainty: The Unfulfilled Promise of Advance Tax Rulings*, 29 VA. TAX REV. 137, 139 (2009).

A typical ATA document contained in the database is comprised of a written submission made on behalf of the taxpayer, signed by the taxpayer's tax advisor, and addressed to LACD. The submission details the transactions at issue, as well as the legal and financial structures in respect of which an ATA is sought. In each submission, the taxpayer explains its position regarding how Luxembourg tax laws should apply to the transactions. In most cases, the ICIJ database also contains the supporting documentation attached to each submission (such as articles of association, purchase agreements, valuation reports, term sheets for financial instruments, and so on).

LACD's approval comes in the form of either an approval stamp or a one-page letter confirming the taxpayer's analysis. There are no submissions in the sample that have been declined by LACD, nor do any of the approvals contain substantive analysis by LACD. All taxpayer positions in the dataset are approved verbatim. The approval secures the tax treatment sought in the ATA.<sup>58</sup>

## 2. *Variables and Observations*

All ATAs contained in the sample were hand-coded. The coded variables can broadly be divided into three categories: taxpayer's characteristics variables, administrative process variables, and ATA substance variables. Below is a brief outline of each of the variable categories.

*Taxpayer's characteristics variables* concern the identity of the taxpayer who sponsors the ruling. Variables in this category include the taxpayer's legal form, whether the sponsor is publically traded, the location of the taxpayer's operational headquarters, and the taxpayer's industry segment. Where such items were not readily apparent from the submission itself, public filings (if available) for the relevant periods were consulted.

*Administrative process variables* refer to the identity of the advisory firm, as well as the individuals within the advisory firm involved in the submission. The coding also identifies the LACD official to the attention of which the submission is made, as well as the official approving the ATA. The ATAs were also coded for the length of the process (from submission to approval). To the extent the submission indicated the schedule of a process taking place prior to the official submission (such as prior meetings or conversations concerning the subject matter discussed in the submission), the coding took note of that as well.

*ATA substance variables* concern the types of legal assurances sought by the taxpayers from LACD. The observations here are too numerous to

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<sup>58</sup> Rulings provide "visibility and legal certainty, which is legitimately sought by companies." LUX. MINISTRY OF FIN., LUXEMBOURG MINISTRY OF FINANCE POSITION PAPER ON THE LUXEMBOURG'S GOVERNMENT POSITION ON THE PRACTICE OF ISSUING TAX RULINGS (Nov. 11, 2014) [hereinafter POSITION PAPER ON TAX RULINGS], [http://www.mf.public.lu/publications/divers/position\\_rulings\\_eng\\_101214.pdf](http://www.mf.public.lu/publications/divers/position_rulings_eng_101214.pdf).

note<sup>59</sup> but concern issues such as withholding tax, tax residence status, financial instruments characterization (debt or equity), the application of favorable tax regimes,<sup>60</sup> and the effects of bilateral tax treaties.

### E. Sample Descriptors

Table 1 summarizes the legal form of the taxpayers sponsoring the rulings. For these purposes, a “sponsor” is defined as the entity or individual at the top of the control chain of the Luxembourg entity that formally submits the request.<sup>61</sup>

TABLE 1 – LEGAL FORMS OF ATA SPONSORS

Type of taxpayer	Count (ATAs)	Percentage (ATAs)
Privately held entity	102	59.30%
Publicly traded entity	65	37.79%
Individuals	5	2.91%
Total	172	100%

I code as “individual” rulings in which a private entity sponsors the ATA, but such entity is wholly owned by individuals and such individuals are named in the submission. I count as “publicly traded” rulings in which the sponsor of the ATA is an entity wholly owned directly or indirectly by a publicly traded entity. I count as “private” all other rulings as well as two government-controlled entities (one controlled by the Chinese government and the other by the Emirate of Abu Dhabi).

Evidently, the majority of the ATAs are sponsored by private entities or individuals. Public entities that may have to disclose the content of agreements with tax authorities to investors could face reputational or trade-secret constraints, which prevent them from seeking ATAs to the same extent as private entities.<sup>62</sup> On the other hand, public entities may be pressured by their shareholders to aggressively seek high after-tax returns.

<sup>59</sup> Overall, the coding documented more than 780 requests for various substantive assurances sought by taxpayers.

<sup>60</sup> For example, under Luxembourg’s “participation exemption” regime, certain dividends received from foreign subsidiaries of certain Luxembourg corporations are exempt from corporate taxes in Luxembourg. See Moons, 7220 T.M., *Business Operations in Luxembourg*, at Part IV.A.3(a) (BNA) [hereinafter *Luxembourg BNA*]. Similarly, under Luxembourg’s “patent box” regime, 80% of the income of a Luxembourg corporation derived from intellectual property is exempt. See *id.* at VI.B.3(g).

<sup>61</sup> The other option would be to have the Luxembourg entity officially submit this request. The Luxembourg entity submitting the request is required to have substantive presence in Luxembourg. This Article questions the significance of this requirement below, at *infra* Part III.B.1.

<sup>62</sup> See Michelle Hanlon & Joel Slemrod, *What Does Tax Aggressiveness Signal? Evidence from Stock Price Reactions to News About Tax Shelter Involvement*, 93 J. PUB. ECON. 126 (2009) (finding that share prices sometimes react negatively to news of corporate involvement in tax controversies, though generally to a limited extent); Victor Fleischer, *A Brand New Deal: The Branding Effect of Corporate Deal Structures*, 104 MICH. L. REV. 1581, 1589

Chart 1 observes the location of the headquarters of each ATA sponsor (where available) as a percentage of the sample of sponsors ( $n = 174$ ).<sup>63</sup> An attempt to code the sponsor's tax residence proved futile: While some ATA submissions explicitly report the tax residence of the sponsors, most do not. This problem is exacerbated by the fact that different countries employ different rules for determining the tax residence of entities.<sup>64</sup> If the submission does not discuss the factors relevant to determining tax residence in the sponsor's home jurisdiction, it becomes impossible to determine tax residence with a reasonable level of confidence.

In addition, many of the sponsors are privately held investment funds that are transparent for tax purposes in their country of residence.<sup>65</sup> In such a case, tax residence is rather meaningless, and the residence of the investors is the more meaningful variable. It is rarely the case, however, that an ATA submission by an investment fund exposes the identity of the investors in such fund.

Unlike tax residence, the location of the sponsor's operational headquarters is more easily observed. In many cases, headquarters locations are specifically reported in the submissions, or can rather easily be ascertained from public disclosures or even the sponsor's website. Moreover, compared with tax residence, the location of operational headquarters is probably a better descriptor of where sponsors direct their operations.<sup>66</sup> This is of particular importance in the case of Luxembourg, since the official position of the Luxembourg Ministry of Finance is that Luxembourg will only grant an ATA where the sponsors "demonstrate to the Luxembourg tax authorities that they have appropriate economic substance and are genuinely active in Luxembourg."<sup>67</sup>

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(2006) (discussing the effect of reputational considerations on the structuring of tax-savings schemes).

<sup>63</sup> Some ATAs are sponsored by more than one taxpayer, and therefore  $n$  is larger than the sample size.

<sup>64</sup> For a survey of such rules, see Omri Marian, *Jurisdiction to Tax Corporations*, 54 B.C. L. REV. 1613, 1619–28 (2013).

<sup>65</sup> For example, private equity funds that are not publicly traded are generally treated as partnerships for tax purposes. Generally, partnerships are transparent for U.S. tax purposes, unless publicly traded, in which case they are treated as corporations and subject to corporate tax. See I.R.C. § 7704 (2016).

<sup>66</sup> See Omri Marian, *Home Country Effects of Corporate Inversions*, 90 WASH. L. REV. 1, 72 (2015) (finding no clear evidence that the location of substantive corporate operation is associated with the place of corporate tax residence); see also Kimberly A. Clausing, *Should Tax Policy Target Multinational Firm Headquarters?*, 63 NAT'L TAX J. 741, 760 (2010) (finding little relationship between multinational firms' headquarters locations and tax policy variables).

<sup>67</sup> POSITION PAPER ON TAX TRANSPARENCY, *supra* note 8.

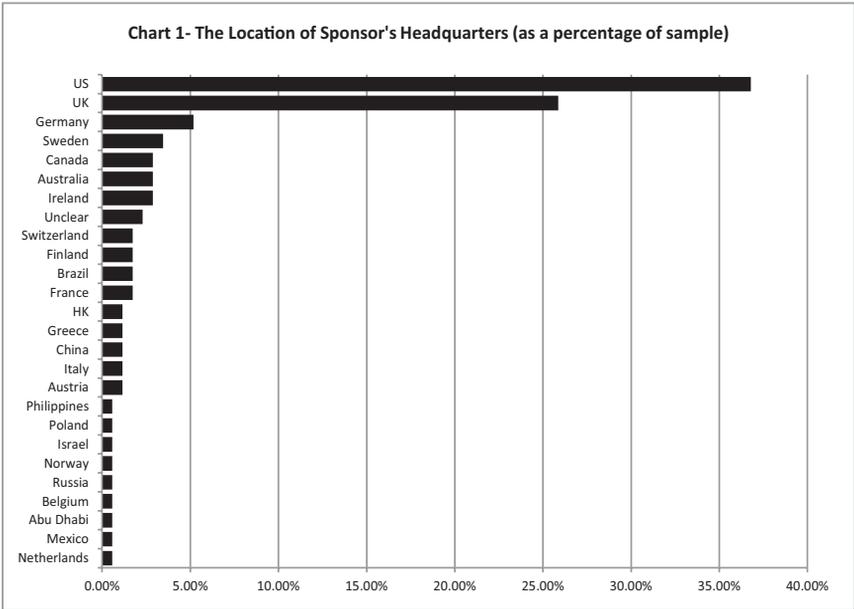


Chart 1 demonstrates that two jurisdictions completely dominate the sample: the United States and the United Kingdom. This is consistent with previous research on the LuxLeaks affair.<sup>68</sup>

Taken together, U.K. and U.S. headquartered sponsors account for almost two-thirds of all ATA entity-sponsors. While one might be tempted to explain this finding by the size of the economies involved, such a conclusion may be hasty. For example, some jurisdictions are extremely under-represented relative to the size of their economies (China, Japan, Russia, Brazil, not to mention India, which is completely absent), while others (such as the United Kingdom and Ireland) are overrepresented.

Therefore, it is possible that other issues are at play here. Several hypotheses can be suggested. One might speculate that taxpayers from some jurisdictions are more pressed than others to seek a reduction in effective tax rates. For example, if one jurisdiction exerts heavier tax burdens on its domestic taxpayers compared with similar jurisdictions, such domestic taxpayers may aggressively engage in tax planning in order to maintain their competitive stance. This explanation seems tenuous in this case, since there is currently no clear evidence showing that U.K. or U.S. MNCs face higher effective tax burdens than their foreign counterparts.<sup>69</sup>

<sup>68</sup> Birgit Huesecken & Michael Overesch, *Tax Avoidance Through Advance Tax Rulings - Evidence from the Lux Leaks Firms 20* (Sept. 25, 2015), <http://ssrn.com/abstract=2664631> (finding that “most ruling firms are headquartered in the United States, followed by European countries like Great Britain or Germany”).

<sup>69</sup> See, e.g., Gabriel Zucman, *Taxing Across Borders: Tracking Personal Wealth and Corporate Profits*, 28 J. ECON. PERSP. 121, 130–33 (2014) (describing the decline of U.S. effective

Alternatively, it is possible that lenient tax rules in certain jurisdictions make taxpayers from such jurisdictions more likely to seek Luxembourg rulings. For example, if it is necessary to gain tax residence in Luxembourg for the tax-reduction scheme to work, it may not be enough to secure an agreement from LACD that an entity is tax-resident in Luxembourg. The home jurisdiction of the sponsor must respect the “foreign” status of the Luxembourg entity as well. For U.S. sponsors, this is a non-issue, since the United States determines the place of tax residence for entities based on the place of incorporation.<sup>70</sup> Any entity incorporated in Luxembourg will be respected as “foreign” from a U.S. point of view, even if such entity has no substantive presence in Luxembourg. On the other hand, Germany (as well as many other countries) determines the place of tax residence based on the place of effective management.<sup>71</sup> If a Luxembourg entity lacks enough substance to be considered resident in Luxembourg from a *German* law point of view, a Luxembourg ATA that respects an entity as tax-resident in Luxembourg offers little solace to a German sponsor: Germany will still treat the entity as a German entity for tax purposes.

To put such discussion in policy relevant terms, it suggests that the tax laws of sponsors’ jurisdictions may play an important role in explaining why some jurisdictions are overrepresented or underrepresented. This implies that domestic laws and unilateral actions (rather than coordinated efforts) may play a role in preventing tax avoidance, even in a cross-border context. For example, sponsors from place-of-effective-management jurisdictions may find it difficult to easily establish Luxembourg shell structures. The reason is that a place-of-effective-management test will require the sponsors to actually move employees and assets to Luxembourg. This is much more expensive than to simply incorporate in Luxembourg, which is possible under a place-of-incorporation residence test.

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corporate tax rate over time and finding a “10 points decline in the effective tax rate between 1998 and 2013”); Edward D. Kleinbard, *‘Competitiveness’ Has Nothing to Do with It*, 144 *TAX NOTES* 1055, 1061 (2014) (“[T]here is no credible evidence as a matter of cash taxes or as a matter of GAAP accounting that U.S. firms are at a fundamental international business competitive disadvantage under current law.”); Reuven S. Avi-Yonah & Yaron Lahav, *The Effective Tax Rate of the Largest U.S. and EU Multinationals*, 65 *TAX L. REV.* 375, 383 (2012) (“U.S.-based multinationals do not face a tax-induced competitive disadvantage in competing against EU-based multinationals. Even though the U.S. statutory rate is ten percentage points higher than the average corporate statutory rate in the European Union, the effective U.S. corporate tax rate is the same or lower than the effective EU corporate tax rate for the largest U.S. and EU multinationals.”).

<sup>70</sup> See I.R.C. § 7701(a)(4) (2016).

<sup>71</sup> See Sieker, 7140 T.M., *Business Operations in Germany*, at Part V.A. (BNA).

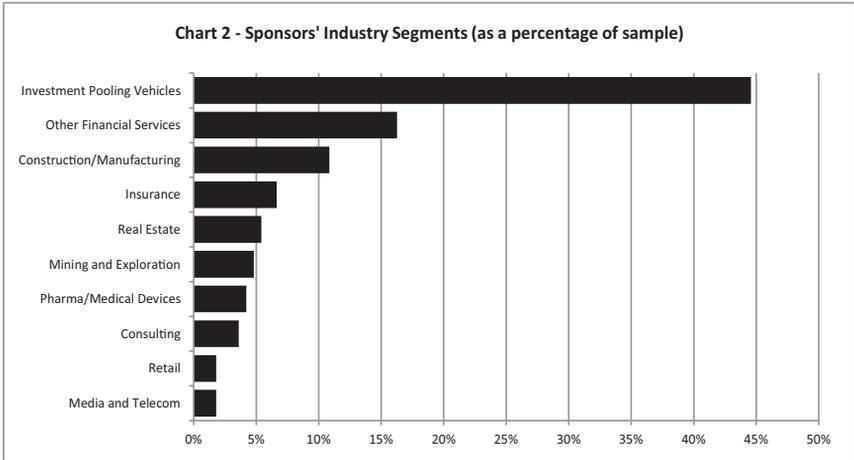


Chart 2 surveys of the industry segments of the sponsors (n = 168).

Chart 2 demonstrates the central role that financial intermediaries play in tax avoidance schemes involving Luxembourg. Of particular note is the fact that private, capital-pooling vehicles (such as private equity, venture capital and hedge funds) sponsor almost half of the ATAs. Equally interesting is the relatively minor appearance in the sample of industries that are heavily reliant on intangible property. Currently, international tax avoidance discourse is largely dominated by schemes executed by MNCs from research-dependent industries, such as pharmaceuticals and technology.<sup>72</sup>

The findings suggest that the focus on research-dependent industries may be somewhat unjustified.

## II. THE ADMINISTRATIVE PROCESS

This Part describes the findings as they pertain to the administrative process. Sections A and B describe the individuals controlling the process. Section C explains the timing of the process. The results presented here suggest that little or no substantive consideration is accorded to the submissions. Rather, the process seems like a negotiation between equal parties who are well acquainted with each other.

### A. “*Monsieur Ruling*” and the Improbability of Substantive Consideration

This section starts with a description of the individuals involved. At the end of the day, individuals execute the process, thereby shaping and creating

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<sup>72</sup> See, e.g., Andrew Blair-Stanek, *Intellectual Property Law Solutions to Tax Avoidance*, 62 UCLA L. REV. 2, 4 (2015) (“Intellectual property (IP) has become the leading tax-avoidance vehicle.”).

practices.<sup>73</sup> In Luxembourg, the administrative agency in charge of the ATA process is called Sociétés 6. During the relevant period, Sociétés 6 was a one man show. Marius Kohl, who headed Sociétés 6 for thirty-two years until his retirement in 2013,<sup>74</sup> “had sole authority . . . to approve or reject”<sup>75</sup> ATA submissions. Indeed, all ATA submissions in the sample were addressed to the attention of Kohl, and all ATA approvals were granted by Kohl. Within Luxembourg financial circles, Kohl has been nicknamed “Monsieur Ruling.”<sup>76</sup> After the revelation of the leaks, Kohl was included in *The Global Tax 50* for 2014, which is an annual list of the fifty most influential individuals and organizations in the tax profession, as selected by the *International Tax Review*.<sup>77</sup>

It is clear that an individual with absolute power to conclude ATAs, who holds such position for a prolonged period of time, plays a significant role in the administrative process. While a full discussion of this issue is beyond the scope of an exploratory article, it does raise several concerns regarding the integrity of the process that are worth addressing, even if only in brief.

Given the volume of submissions, it seems unreasonable to expect a single individual to substantively consider the merits of each submission, make an informed decision, and properly document his decisions. For example, on April 21, 2010, Kohl received eleven new ATA submissions that appear in the sample. He approved eight of them *the same day*, in addition to four other approvals he issued the same day in respect of previously submitted ATAs. The volume of April 21, 2010 submissions and approvals is most likely understated as it only contains submissions and approvals that appear in the sample. It is possible that Kohl issued additional ATAs that day. In fact, as further discussed below,<sup>78</sup> about 40% of the ATAs were approved the same day they were submitted (some of these submissions were hundreds of

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<sup>73</sup> See, e.g., Terence C. Halliday & Gregory Shaffer, *Transnational Legal Orders*, in *TRANSNATIONAL LEGAL ORDERS* 3, 6 (Terence C. Halliday & Gregory Shaffer, eds., 2015) (Actors who shape transnational legal order include “individuals whose activities and careers cross national boundaries”). For the tax context, see Philipp Genschel & Thomas Rixen, *Settling and Unsettling the Transnational Legal Order of International Taxation*, in HALLIDAY & SHAFFER 154, 163 (arguing that confining tax writing expertise to international organizations such as the OECD “allowed the experts to craft a compromise solution without major intervention from their political principals. The [relevant tax writing committee in the OECD] became the focal point of a transnational expert community of lawyers, administrators, and advisers.”).

<sup>74</sup> Karnitschnig & Van Daalen, *supra* note 39, at 7 (“In 2013, Mr. Kohl took early retirement, after 37 years at the tax office.”).

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> See *Global Tax 50 2014: Marius Kohl*, INT’L TAX REV. (Dec. 16, 2014), <http://www.internationaltaxreview.com/Article/3406724/Marius-Kohl.html>.

<sup>78</sup> See discussion *infra* Part II.C.

pages long). It is unlikely that Kohl was able to give substantive consideration to such submissions before approving them.<sup>79</sup>

This conclusion is also supported by the fact that none of the decisions issued by Kohl contain any form of substantive analysis. Rather, all ATAs contain only the written legal analysis of the sponsor, followed by Kohl's acceptance of such analysis verbatim. Kohl's approval decisions come in a cookie-cutter format that reads as follows:

Dear Sir/Madam,

Further to your letter dated [date of submission] and reference [past references, if relevant] relating to the transactions that [name of sponsor] would like to conduct, I find the contents of said letter to be in compliance with current tax legislation and administrative practice.

It is understood that my above confirmation may only be used within the framework of the transactions contemplated by the abovementioned letter and that the principles described in your letter shall not apply ipso facto to other situations.

The sample contains only one instance in which Kohl departed from such format. Even in that case, the only distinction is that at some point after the submission Kohl approached the sponsor's advisor with a request for additional information.

Important questions arise if, as is evident from the data, Kohl could not have possibly considered the merits of each submission. For example, based on what standards have the submissions been considered? Are there undocumented considerations at play? As far as administrative process is concerned, these questions weigh negatively on Luxembourg's practices.

### B. *The Tax Advisors*

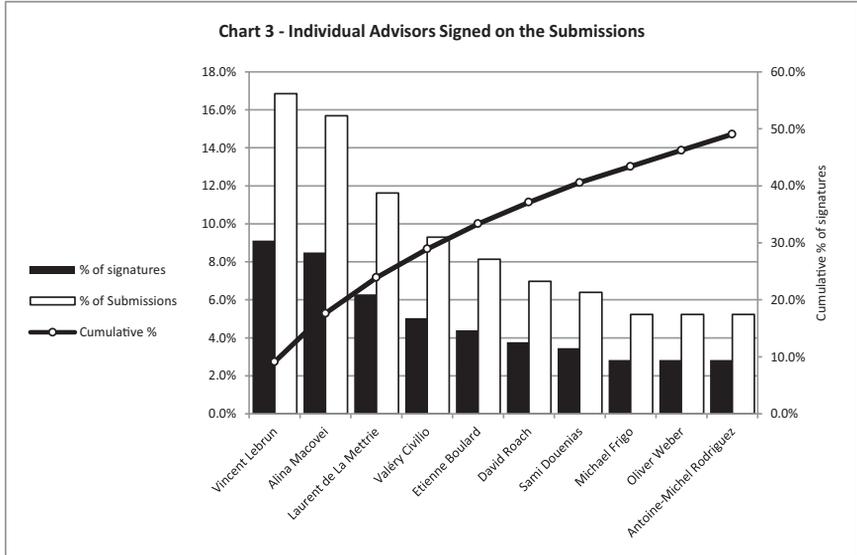
The role played by individual tax advisors is also a relevant consideration in the context of the administrative process. Tax practitioners "are not passive agents in the environment in which they work, but actors who create and maintain the institutions that structure practice."<sup>80</sup> This is particularly true in this case, where a single official completely controlled the process. If individual advisors are repeat actors, they may create close relationships with the official. This may affect the process and its outcomes.

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<sup>79</sup> See Lee A. Sheppard, *News Analysis: Luxembourg Lubricates Income Stripping*, 76 TAX NOTES INT'L 851, 851 (2014) ("Implausibly, rogue tax administrators in Luxembourg were giving so many rulings to multinationals that it was not possible to have read them all!").

<sup>80</sup> ROSTAIN & Regan, Jr., *supra* note 53, at 7.

The individuals who advised taxpayers in their ATA process are identified by name in each ATA submission.<sup>81</sup> Most ATA submissions were signed by two advisors. Overall, seventy-one different tax practitioners are involved in the submissions contained in the sample. Altogether, they have signed on the submissions in the dataset 318 times. The data in respect of the ten practitioners who appear most frequently in the sample are summarized in Chart 3.



For example, Vincent Lebrun, the leader of the private equity tax advisory group at PwC Luxembourg during the relevant period, signed almost 17% of the submissions and represents about 9% of all signatures. The top five practitioners in the sample account for a third of the total sample of signatures. The ten practitioners that appear most frequently in the sample account for almost half of the sample. Such an outcome implies a considerable concentration of PwC’s ATA practices in the hands of very few practitioners.

### *C. Timing of the Process*

Table 2 summarizes the period from the time advisors first engaged LACD, to the time a submission was made, to the time approval was granted.

<sup>81</sup> The assumption is that the individual practitioners signing the submission are in fact the ones who advised each ATA sponsor. Further, it is assumed that the content of the submission accurately represents the facts as understood by the individual advisors and that their legal conclusions accurately represent their opinion on the matter at hand.

TABLE 2 – TIMING OF THE ADMINISTRATIVE PROCESS (DAYS)

	Meeting to Approval	Meeting to Submission	Submission to Approval
n	98	98	170
Mean	104.46	88.64	18.92
Mode (count)	0 (11)	0 (19)	0 (68)
Q1	28	14	0
Q2	60.5	38.5	5
Q3	138.75	107.75	35
SD	124.94	124.85	27.82
Min	0	0	0
Max	588	547	198

The striking fact about the timing data is the frequency of instances in which LACD’s approval was granted the day of the submission. Sixty-eight of the ATAs, about 40% of the ATAs for which data are available, were approved the same day of the submission. Eleven of the ATAs, 11.22% of the ATAs for which data are available, were approved the same day that the taxpayer apparently first engaged LACD. These findings further exacerbate the suspicion discussed above that LACD, in many instances, did not give substantive consideration to the contents of the submission.

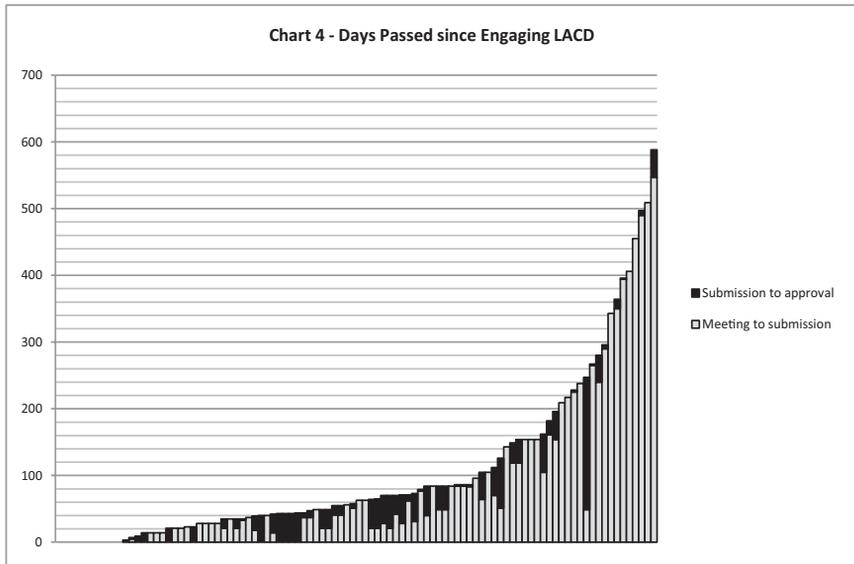


Chart 4 graphically displays the length of the process from initial engagement until formal submission and from formal submission until approval for each of the ninety-eight ATAs for which data is available (ATAs with a value of zero were approved the same day LACD was first engaged). Quite clearly, much time is spent before any formal submission is made. In

fact, of the total amount of days of process covered by this sample, about 85% were spent before formal submission, and only about 15% were spent after the submission. It seems that after a submission is made, hardly any time passes until formal approval. This further exacerbates the suspicion that the process of an ATA approval is a mere formality.

The Luxembourg Ministry of Finance addressed related issues after LuxLeaks broke, stating that “[b]ecause of its complexity, the ruling practice regarding the tax treatment of international corporate business usually requires by its essence and for the sake of clarification prefilling meetings where the taxpayer has the possibility to explain in a more detailed manner the planned transaction, before submitting a more formal written ruling request.”<sup>82</sup> This explanation, however, does not address the fact that very little time, if any at all, is spent by LACD scrutinizing taxpayers’ submissions.

It is not uncommon for taxpayers in many other jurisdictions to approach tax authorities prior to formal submission in order to gauge the receptiveness of the authorities to the taxpayer’s position. However, proper process dictates that the authorities will eventually substantively consider the actual submission on its merits, rather than rubber-stamp it. This is particularly true where no substantive justification for the authority’s decisions are provided and where the decisions remain unpublished.

As a contrarian example, consider the United States. In the United States, Private Letter Rulings (PLRs—the United States equivalent of an ATA) are always supported by a detailed substantive explanation of the IRS’s position to approve or deny the submission. Moreover, redacted versions of the PLRs are made public.<sup>83</sup> To the extent LACD was engaged in substantive discussions with taxpayers, it seems such discussions mostly happened before a formal process was launched. This means that substantive discussions were not documented, and it is impossible to extrapolate about their nature. This weighs negatively on the integrity of the administrative process.

### III. THE SUBSTANCE OF ARBITRAGE MANUFACTURING

The lack of administrative rigor described in Part III may allow taxpayers and tax authorities to base ATA determinations on desired outcomes, rather than on a clear set of legal standards. As explained in this Part, this indeed seems to be the practice. This Part surveys the types of substantive assurances that taxpayers sought to secure from LACD and identifies an administrative process best described as “arbitrage manufacturing.” One type of arbitrage manufacturing is described in detail: debt-equity arbitrage involving conduit financing. Before presenting the findings, however, some background on tax arbitrage and conduit financing is necessary.

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<sup>82</sup> POSITION PAPER ON TAX RULINGS, *supra* note 58.

<sup>83</sup> See I.R.C. § 6110 (2016).

### A. International Tax Arbitrage: Background and an Example

In its most basic definition, international tax arbitrage (ITA) “refers to a situation in which . . . taxpayers rely on conflicts or differences between two countries’ tax rules to structure a transaction . . . with the goal of obtaining tax benefits . . . .”<sup>84</sup> For example, if two countries define the tax residence of a corporation differently, it is possible to create a corporation that is tax-resident in no jurisdiction<sup>85</sup> or in both jurisdictions (such corporations are known as Dual-Residence Corporations or DRCs). A DRC can claim interest paid to a third-party lender as a deductible expense twice, once in each jurisdiction, and reduce tax liability in both jurisdictions.<sup>86</sup> The trademark characteristic of an ITA scheme is “full compliance with the laws of both jurisdictions while achieving a net tax savings.”<sup>87</sup>

In recent years, there seems to be an emerging consensus that ITA is a critical policy problem.<sup>88</sup> ITA is seen as inefficient, as it distorts taxpayers’ investment decisions; unfair, as it benefits high-income multinational taxpayers while shifting the tax burden to low-income and middle-income domestic taxpayers; and costly, as it reduces revenue and exacerbates national fiscal deficits.<sup>89</sup> ITA has also been singled out by the Organisation for Economic Co-operation and Development (OECD): The OECD is currently engaged in The Base Erosion and Profit Shifting (BEPS) Project, which is one of the most remarkable attempts to-date at a coordinated international effort to combat tax avoidance. The founding document of the BEPS Project decries MNCs’ exploitation of “differences in domestic tax rules and international standards that provide opportunities to eliminate or significantly reduce taxation.”<sup>90</sup> One of the action items of the BEPS Project is specifically aimed at eliminating arbitrage opportunities.<sup>91</sup>

The theoretical panacea to the ITA problem is full harmonization of tax laws. In the absence of differences in national tax laws, MNC taxpayers

<sup>84</sup> Diane Ring, *One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage*, 44 B.C. L. REV. 79, 80 (2002).

<sup>85</sup> See *supra* notes 43–44 and accompanying text.

<sup>86</sup> For a discussion of DRC-related arbitrage, see, for example, Ring, *supra* note 84, at 95–96; Adam H. Rosenzweig, *Harnessing the Costs of International Tax Arbitrage*, 26 VA. TAX REV. 555, 561–62 (2007).

<sup>87</sup> Rosenzweig, *supra* note 86, at 562.

<sup>88</sup> The OECD identified international tax arbitrage as a policy issue in 2012. See OECD, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* 5 (Mar. 2012).

<sup>89</sup> For a discussion of such negative aspects of international tax arbitrage, see Reuven S. Avi-Yonah, *Commentary*, 53 TAX L. REV. 167, 170–73 (2000). *But cf.* H. David Rosenbloom, *The David R. Tillinghast Lecture: International Tax Arbitrage and the “International Tax System”*, 53 TAX L. REV. 137, 140–41 (2000) (questioning whether international tax arbitrage is indeed an urgent policy problem).

<sup>90</sup> OECD, *Addressing Base Erosion and Profit Shifting*, at 5–6 (2013) [hereinafter *BEPS Project*].

<sup>91</sup> Action Item 2 of the BEPS Project is specifically aimed at curtailing international tax arbitrage. See OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report* (2015) [hereinafter *BEPS Action 2*].

have no arbitrage opportunities to exploit, and income from cross-border transactions is taxed in at least one jurisdiction (or it may be the case that the jurisdictions involved share the tax revenue under a bilateral income tax treaty). It is, of course, unrealistic to expect such a level of legal harmonization. Jurisdictions have therefore responded to ITA in two primary fashions. First, through periodic attempts at international coordination that would generate some, even if not full, harmonization in tax laws.<sup>92</sup> One contemporary example is the BEPS Project noted above. The other way jurisdictions are dealing with ITA is by acting unilaterally to deny tax benefits associated with certain ITA schemes.<sup>93</sup>

The study of Luxembourg's ATA practices suggests that our understanding of the ITA problem lacks an institutional dimension. The existence of such institutional dimension may explain the inadequacy of traditional solutions to ITA. Specifically, ITA is generally viewed as a taxpayer-centered phenomenon, where taxpayers are the active actors who take advantage of the differences in tax laws. State actors are generally understood to play a passive role. Contrary to such an approach, this Article argues that state actors may deliberately collude with taxpayers to create arbitrage opportunities.

If one ignores the institutional dimension of ITA, as is traditionally the case, then ITA is perceived as a dual-jurisdiction problem: When the tax laws of residence and source jurisdictions are different, taxpayers will take advantage of the differences.<sup>94</sup> If the tax laws of the source and residence jurisdictions were harmonized, compliance with the laws of both jurisdictions would yield no tax benefit. Referring back to our DRC example above, if the source and residence jurisdictions each define corporate tax residency the same way, a corporation can theoretically only be a tax resident in one jurisdiction or the other and can only claim interest deduction once.

However, what if a third jurisdiction—which is neither the source jurisdiction nor the residence jurisdiction—inserts itself as an intermediary be-

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<sup>92</sup> For a thorough discussion of harmonization of tax laws around the world, including past attempts for coordinated harmonization efforts, see Yariv Brauner, *An International Tax Regime in Crystallization*, 56 *TAX L. REV.* 259 (2003). For more recent examples of multilateral projects that addressed, among others things, harmonization of tax laws, see *Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)*, COM (2011) 121 final/2 (Oct. 3, 2011) (proposing common EU-wide rules for the determination of corporate tax base, known as the CCCTB); OECD, *Standard for Automatic Exchange of Financial Account Information in Tax Matters* (2014) (outlining a harmonized approach to tax reporting and exchange of tax information).

<sup>93</sup> For example, the I.R.C. denies a DRC the ability to deduct in the United States losses or other expenses that are potentially deductible elsewhere. See I.R.C. § 1503(d) (2016).

<sup>94</sup> Some differences will obviously always exist, resulting in at least some arbitrage opportunity. See Gregory May, *Getting Realistic about International Tax Arbitrage*, 85 *TAXES* 37, 37 (2007) (“National tax systems will continue to differ, resulting pitfalls and windfalls will remain and those who pay taxes will have a different point of view from those who collect them. Whatever consensus may prevail even among developed countries about normative principles for international taxation will not eliminate exploitable differences between their tax systems.”).

tween these two jurisdictions? Such intermediary jurisdiction could issue regulatory instruments that make it seem *as if* there exist differences between the tax laws of the source and residence jurisdictions. This is exactly the role played by Luxembourg in its ATA practice. For a fee, Luxembourg issues tax rulings to taxpayers that reside outside Luxembourg, in respect of investments outside Luxembourg. These regulatory instruments are structured so as to generate artificial differences between the source and residence jurisdictions.

To best understand this maneuver, a stylized example is helpful. The example uses one of the most prevalent forms of tax avoidance evident in the ATA submissions: debt-equity arbitrage with conduit financing.<sup>95</sup> A simplistic visual depiction of this form of planning is available in Appendix A. It is advised to follow the explanation below with the Appendix in hand.

Assume that a Country A investor wishes to invest in a manufacturing plant in Country B. To finance the investment, the investor sets up a Country A corporation, ResCo. ResCo then invests in a Country B corporation, SorCo, which owns the operational plant. Assume for now that ResCo finances the investment in SorCo directly (the right-side structure in the Appendix). ResCo can finance SorCo with debt, equity, or a combination of both.

If SorCo is directly financed with equity and the investment is successful, SorCo would pay corporate tax on its profits generated in Country B. A repatriation of the after-tax profits to ResCo will be in the form of dividends (on account of the equity investment). Most jurisdictions in the world do not tax dividends received from foreign corporations engaged in active business in a foreign jurisdiction.<sup>96</sup> Thus, the dividends to ResCo in Country A will

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<sup>95</sup> Tax advisors frequently mention debt-equity arbitrage financing involving Luxembourg as a primary reason to establish Luxembourg structures. See, e.g., Julien Bieber et al., *Private Equity Structuring In Luxembourg – Key Tax Aspects*, BNA INT'L INC.: TAX PLAN. INT'L REV. (May 6, 2011), <https://www.kpmg.com/LU/en/IssuesAndInsights/ArticlesPublications/Documents/Private-Equity-structuring-in-Luxembourg-BNA-May-2011.pdf> (“[M]any [Luxembourg entities] are financed through so-called ‘hybrid instruments’, which provide for a divergent qualification of the instrument at the level of the [Luxembourg entity] and at the level of the investors, in a view to optimise the cash repatriation and the overall tax charge.”); Jasper L. Cummings, Jr. & Edward Tanenbaum, *Convertible Preferred Equity Certificates*, ALSTON & BIRD TAX BLOG (Jul. 13, 2011), <http://www.alstontax.com/convertible-preferred-equity-certificates/> (“These [hybrid] instruments are often used within a multinational group to achieve cross-border tax arbitrage, to accomplish foreign or U.S. tax base erosion, or to engage in foreign tax credit planning.”).

<sup>96</sup> Most developed jurisdictions have in place some version of a “territorial” system of taxation, under which dividends from foreign corporations are mostly exempt from tax. See PHILIP DITTMER, TAX FOUND., A GLOBAL PERSPECTIVE ON TERRITORIAL TAXATION 2–3 (2012), [http://taxfoundation.org/sites/taxfoundation.org/files/docs/sr202\\_0.pdf](http://taxfoundation.org/sites/taxfoundation.org/files/docs/sr202_0.pdf) (“Overwhelmingly, developed economies are turning to the territorial approach.”). Few countries, of which the United States is one, have in place a “worldwide” system of taxation, under which income from whatever source is taxed. MNCs in such countries would insert an additional foreign subsidiary between themselves and the Luxembourg structures. Thus, payments from Luxembourg to such subsidiary will accrue to the additional subsidiary and will not be taxed until actually repatriated to the home jurisdiction, which may never happen.

not be taxed upon receipt. To summarize, in the case of equity financing, the earnings are only taxed once in the source jurisdiction, Country B, in the form of corporate tax.

If the investment is directly financed with debt, earnings are repatriated from SorCo to ResCo in the form of interest payments. Unlike dividends, interest payments made from SorCo are deductible, thus stripping SorCo's income in Country B and eliminating SorCo's corporate tax liability.<sup>97</sup> However, interest receipts from foreign controlled corporations are rarely exempt from taxation and, hence, will be taxed to ResCo in Country A upon receipt. Thus, in the case of debt financing, income is again taxed once, but this time in Country A, the country of residence. The bottom line is that in either case of direct investment profits are taxed, in Country B or in Country A, depending on whether the investment is financed with debt or equity.<sup>98</sup>

It would be great for the investor if he could devise a financing instrument that is treated as equity from a Country A perspective, but as debt from a Country B perspective. In such a case, Country B would treat payments from SorCo to ResCo as a deductible interest expense, while Country A would view the same receipts to ResCo as non-taxable dividends. The payment would strip out SorCo's income, yet would not be includable as income to ResCo. The result would be an effective elimination of tax on the profits. Such an opportunity would be available if Country A and Country B's tax laws differed on how they define debt or equity for tax purposes. Unfortunately for taxpayers, such an easy arbitrage opportunity is rarely available.

Enter Luxembourg (the left structure in the Appendix). ResCo could alternatively finance its Country B investment not directly, but through an intermediary shell entity in Luxembourg (IntCo). The unique aspect of this structure would be to finance IntCo with a financing instrument that—with the agreement of tax authorities in Luxembourg—would be treated as debt in Luxembourg, even though the instrument is structured to generate an equity-like return. Such a hybrid instrument can be structured, for example, by linking the payments on the instrument directly to SorCo's profits. IntCo then uses the proceeds from the hybrid instrument to finance SorCo with debt.

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<sup>97</sup> A U.S. corporation can generally strip up to 50% of the adjusted taxable income (adjusted gross income without deductions for interest and depreciation) by way of interest payment to a foreign parent. *See* I.R.C. § 163(j) (2016). It is possible to strip more of the tax base with other intercompany deductible payments (such as fees and royalties) or other mechanisms of tax planning.

<sup>98</sup> This result is the expected outcome of the "Single Tax Principle" of international customary law of taxation, under which "income from cross-border transactions should be subject to tax once (that is, neither more nor less than once)." REUVEN S. AVI-YONAH, *INTERNATIONAL TAX AS INTERNATIONAL LAW: AN ANALYSIS OF THE INTERNATIONAL TAX REGIME* 8 (2007); *see also id.* at 8–10 (discussing the Single Tax Principle).

Under the debt, SorCo makes deductible interest payments to IntCo and by doing so reduces SorCo's tax obligation in Country B.<sup>99</sup> Under the terms of the hybrid instrument, IntCo immediately pays the interest received from SorCo to ResCo. Since Luxembourg agrees to treat this payment as interest, it is deductible in Luxembourg, eliminating taxation of IntCo in Luxembourg. This aspect of an ATA is particularly important, since Luxembourg's corporate tax rate is nominally set at about 29.00%.<sup>100</sup>

Now the arbitrage comes into play. In Country A, the hybrid instrument's "interest" receipt from IntCo is classified as a dividend (and rightfully so since the receipts are directly related to the performance of the underlying investment). As such, the receipts are not taxable to ResCo. The result is that the investor was able to take advantage of how different jurisdictions define debt for tax purposes, even though both Country A (the residence jurisdiction) and Country B (the source jurisdiction) define debt similarly. The investor was able to do so because Luxembourg acted as an accommodation party and issued, for a small fee, an ATA that artificially generated an arbitrage opportunity. In the simplest terms possible, the ATA took a deductible interest payment from Country B and forwarded it to Country A as a non-includible dividend. This short example is simplified. Appendix B contains an actual example from the dataset, which explains how such a structure operates in practice.

### B. Luxembourg's Debt-Equity Arbitrage Manufacturing

This subpart describes the substantive assurances sought by taxpayers and explains how the most common assurances provide the building blocks of debt-equity arbitrage described above. It also demonstrates LACD's willingness to rule on such matters and create the synthetic arbitrage opportunity, even when the submissions seem to lack merit.

Each observation type is coded once for each submission.<sup>101</sup> The data is presented as the percentage total of ATAs in the sample in which such assurance is sought.<sup>102</sup> Chart 5 shows the most common requests made by sponsors (defined as requests that appear in at least 15% of the submissions and, thus, can reasonably be regarded as repeating ATA practices).

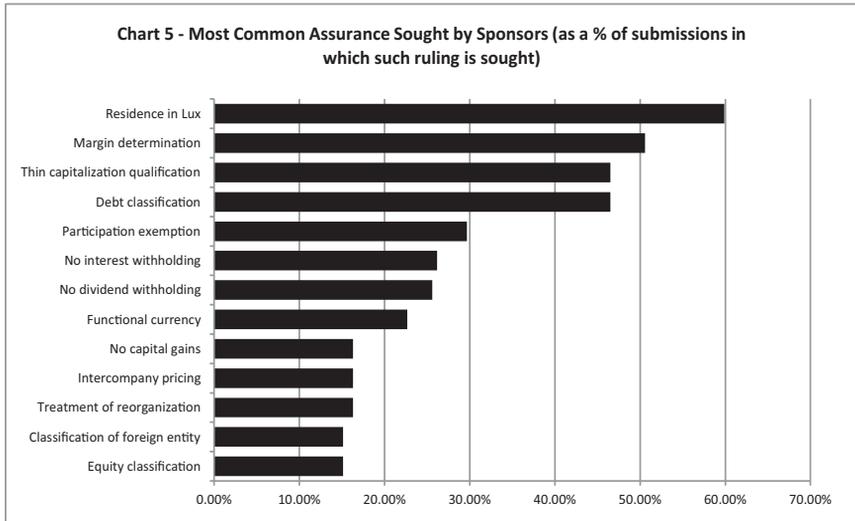
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<sup>99</sup> This scheme would work with any deductible payment made from SorCo to IntCo. For example, SorCo can pay fees to IntCo for "services" provided by IntCo to SorCo or royalties for the use of intangible property owned by IntCo.

<sup>100</sup> To be exact, for 2010 the Luxembourg statutory corporate tax rate was 21.00%. Combined with surtax and local corporate taxes of 6.75%, the rate was 28.59%. See *OECD Tax Database*, *supra* note 6.

<sup>101</sup> This means, for example, that even if residence determinations were sought in respect of multiple entities in a single submission, the submission is coded for residence only once.

<sup>102</sup> For example, if a taxpayer requested assurances in respect of the withholding rate on interest paid by multiple entities, the ATA will be coded only once with the observation "IntWh" to note that the ATA deals with interest withholding issues.



The four most common assurances sought by taxpayers are (1) the qualification of an entity as a resident in Luxembourg, (2) the margin or spread of payments subject to tax in Luxembourg, (3) qualification under Luxembourg's thin-capitalization guidance, and (4) the classification of a financial instrument as debt for Luxembourg tax purposes. As explained below, these are the necessary building blocks for a scheme of intermediary financing with debt-equity arbitrage. Appendix A is used again for purposes of the explanation.

First, the intermediary entity organized in Luxembourg (IntCo) must gain tax residence in Luxembourg in order to enable the back-to-back nature of the arrangement. As evident from Chart 5, residence determination is the most sought-after assurance from LACD.

Second, there is the issue of instrument classification. As explained above, the scheme only makes sense if payments from SorCo to IntCo are (1) deductible to SorCo (hence reducing SorCo's tax liability in the source jurisdiction) and (2) do not create taxable income to IntCo in Luxembourg. These goals can be achieved by having ResCo finance IntCo with debt, the interest in respect of which equals the amount of payments received by IntCo from SorCo. Obviously, this would be futile if the interest paid in respect of such debt is taxable to ResCo upon receipt in Country A. However, the problem is solved if Luxembourg is willing to grant an ATA, according to which the financing instrument will be treated as debt to IntCo, even though it is clear that Country A will treat the instrument as equity. In such a case, interest remains deductible to IntCo, but the payment to ResCo is treated as a dividend in the residence jurisdiction and is granted favorable tax treatment.

Since most industrialized jurisdictions tend to characterize debt or equity similarly, such an arbitrage opportunity would not be available to

ResCo if it invested directly in SorCo. This arbitrage opportunity is artificially manufactured by the ATA. Indeed, over 45% of the ATAs in the sample generate such arbitrage by the classification of hybrid financial instruments as debt for Luxembourg tax purposes (taxpayers seek assurances that the LACD will treat the instrument as debt despite it resembling equity).

The 45% figure understates the frequency of debt-equity arbitrage schemes since there are additional ways to generate such opportunities. For example, IntCo could finance SorCo with a hybrid *equity* instrument, which is treated as debt by SorCo (thus having the payments deductible to SorCo but not includible to IntCo). About 15% of the ATAs in the sample execute this type of arbitrage. The idea that manufacturing debt-equity arbitrage is central to Luxembourg's ATA practice<sup>103</sup> seems to be supported by the data.

Third, having achieved a hybrid debt-equity treatment for a financing instrument is not enough. Most jurisdictions employ some kind of thin capitalization safeguard measures. Thin capitalization rules are intended to make sure that the income tax base of a corporate entity is not completely eliminated by excessive deductible payments to foreign affiliates.<sup>104</sup> Luxembourg indeed has thin capitalization rules, promulgated by administrative guidance.<sup>105</sup> Under these rules, a Luxembourg corporation's debt-to-equity ratio must not exceed 85:15.<sup>106</sup> If the threshold is crossed, interest payments are re-characterized as dividends and therefore no longer deductible. In addition, dividends paid to a foreign taxpayer from a Luxembourg corporation are generally subject to a 15% withholding tax in Luxembourg (unless a tax treaty dictates a lower withholding rate).<sup>107</sup> Theoretically, this rule should prevent ResCo from financing IntCo with instruments that are classified as debt in excess of 85% of total financing.

Since the entire financing scheme relies on the deductibility of payments made from IntCo to ResCo, it is crucial to make certain that IntCo

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<sup>103</sup> See *supra* note 95 and accompanying text.

<sup>104</sup> See J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Getting Serious About Cross Border Earnings Stripping: Establishing an Analytical Framework*, 93 N.C. L. REV. 673, 680–84 (2015) (explaining how source taxation is eliminated by way of excessive intra-group interest payments). In the United States, I.R.C. § 163(j) (2016) disallows the deduction of “disqualified interest.” Section 163(j) is applicable if a U.S. corporation's debt-to-equity ratio exceeds 1.5 to 1. In such a case disqualified interest is, generally speaking, any interest in excess of 50% of EBITDA that is paid to a related foreign party, if such foreign party is subject to reduced taxation in the United States on such interest receipts. See *id.*

<sup>105</sup> See *Luxembourg BNA*, *supra* note 60, at Part IV.A.3.b(2).

<sup>106</sup> *Id.* See generally Jennifer Blouin et al., *Thin Capitalization Rules and Multinational Firm Capital Structure* 23–24 (Int'l Monetary Fund, Working Paper No. 14/12, 2014) (demonstrating that Luxembourg's debt-to-equity allowance—the equivalent of 5.66 in column 5 of the table—is higher than that of all other jurisdictions included in the table except for Switzerland).

<sup>107</sup> For example, under the Luxembourg-Canada income tax treaty, withholding tax on dividend payments from a subsidiary in one jurisdiction to its parent in another jurisdiction is limited to 5%. See Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, Can.-Lux., art. 10.2, Sep. 10, 1999, 2148 U.N.T.S. 557 [hereinafter *Canada-Luxembourg Tax Treaty*].

does not fail Luxembourg's thin capitalization rules. It is therefore not surprising that ATA determination regarding thin capitalization rules is common.

The first three steps described above complete the necessary scheme, at least as far as taxpayers are concerned. But one question lingers: Why would Luxembourg agree to help taxpayers eliminate tax liability in other jurisdictions, while at the same time allowing them to completely strip their income tax liability in Luxembourg (by allowing a deductible payment from IntCo to ResCo)? The answer, of course, is that Luxembourg charges a fee. The fee comes in the form of a margin that is determined in the ATA. The back-to-back payments from SorCo to ResCo (through IntCo) are not completely identical in amounts. Luxembourg—just like a bank in a wire transfer—demands that the taxpayer leave a small margin, or “spread,” in Luxembourg, which is taxable at the Luxembourg corporate tax rate. As shown in Chart 5, margin arrangements are the second most common assurance sought by MNCs.

To summarize, the most common substantive rulings sought by taxpayers in their submissions concern the building blocks of intermediary financing arrangements in which debt-to-equity arbitrage is the primary component. Such arrangements are not available to taxpayers who invest directly in their jurisdiction of choice.

Following such findings, the sample was consulted again to determine how many of the ATAs can be described as an arrangement in which the sponsor sought approval of an “intermediary financing arrangement.” For that purpose, this Article defines an intermediary financing arrangement as any financial structure in which Luxembourg is neither the source jurisdiction, nor the residence jurisdiction, and where the submission does not evidence any significant substantive presence of the sponsor in Luxembourg. One hundred and forty submissions, or about 81.40% of the sample, can be classified as such.

Given the centrality of financing arrangements to the findings, the practices concerning each of the building blocks of such arrangements were further investigated: gaining Luxembourg tax residence, debt-to-equity classification, thin capitalization qualification, and margin determination. The findings in respect of these are discussed immediately below.

### *1. Gaining Luxembourg Tax Residence: A Mere Formality*

Under Luxembourg law, a company is tax-resident in Luxembourg if it has its “statutory seat or principal establishment in Luxembourg.”<sup>108</sup> A company’s “principal establishment” is “the center from which the activities of a company are directed.”<sup>109</sup> The analysis in the ATA submissions in this regard

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<sup>108</sup> *Luxembourg BNA*, *supra* note 60, at Part VI.A.

<sup>109</sup> *Id.*

is extremely simplistic and rarely extends to more than one paragraph. Most submissions simply refer to the place of board or shareholders meetings as the place of central administration. This is a highly formalistic view of what constitutes corporate residence for tax purposes. Theoretically, all one needs to do to meet such interpretation is to travel to Luxembourg once a year and have a “board meeting” there. Investigative journalistic inquiries indeed found that several Luxembourg entities named in LuxLeaks had little substantive presence in Luxembourg.<sup>110</sup> Single addresses in Luxembourg City were found to be shared by thousands of companies (in one instance, as many as 1,600 companies shared the same address),<sup>111</sup> and the Luxembourg offices of huge multinational corporations are sometimes located in small residential apartments, staffed by a single person.<sup>112</sup>

Nonetheless, such minimal presence seems to be sufficient to gain tax residence in Luxembourg under the ATAs. This arguably contradicts the Luxembourg Ministry of Finance’s assertion that ATAs are only issued to entities with substantive presence in Luxembourg.<sup>113</sup> Rather, LACD’s view of residence seems to be almost completely devoid of any requirement for real presence, certainly when considering the vast amounts of funds transferred through such entities.

## 2. Debt or Equity Classification at the Whim of the Sponsor

Overall, the sample contains twenty-four different types of instruments in respect of which debt or equity classification has been requested. Chart 7 depicts the five most common instruments, and whether the request in respect thereof has been for debt or equity classification.

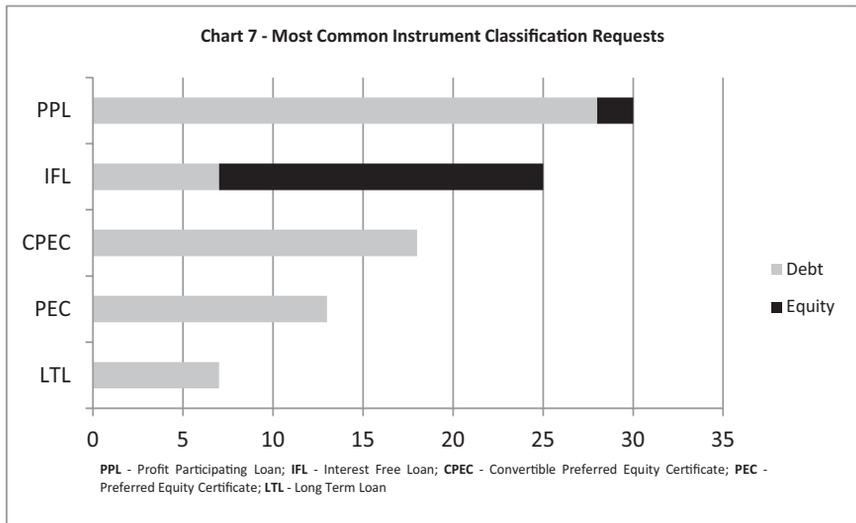
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<sup>110</sup> See Wayne et al., *supra* note 2 (reporting that “a Luxembourg office can be just a mailbox. Office buildings throughout the city are filled with brand-name corporate nameplates and little else”).

<sup>111</sup> *Id.*

<sup>112</sup> See Alison Fitzgerald & Marina Walker Guevara, *New Leak Reveals Luxembourg Tax Deals for Disney, Koch Brothers Empire*, INT’L CONSORTIUM INVESTIGATIVE JOURNALISTS (Dec. 9, 2014, 4:00 PM), <http://www.icij.org/project/luxembourg-leaks/new-leak-reveals-luxembourg-tax-deals-disney-koch-brothers-empire> (describing the Luxembourg offices of the Disney companies, which are located in a residential apartment, where a single employee serves as an officer in multiple companies).

<sup>113</sup> See *supra* note 8 and accompanying text.



In order to understand the data presented in Chart 7, a brief explanation of some of the instruments is warranted. For these purposes, Appendix A is again utilized.

A Profit Participating Loan (PPL) is an instrument in which one entity (typically a parent entity) finances an affiliated entity (usually a subsidiary), in return for interest payments consisting of two components: a small fixed component (usually not more than 1.00% per annum) and a variable component, which is directly linked to the profits of the affiliated entity, usually on a one-to-one basis. Most jurisdictions would characterize such instrument as some form of equity because the bulk of the return is linked to performance, and payments are made out of operational profits.<sup>114</sup> If ResCo finances IntCo with a PPL, “interest” paid from Luxembourg may be viewed by the residence jurisdiction as a dividend or some other form of return on equity. As demonstrated in Chart 7, however, Luxembourg is usually willing to treat PPLs as debt.<sup>115</sup> Thus, all payments on the PPL made from Luxembourg are deductible to IntCo, but generally not includible to ResCo.<sup>116</sup> Had such payments been made directly from SorCo to ResCo, they would probably be characterized as dividends by the source jurisdiction (because they represent a return on equity) and would not be deductible.<sup>117</sup>

<sup>114</sup> An exhaustive analysis of the distinction between debt and equity for tax purposes is beyond the scope of this text. For the relevant considerations, see DAVID C. GARLOCK ET AL., *FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS*, ¶102.01 (6th ed. 2010).

<sup>115</sup> Reading the submissions, it seems that the small fixed interest component is the most important factor in qualifying such instruments as “debt.”

<sup>116</sup> As explained above, if ResCo is resident in a jurisdiction that employs a “worldwide” system of taxation, it may be the case that an additional entity will be inserted between IntCo and ResCo. See *supra* note 96 and accompanying text.

<sup>117</sup> An additional benefit of such an instrument is that it can generate tax credits on foreign tax paid by SorCo if IntCo resides in worldwide jurisdictions. Certain dividends paid by sub-

Interest Free Loans (IFLs), as the name suggests, are financing instruments on which no interest is paid. If ResCo uses IFLs to finance IntCo and such instrument is classified as debt in Luxembourg, interest is imputed and deductible in Luxembourg to IntCo, even though no payments are made by IntCo. However, the jurisdiction of ResCo may treat such instrument as equity or, alternatively, not tax interest payments until actually made. Because no actual payments are made, the Luxembourg deductions are not matched by a corresponding inclusion to ResCo, since most jurisdictions generally do not impute income on equity holdings.

IFLs can also be beneficial to Luxembourg entities if classified as equity. For example, IntCo can choose to finance SorCo with an IFL. If the IFL is treated as debt from the source jurisdiction's point of view, accrued but unpaid interest will be deductible to SorCo. If Luxembourg agrees to treat the IFL as equity, the fact that no actual payments are made to Luxembourg eliminates any potential tax burden to IntCo.

In the sample, Convertible Preferred Equity Certificates (CPECs) are always viewed as debt for Luxembourg tax purposes. Other jurisdictions view CPECs as equity for tax purposes. A CPEC typically pays a fixed arm's length interest rate and is convertible to equity at the request of the holder. It should be noted that in all ATAs in the sample where the issue of arm's length interest has been discussed, LACD simply accepted the sponsor's assertion that the interest is arm's length. None of the submissions reviewed provided any support for the assertion that such intercompany interest is indeed arm's length.

CPECs are typically used by pooled investment vehicles as a way to strip income from IntCo and, at the same time, prevent corresponding inclusion to ResCo. The classification of a CPEC as debt in Luxembourg will generate an imputed deduction that will prevent accumulation of income in Luxembourg (which otherwise may be the result of payments received by IntCo from SorCo). Actual interest payments to ResCo are much lower than the imputed deduction, since the imputed deduction takes into account the conversion feature. In the alternative, CPEC interest payments may be linked to the performance of the underlying investment (like in the case of PPLs). Upon maturity of the investment, CPECs are converted to equity, which then produces equity-related returns that are favorably taxed to ResCo. Any conversion payments are nonetheless treated as deductible interest in Luxembourg.

Preferred Equity Certificates (PECs) are similar to CPECs but usually lack the conversion feature. Therefore, PECs generally pay a higher interest

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subsidiaries of U.S. corporations carry with them credits in respect of taxes paid by subsidiaries in foreign jurisdictions. The assumption is that such dividends are not deductible for the subsidiary. PPLs, however, are deductible for the subsidiary and are nonetheless viewed as "dividends" that entitle the recipient to a credit. Thus the payment generates a double tax benefit: a deduction at the source jurisdiction and a credit at the residence jurisdiction. In 2010, Congress enacted I.R.C. § 909 to combat such perceived abuse. *See* I.R.C. § 909 (2016).

payment than CPECs. PECs' interest payments are frequently only made out of available funds (though deductions in respect thereof continue to accrue to IntCo). Since IntCo will only have funds available if SorCo is profitable, PECs' returns appear to be very linked to the performance of SorCo. PECs are also redeemable at the option of the holder. Such features make PECs financially similar to equity, yet Luxembourg agrees to treat them as debt.

Evidently, the financing instruments used by MNCs in their Luxembourg structures are extremely versatile. The bottom line, however, is that Luxembourg is willing to classify instruments that produce an equity-like return as debt.

Another important issue in this context is the enforcement of intercompany debt. The classification of instruments issued by a parent to its wholly owned subsidiary as "debt" is almost always suspicious. One might question to what extent a parent will enforce debt obligations against a non-performing subsidiary. A lack of enforcement may evidence the fact that the parties never truly regarded the instrument as debt.

Indeed, the sample contains thirteen ATAs in which sponsors requested to waive an obligation on an instrument previously characterized as debt, issued by a currently non-performing subsidiary. These usually came up in the context of the 2008 financial crisis, when investments made through Luxembourg performed poorly. Under accepted tax principles, however, a debt waiver would generate taxable income to the obligor. Instead, sponsors of debt waiver rulings explicitly stated that due to the special relationship between the borrower and the lender, the waiver should instead be treated as a contribution of additional capital, which is not a taxable event.<sup>118</sup> This implies that the debt was never truly regarded as debt by the sponsor, but rather as intercompany equity. It thus seems acceptable practice not to enforce intercompany debt, still treating it as debt as long as it performs but as equity once it does not.

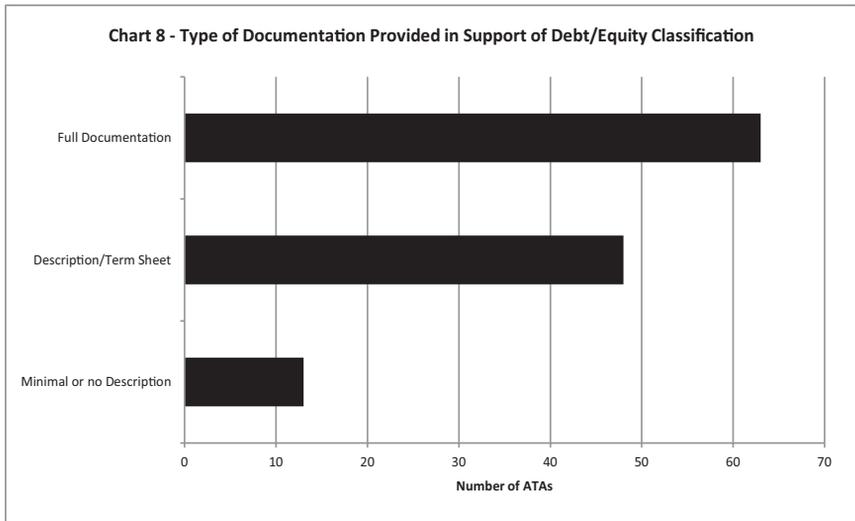
To summarize, the first observation from Chart 7 is that Luxembourg is willing to go to great lengths to classify instruments in ways that benefit taxpayers, even though it is quite clear that such classifications do not follow the economic reality of the instrument.

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<sup>118</sup> See, e.g., Advance Tax Agreement Submission from Mold-Masters Lux. Acquisitions S.a.r.l., to LACD (Jan. 28, 2010) at 3, <https://assets.documentcloud.org/documents/1345255/3i-2010-tax-ruling.pdf> (requesting that "accrued interest on the sub-debt will be waived and the holders of the sub-debt will each forgive part of their respective share of the sub-debt," and that "the waiver should be treated taxwise as an 'informal capital contribution' *given the related party relationship between the lenders and the borrower*" (emphasis added)); Advance Tax Agreement Submission from Belfor Lux. S.a.r.l to LACD (Nov 11, 2009) at 2, <https://assets.documentcloud.org/documents/1345380/belfor-2009-tax-ruling.pdf> (contending the debt waiver "is justified only by the *shareholder relationship and not by a commercial reason*, therefore it will be considered as a 'supplement d'apport' under the meaning of Article 18 § 1 of the Luxembourg Income Tax Law in the sense of a hidden contribution. As a result, this waiver of debt from Belfor Gibraltar to Belfor Lux will not be a taxable event from a corporate income tax and a municipal business tax perspective." (emphasis added)).

Another obvious observation that emerges from Chart 7 is that LACD is not always consistent in its characterization of financial instruments. Interest Free Loans, for example, seem to be characterized as either debt or equity at the request of taxpayers. Profit Participating Loans, while usually characterized as debt, have been classified as equity in at least two cases.

Maybe the most direct evidence of the lenient LACD approach to the classification of financial instruments is the type of documentation submitted by taxpayers to support the requested classification. Chart 8 summarizes the data in this regard for 124 submissions for which such data could be ascertained.



Proper administrative procedure would dictate that LACD classification of a financial instrument will be made based on close scrutiny of the terms of the instrument. However, only about half of the submissions for which data are available (50.81%;  $n = 63$ ) seem to provide LACD with the full documentation of the instrument. About 38.71% ( $n = 48$ ) only describe the terms of the instrument in the submission itself but provide no actual documentation of the instrument. In 10.48% ( $n = 13$ ) of the submissions, there is almost no description of the terms. Nonetheless, in all cases, LACD was willing to rule on the classification of the instrument.

One submission in the sample is especially egregious. In that case, the sponsor explicitly acknowledged that no documentation is provided and that the terms of the instrument had yet to be determined. The taxpayer promised to provide such documentation in the future (without committing to a specific date). Yet, an ATA was issued in respect of that instrument on the same

day of the submission, classifying the instrument as debt (apparently without even considering the terms of the instrument).<sup>119</sup>

### 3. *Ignoring Luxembourg's Own Thin Capitalization Guidance*

Luxembourg has no statutory thin capitalization law. "In practice, the tax administration applies a debt/equity ratio of 85:15."<sup>120</sup> The existence of such practice is supported by the fact that ATA sponsors frequently seek an assurance that that 85:15 threshold is not violated.

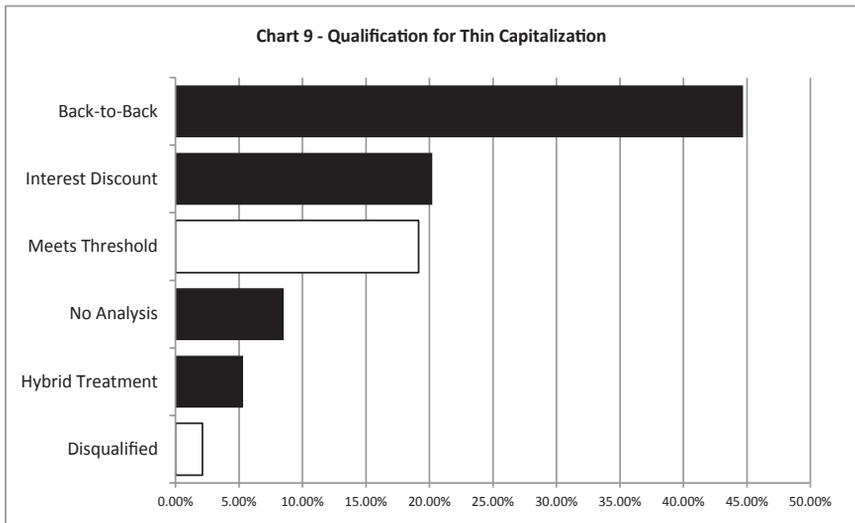
However, a close look into LACD's ruling practices teaches that the 85:15 ratio is lip service. In fact, of the ninety-four Luxembourg entities in the sample for which thin capitalization assurance was sought, only eighteen (19.14%) actually met the threshold. In only two instances, the sponsor conceded that an entity did, in fact, fail to meet the threshold and would therefore face adverse tax results.<sup>121</sup> In all of the other cases, the Luxembourg entities at issue clearly failed the 85:15 test. Nonetheless, in all such instances, the ATA provided sponsors assurances that they will not be sanctioned for failing to meet the threshold. Chart 9 outlines the justifications made by taxpayers in the submissions (and accepted by LACD) to avoid the sanctions of Luxembourg's thin capitalization rules.

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<sup>119</sup> See Advance Tax Agreement Submission from Dean Foods Eur. Holdings S.a.r.l., to LACD (Mar. 10, 2010) at 3, <https://assets.documentcloud.org/documents/1345440/dean-foods-2010-tax-ruling.pdf> ("A copy of the executed MFA [Master Facility Agreement] will be provided to you at a later date . . . . The MFA will be considered debt for CIT, MBT and NWT purposes, and interest thereon will be considered fully tax deductible (see Enclosure 8 for a description of the MFA)."). Enclosure 8 adds no information other than that the facility will be comprised of two tranches that each will carry arm's length interest. The enclosure does not describe even the most basic terms such as the face amount of each tranche, the interest rates, or the term to maturity.

<sup>120</sup> Linda Brosens, *Thin Capitalization Rules and EU Law*, 13 EC TAX REV. 188, 200 (2004).

<sup>121</sup> This is shown as "disqualified" in Chart 9.



The most common justification for the non-application of the 85:15 threshold is that the entity is in a back-to-back position in respect of its debt to a controlling entity (in Appendix A, IntCo's debt to ResCo is back-to-back to SorCo's debt to IntCo). The argument goes as follows: Since the Luxembourg entity is in a back-to-back position in respect of the underlying investment, it will only have to make deductible interest payments up the chain if the underlying investment is successful. The Luxembourg entity will not be required to make deductible payments if the investment fails (except maybe for a small fixed interest component), since no payment will be made from SorCo to IntCo.<sup>122</sup> Since the payments are linked, the Luxembourg entity (IntCo) does not present any true credit risk to its lender (ResCo) in respect of the financing activity. Therefore, the argument is that the back-to-back financing activities should not be taken into account for purposes of calculating the debt-to-equity ratio.<sup>123</sup>

Financially speaking, such an argument makes sense. The back-to-back financing indeed does not generate any credit risk normally associated with debt financing. However, it also begs the question: If the back-to-back payments represent a return on investments rather than a credit risk, why did LACD agree to treat such financing as debt in the first place? There seems to be no reason for such classification other than to generate deductible payments.

<sup>122</sup> See, e.g., Advance Tax Agreement Submission from RREEF Global Opportunities Fund II, LLC, to LACD (Jun. 24, 2009) at 22, <https://assets.documentcloud.org/documents/1345444/deutsche-bank-2009-tax-ruling.pdf> (describing the back-to-back position of the financing structures, arguing that such structures should not be taken into account for purposes of calculating the 85:15 ratio).

<sup>123</sup> *Id.*

LACD and the taxpayers are holding the stick at both ends here. On the one hand, they argue that the financing arrangement presents enough debt-like features so as to have payments on the financing instrument treated as deductible interest. On the other hand, they claim that the instrument is not really debt, so thin capitalization rules are not triggered. This defies basic financial logic. Thin capitalization rules and debt-to-equity rules are aimed at the same purpose: preventing excessive income stripping by way of interest deduction. If an instrument is classified as debt, thin capitalization rules are there to specifically prevent excessive deduction. Luxembourg's ATA practice effectively allows for lenient debt classification while at the same time eliminating the safeguard against lenient debt classification.

The second most popular way sponsors ask for qualification of thin capitalization rules is by discounting the interest paid by the Luxembourg entity.<sup>124</sup> For example, even if an entity is 100% debt-financed, there will be no excessive deduction if the interest paid is discounted 15% to market rate. In such a case, the amount of interest deduction would be the same as if the 85:15 ratio had been met and interest been paid at market rate.

The discounted rate method in Luxembourg's ATAs practice, however, seems questionable at best. While sponsors agree to discount interest on debt-classified instruments by 15% below market rate, the submissions in the sample rarely substantiate the level of market rate. More importantly, the 15% discount almost always applies to the fixed component of the interest. For example, a PPL with a fixed interest of 1.00% per annum and a variable rate of 100% of the underlying profits is excluded from the 85:15 calculation if the *fixed component* is discounted to 0.85%. The variable component (which represents the bulk of the financial return) remains deductible in full.

The most egregious form of qualification is an explicit statement that even though an instrument has been qualified as debt for interest deduction purposes, the sponsor intends to treat it as equity for thin capitalization purposes, which defies the basic logic of thin capitalization rules (this is shown as "Hybrid Treatment" in Chart 9).<sup>125</sup>

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<sup>124</sup> See, e.g., Advance Tax Agreement Submission from Ace Group – Luxembourg Restructuring to LACD (Mar. 10, 2010) at 5, <https://assets.documentcloud.org/documents/1345271/ace-group-2010-tax-ruling.pdf> ("Given that the fixed and variable interest on the PPL will be discounted by 15%, LuxCo will comply with the 85: 15 debt-to-equity ratio requirement applied in Luxembourg's practice for the intragroup financing of participations."). The fixed component of the PPL in this case was 0.85% after the discount. The profit participating component was 85% of the net accounting profit from the underlying investment.

<sup>125</sup> An example is warranted. In a 2009 ATA issued to Baring, a private equity fund, interest-free CPECs issued by a Luxembourg entity were classified as debt. This meant that any amount paid in respect of the CPEC (as well as any potential imputed interest) would be deductible as interest in Luxembourg. Notwithstanding that fact, Baring went on to suggest that since the "CPECs are interest-free, they will be deemed to be equity for Luxembourg thin capitalisation purposes only." Advance Tax Agreement Submission from Baring Private Equity Asia IV Holding (7) S.a r.l., to LACD (Mar. 18, 2009) at 3, <https://assets.documentcloud.org/documents/1345370/baring-private-equity-asia-2009-tax-ruling.pdf>.

Interestingly, eight ATAs in the sample provide no analysis of thin capitalization rules, other than a blanket statement that the rules are not triggered.

To summarize, LACD does not follow Luxemburg's administrative thin capitalization rules. At best, one can view them as leverage that LACD can use to draw taxpayers into seeking an ATA.

#### 4. *Margin Determination and the Problem of State Aid*

Probably the most important assurance that sponsors receive in an ATA concerning a financing arrangement is the amount of taxes to be paid in Luxembourg. This represents the fee that Luxembourg charges for generating the arbitrage opportunity for the taxpayer. Effectively, a margin determination is an agreement by Luxembourg to a fixed formula that determines, in advance, the amount of taxes to be paid by the sponsor in Luxembourg.

Luxembourg imposes corporate taxes at a nominal rate of about 29.00%. However, since the Luxembourg entity is in a back-to-back position, all income received from the source jurisdiction is eliminated by the matching deductible payment to the residence jurisdiction. LACD agrees to do that provided that a small spread remains taxable in Luxembourg. In that sense, Luxembourg simply operates as a rent-seeking conduit for the transfer of funds from the source jurisdiction to the residence jurisdiction.

The determination of the taxable spread seems to depend solely on the face amount of financing made through Luxembourg. The spread diminishes as the amount financed through Luxembourg increases. For example, an ATA issued in 2008 to Doughty Hanson, a British private equity firm, provides the following taxable margin determination:<sup>126</sup>

TABLE 3 – MARGINS CHARGED BY LUXEMBOURG

Face Amount Financed through Luxembourg (in EUR millions)	Taxable Margin
< 25	0.25%
25 to 187.5	0.125%
187.5 to 500	0.09375%
500 to 1,250	0.0625%
1,250 to 6,250	0.03125%
> 6,250	0.015625%

<sup>126</sup> Advance Tax Agreement Submission from Project Doughty Hanson & Co Real Estate Fund II to LACD (Dec. 3, 2008) at 28, <https://assets.documentcloud.org/documents/1345458/doughty-hanson-2008-tax-ruling.pdf>.

Luxembourg's fee structure is obviously built to incentivize taxpayers to increase the amounts transferred through Luxembourg. However, the amount of tax paid in Luxembourg is completely unrelated to any actual activity in Luxembourg. Luxembourg's revenue from an ATA is directly linked to the profits generated in *other* jurisdictions that are transferred through Luxembourg. It is important to note that investment behavior is not changed, meaning that the income-generating activity is still happening outside Luxembourg (at the source jurisdiction). Luxembourg does not operate to attract investment. Rather, Luxembourg operates to collect revenue from the tax bases generated by profitable investments in source jurisdictions.

In one particularly egregious scenario, LACD agreed to collect a fixed spread based on the amount of financing, even though the amount actually netted by the Luxembourg entity was *larger* than the agreed-upon spread.<sup>127</sup> In that case, the Luxembourg entity derived a profit of 0.269% of the face amount of financing. Notwithstanding that fact, the ATA assured that only a margin of 0.125% would be taxed. Simply put, Luxembourg agreed to exempt more than half the income *actually earned* in Luxembourg.

One curious aspect of such a fee structure is that it has already been subject to scrutiny by the European Commission. A 2002 investigation by the Commission explored whether Luxembourg's method of taxable margin determination "might confer an advantage on finance companies," thus constituting state aid, which is forbidden under the Treaty on the Functioning of the European Union.<sup>128</sup> As explained in the Commission Decision on the matter, Luxembourg previously determined taxable spreads on financing activity based on an official circular issued in 1989.<sup>129</sup> Under the circular, a minimum intra-group spread of 0.25% was considered appropriate and would, under certain circumstances, be reduced to 0.125%.<sup>130</sup> This circular, however, was withdrawn in 1996.<sup>131</sup> One of Luxembourg's main arguments in its own defense was that since the circular had been withdrawn and was no longer in force, the procedure was moot.<sup>132</sup> Nonetheless, Luxembourg made lengthy arguments to the Commission as to why such margin determination procedures should not be regarded as illegal state aid.

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<sup>127</sup> Advanced Tax Agreement Submission from Argan Capital - Project H to LACD (Oct. 22, 2008) at 3, <https://assets.documentcloud.org/documents/1345318/argan-capital-2008-tax-ruling.pdf> ("Luxco will derive a 0.269% gross margin on its back-to-back position as a difference between the interest rates applied on the promissory note (i.e., 12%) and the interest-bearing PECs (i.e., 11.731%). However, considering the amounts involved and the financing risk's profile, the taxable profit realised by Luxco in relation to its financial activities will be considered as appropriate and acceptable insofar as it represents a net taxable margin of 0.125%.").

<sup>128</sup> The terms of the circular are discussed in Commission Decision 2003/438, 2003 O.J. (L 153) 40, ¶ 14 [hereinafter Commission Decision].

<sup>129</sup> *Id.* ¶ 7, 10.

<sup>130</sup> *Id.* ¶ 10.

<sup>131</sup> *Id.* ¶ 7.

<sup>132</sup> *Id.* ¶ 16.

The Commission rejected most of Luxembourg's arguments and concluded that the 1989 circular indeed constituted state aid,<sup>133</sup> mostly on the basis that the margin determination seemed to be determined arbitrarily and had no link to the substance of operations in Luxembourg.<sup>134</sup> However, the Commission did not impose any sanctions on Luxembourg, noting "that the system was withdrawn on 20 February 1996 and that the tax advantages granted to beneficiaries ceased on 31 December 2001."<sup>135</sup>

Notwithstanding that Luxembourg officially represented to the European Commission that it ceased its practice of arbitrary spread determinations, the sample tells a different story. Luxembourg seemed to have continued to determine spreads based solely on the amounts financed through Luxembourg and completely disconnected from the substantive activities taking place in Luxembourg. It even allowed margins lower than the minimum 0.125% prescribed by the withdrawn 1989 circular. Luxembourg's continued margin determination practice is therefore inconsistent with the representations Luxembourg made to the Commission in the context of the 2002 decision.

#### IV. THE RESULTS OF MANUFACTURED ARBITRAGE

While the conceptual operation of manufactured debt-equity arbitrage should by now be clear, numerical examples can help to demonstrate how shocking the outcome of such a scheme is, particularly from the point of view of the source jurisdiction.

Assume a taxpayer invests an amount  $F$  in the source jurisdiction. If the investment is expected to generate an annual pre-tax return  $i$  and the tax rate in the source jurisdiction is  $T_s$ , the amount of expected source taxation is:<sup>136</sup>

$$F \cdot i \cdot T_s$$

Assume, instead, that the taxpayer finances the investment through Luxembourg. Further, assume that all the return is stripped from the source jurisdiction in the form of deductible payment made to the Luxembourg intermediary. The source tax on the return is thus eliminated, and the taxpayer instead pays Luxembourg an amount based on the margin determined in the ATA. This amount can be expressed as follows:

$$(F_1 \cdot m_1 + F_2 \cdot m_2 + \dots + F_n \cdot m_n) \cdot T_i$$

<sup>133</sup> *Id.* § VI.

<sup>134</sup> *Id.* ¶ 43 ("The Commission thus concludes that finance companies and the groups to which they belong were able to derive an advantage by dint of the fact that, in practice, Luxembourg systematically granted the minimum rate without checking whether it corresponded to the economic reality of the underlying services.")

<sup>135</sup> *Id.* § VI.

<sup>136</sup> This assumes no withholding taxes on deductible payments from the source to the residence jurisdiction.

where  $m$  is the agreed upon margin in the ATA and  $T_l$  is Luxembourg's corporate tax rate of 29.00%. The subscripts represent the diminishing margins applied as the face amounts of financing increase. The effective (ETR) and marginal (MTR) tax rate on the investment can therefore be expressed as follows:

$$ETR = \frac{(F_1 \cdot m_1 + F_2 \cdot m_2 + \dots F_n \cdot m_n) \cdot T_l}{\sum F \cdot i}$$

$$MTR = \frac{F_n \cdot m_n \cdot T_l}{F_n \cdot i} = \frac{m_n \cdot T_l}{i}$$

For example, consider a UK investor seeking to make a €100 million investment in France, where the corporate tax rate is about 34%. Further, assume that intercompany deductible payments (from SorCo to ResCo) are made at a rate of 5.00%, which represents the expected return on the investment. In such a case the tax in France would be:

$$€100,000,000 \cdot 0.05 \cdot 0.34 = €1,700,000$$

Assuming Luxembourg would charge a margin of 0.25%,<sup>137</sup> the cost to the taxpayer in Luxembourg would be:

$$€100,000,000 \cdot 0.0025 \cdot 0.29 = €72,500$$

Thus, the taxpayer is paying Luxembourg €72,500 for a regulatory product (the ATA) that eliminates a French tax liability of €1.7 million. The effective tax rate that the taxpayer paid on its profits in France that were financed through Luxembourg is<sup>138</sup>:

$$\frac{0.0025 \cdot 0.29}{0.05} = 1.45\%$$

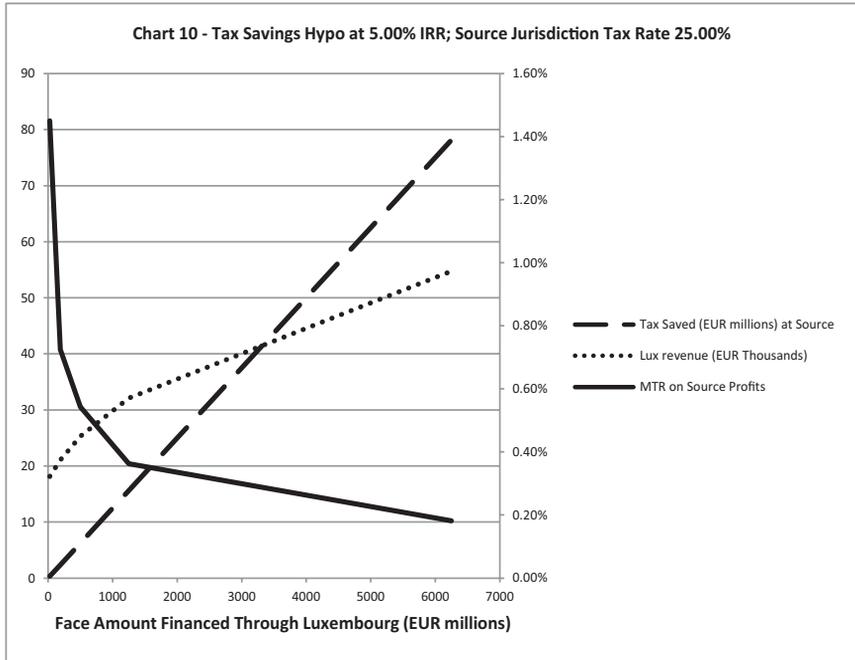
An effective tax rate of 1.45% is by all measures drastically low. Moreover, such low tax is only paid in Luxembourg (the arbitrage manufacturer). No tax is paid in France, where the investment is located. To the extent financing through Luxembourg is increased, the margin that Luxembourg would demand will decrease, thereby decreasing the effective tax rate. In addition, if the taxpayer is able to generate a higher intercompany deductible

<sup>137</sup> See *supra* Part III.B.4 (this is the maximum cost that Luxembourg charges).

<sup>138</sup> In this case, the effective tax rate is also the marginal rate, given that 0.25% is the first and last margin level.

payment, the effective tax rate would be further diminished. Indeed, the margins on some intercompany payments in the dataset are in double-digits.<sup>139</sup>

Using Table 3 above as a guide for margin determination, it is possible to present a simple graphic simulation of the tax savings outcomes, depending on the amounts financed through Luxembourg. Chart 10 displays the amount of tax saved in the source jurisdiction (in Millions), the amount of fee collected by Luxembourg (in Thousands), and the marginal tax rate on an investment. Chart 10 assumes a 5.00% annual return on investment and a source-jurisdiction corporate-tax rate of 25.00%.<sup>140</sup>



The chart tells a simple story: the more tax that is avoided in the source jurisdiction (where activity actually takes place), the greater the benefit for Luxembourg (where no activity takes place) and the lower the marginal tax rate for taxpayers. Luxembourg simply collects revenue from a tax base that was generated in other jurisdictions. Taxpayers' interests are aligned with Luxembourg's since they prefer to pay a marginal rate of, for example,

<sup>139</sup> See, e.g., discussion *infra* Appendix B (in that case the intercompany payments are made at a rate of about 14.00%).

<sup>140</sup> This is roughly the non-weighted average rate for OECD jurisdictions. See TAX FOUND., PUTTING A FACE ON AMERICA'S TAX RETURNS: A CHART BOOK 44 (Scott A. Hodge ed., 2nd ed. 2013).

1.45% to Luxembourg than 25.00% to the jurisdiction where income has been substantively created.<sup>141</sup>

## V. THE IMPLICATIONS OF ARBITRAGE MANUFACTURING

This Part discusses the normative and practical implications of arbitrage manufacturing. Subparts A and B explain arbitrage manufacturing in the context of the academic debate on the nature of tax competition and tax havens. Subpart C discusses arbitrage manufacturing in the context of current initiatives to combat international tax avoidance.

### A. Arbitrage Manufacturing and Tax Competition

#### 1. Arbitrage Manufacturing Unbundles Costs and Benefits

The idea that tax competition may be welfare-enhancing leans on the seminal Tiebout model,<sup>142</sup> and its multiple extensions, according to which “the level of expenditures for local public goods . . . reflects the preferences of the population.”<sup>143</sup> The model “links citizen mobility with preference revelation and predicts that locational decisions will reveal individual preferences for public goods and levels of taxation.”<sup>144</sup> Over the years the model has been extended to include multiple areas of law,<sup>145</sup> as well as locational investment decisions by business entities.<sup>146</sup> A Tiebout-based competition model predicts that “local public goods equilibrium will be established because, like producers of private goods and services, local government units will compete with their public goods offerings to attract new residents.”<sup>147</sup>

Arbitrage manufacturing as depicted in this Article does not fit the basic premise of the model because arbitrage manufacturing does not aim to create public goods in order to attract new investments. Arbitrage manufacturing as described herein is simply the process of transferring revenue generated by investment in one jurisdiction to the arbitrage manufacturer. The arbitrage manufacturer can satisfy its revenue needs with very little tax col-

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<sup>141</sup> Of course, taxpayers incur other costs associated with a Luxembourg ATA, such as the fees paid to tax advisors and the fees paid for incorporation of the companies. However, such fees are negligible compared to the amount of taxes saved.

<sup>142</sup> John Douglas Wilson, *Theories of Tax Competition*, 52(2) NAT'L TAX J. 269, 270 (1999) (“Tiebout (1956) argues that competition for mobile households is welfare enhancing, and subsequent work has applied similar ideas to competition for mobile firms . . .”).

<sup>143</sup> Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 416 (1956). For a discussion of the vast influence the model had on regulatory competition literature, see William W. Bratton & Joseph A. McCahery, *The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World*, 86 GEO. L.J. 201, 207–17 (1997).

<sup>144</sup> Bratton & McCahery, *supra* note 143, at 208.

<sup>145</sup> *Id.* at 209–12.

<sup>146</sup> Wilson, *supra* note 142.

<sup>147</sup> Bratton & McCahery, *supra* note 143, at 209.

lection because there is no need to finance public outlays required to support investment. The infrastructure-related expenditure is still borne by the jurisdiction where the operational investment is located. This is not the standard story of competition for capital. At best, it is a competition for *revenue*. At worst, it is government-sanctioned revenue-poaching.

Consider the following analogy: A family with school-age children may be willing to be burdened by high county taxes and live in County A, which offers an excellent public education system. A married couple without children, however, may rather live in nearby County B, which has a subpar public education system but very low county taxes. This is the “taxpayer preference revelation” the Tiebout model speaks of. Assume now that County B is able to create a regulatory instrument, which is issued for a fee, that declares a taxpayer resident in County B, except for public education purposes, in which case the taxpayer is considered resident in County A. The family could still send their children to the excellent public school system in County A but pay taxes as if it lived in County B.

Under such conditions, the competitive Tiebout equilibrium cannot be created, not even in theory. A Tiebout-type competitive model assumes that taxpayers will make locational investment decisions based on the mix of public benefits and the tax cost associated with them. Presumably, the more developed the infrastructure is in a jurisdiction, the higher the tax rate; government spending is needed to support such infrastructure. Arbitrage manufacturing enables taxpayers to unbundle costs and benefits. Taxpayers can locate their real activity in industrialized jurisdictions, thus enjoying the benefits of developed infrastructure. However, instead of paying presumably high taxes in the jurisdiction in which they operate, taxpayers can elect to pay the low tax charged by a jurisdiction with no infrastructure—a tax haven.<sup>148</sup>

Moreover, since arbitrage manufacturing is not intended to shift actual investment, it has no disciplining effect on governments in industrialized jurisdictions. The reason is that jurisdictions where real investment is actually located have no available competitive policy response to arbitrage manufacturing. The effective outcome of arbitrage manufacturing is to reduce taxation on successful investment to a near-zero rate. Industrialized jurisdictions simply cannot respond by lowering their own taxes to such a rate, and at the same time maintain their developed infrastructure. On the other hand, small tax haven jurisdictions such as Luxembourg, can collect a single-digit effective tax rate when such rate is applied to the broad tax base generated in *other* jurisdictions. Luxembourg is not required to finance any infrastructure or workforce necessary to support real investment. Thus, “competition” in this context is a misnomer. Industrialized jurisdictions with developed markets may compete with each other, but they cannot “compete” with tax havens that need not finance any infrastructure.

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<sup>148</sup> See also Palan, *supra* note 21.

The foregoing discussion demonstrated that arbitrage manufacturing is unlikely to bring about “welfare-enhancing” tax competition. Moreover, arbitrage manufacturing is likely to bring to fruition the negative aspects of inter-jurisdictional competition. The negative view of tax competition purports that “The result of tax competition may well be a tendency toward less than efficient levels of output of local services. In an attempt to keep taxes low to attract business investment, local officials may hold spending below those levels for which marginal benefits equal marginal costs . . . .”<sup>149</sup>

As explained above, industrialized jurisdictions cannot compete with arbitrage manufacturers, while at the same time maintaining a developed level of infrastructure. Thus, industrialized jurisdictions are faced with two alternatives. The first is to become a tax haven themselves by giving up taxation. For most developed economies, this is not a viable option, since this means the elimination of the welfare state as we know it. The other alternative for these jurisdictions is to maintain their public outlay as much as they can, which means shifting the tax burden to taxpayers who cannot make use of arbitrage manufacturing. These would likely be domestic taxpayers with no multinational activity, such as small business owners and individuals who derive most of their income from labor. There is a limit to the extent to which industrialized jurisdictions can maintain their public outlays by shifting the burden to taxpayers who cannot take advantage of arbitrage manufacturing. As explained in a seminal article by Professor Reuven Avi-Yonah, “if developed countries are unable to tax income from capital and if alternative taxes are not feasible, their only recourse is to cut the social safety net . . . .”<sup>150</sup> The only option to mitigate such a shifting of the tax burden is to combat tax arbitrage itself, denying the ability of multinational taxpayers to engage in it.<sup>151</sup>

## 2. *Arbitrage Manufacturing v. Other Types of Income Shifting*

The fact that multinational taxpayers divorce the location of their economic activity from where they report income for tax purposes is well known. Taxpayers regularly engage in income shifting<sup>152</sup> in order to generate what Professor Edward Kleinbard has famously coined “stateless income.”<sup>153</sup> Stateless income is “income derived for tax purposes by a multinational group from business activities in a country other than the domicile

<sup>149</sup> Wilson, *supra* note 142, at 269 (citing WALLACE E. OATS, *FISCAL FEDERALISM* 143 (1972)).

<sup>150</sup> Reuven S. Avi-Yonah, *Globalization Tax Competition and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1578 (2000).

<sup>151</sup> Such efforts are discussed below, see *infra* Part V.C.

<sup>152</sup> There is an extensive body of literature analyzing income shifting. For a summary, see Dhammika Dharmapala, *What Do We Know About Base Erosion and Profit Shifting? A Review of the Empirical Literature* (Coase-Sandor Working Paper Series in Law and Economics, Paper No. 702, 2014).

<sup>153</sup> Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 700 (2011).

of the group's ultimate parent company, but which is subject to tax only in a jurisdiction that is not the location of the customers or the factors of production through which the income was derived, and is not the domicile of the group's parent company."<sup>154</sup>

Stateless income is the functional outcome of arbitrage manufacturing. However, income shifting and arbitrage manufacturing are not the same phenomena. The difference between the two is institutional. Income shifting is the generic phenomenon in which taxpayers arrange their affairs in a way that separates the location of activity from the location where taxable income is reported. This may be done in many ways, for example, by intra-group transactions that generate deductions in high tax jurisdictions and inclusions in low tax jurisdiction ("transfer pricing"), by tax arbitrage, or by any other number of mechanisms.

Income shifting is a taxpayer-focused phenomenon; it refers to taxpayers' induced schemes that government may wish to curtail. Arbitrage manufacturing, on the other hand, is government-focused. Unlike other taxpayer-created mechanisms of income shifting, arbitrage manufacturing is a government-created instrument that may be used to facilitate income shifting. This institutional distinction is of importance, to the extent that one believes tax arbitrage opportunities should be prevented. As further discussed below,<sup>155</sup> arbitrage manufacturing creates unique challenges to international coordinated attempts challenging income shifting.

### B. Arbitrage Manufacturing and Tax Havens

The competitive analysis of arbitrage manufacturing puts tax havens in a negative light. Tax havens may be parasitic in the sense that they poach from other jurisdictions' revenues.<sup>156</sup> Luxembourg's ATA practice is a perfect example of such rent-seeking behavior.

The idea that tax havens effectively pull revenue from other jurisdictions is not new. But the "positive" view of such behavior is that tax havens are competing for mobile capital, by eliminating the taxation on the return from mobile capital. Arbitrage manufacturing is different. Arbitrage manufacturing disguises the returns on *immobile* capital in developed economies as "mobile," so that tax-havens can make a claim for it.

What is disturbing about Luxembourg's case is the seemingly conscious participation of a state administrator in the facilitation of international tax avoidance. Luxembourg is not a benign participant in the scheme. It is an accommodation party, the cooperation of which is a necessary condition for a successful execution of the avoidance scheme. In fact, it seems that LACD is consciously engaged in facilitating avoidance through ATAs. Without an

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<sup>154</sup> *Id.* at 701.

<sup>155</sup> See discussion *infra* Part V.C.

<sup>156</sup> See *supra* notes 20–21 and accompanying text.

ATA, Luxembourg is hardly an attractive tax haven. It has a high corporate tax rate (about 29.00%) and anti-avoidance measures (such as thin capitalization rules). Taxpayers who would finance activities through Luxembourg without an ATA would enjoy no tax benefit. Luxembourg's selling point is LACD's readiness to eliminate all taxation (in Luxembourg or elsewhere) with almost no administrative hassle while ignoring its own substantive guidance.

To summarize, at least during the sample period, Luxembourg was a tax-haven made *by administrative practices*, not by law. This enabled Luxembourg's officials to maintain a façade of a legitimate tax regime, when Luxembourg's was anything but. Marius Kohl in fact provided a half-hearted admittance of such view in a recent interview. He stated: "The work I did definitely benefited [Luxembourg], though maybe not in terms of reputation."<sup>157</sup>

It is obviously impossible to generalize Luxembourg's practices to other tax havens. However, it seems plausible to expect other tax havens would behave in a similar manner. Interests of taxpayers and tax havens are aligned. From the administrator's point of view, the cost of issuing an administrative ruling is low, but the benefit for a small jurisdiction is immense. The cost for taxpayers of setting up legal structures in a small jurisdiction is minimal,<sup>158</sup> but the tax savings in the source jurisdiction are huge. Under such conditions, it is to be expected that such activity will flourish.

A recent study had indeed shown that securing a Luxembourg ATA reduces an MNC's *worldwide* effective tax rate by about 4.00%, on average, in the absolute (for example, from 20% to 16%).<sup>159</sup> The fact that an administrative ruling from a small jurisdiction—where a taxpayer has no operations—can reduce the *global* tax liability in such magnitude is quite astonishing. The result, as explained above, is distorted tax competition.

<sup>157</sup> Colm Keena, 'Letters of Comfort' Show Agreement on Interpretation of Luxembourg Law, IRISH TIMES (Nov. 5, 2014), <http://www.irishtimes.com/business/economy/letters-of-comfort-show-agreement-on-interpretation-of-luxembourg-tax-law-1.1989497>.

<sup>158</sup> *We Set Up an Offshore Company in a Tax Haven*, NPR (Jul. 27, 2012), <http://www.npr.org/blogs/money/2012/07/27/157499893/episode-390-we-set-up-an-offshore-company-in-a-tax-haven> (illustrating how cheap and easy it is to set up offshore companies).

<sup>159</sup> See Huesecken & Overesch, *supra* note 68, at 3 ("Our empirical analysis shows that the additional effect of [ATAs] on the multinationals' ETRs consists of a decline by about four percentage points. In this setting, the significant reduction of ETRs implies that firms avoid taxes through tax planning strategies legally assured by [ATAs]."); see also Inga Hardeck & Patrick Uwe Wittenstain, *Achieving Tax Certainty and Avoiding Taxes? – Evidence from Luxembourg Tax Rulings* (Aug. 2, 2016), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2709629](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2709629) (finding that firms with Luxembourg rulings have lower effective tax rates than similar firms without such rulings).

C. *Arbitrage Manufacturing and Global Efforts  
to Prevent Tax Avoidance*

LuxLeaks came at a crucial moment in international tax policy discourse. Recent years have seen a dramatic increase of interest in tax avoidance by MNCs.<sup>160</sup> Recent press coverage of MNCs' conduct created what one commentator referred to as "a perfect storm."<sup>161</sup> Together with the world economic downturn that affected many developed economies, demands for action were soon to follow.<sup>162</sup> Several unprecedented coordinated efforts to combat MNCs tax avoidance took shape. For example, the BEPS Project discussed above, launched by the OECD in early 2013, is probably the most remarkable effort to date to address tax avoidance in an internationally coordinated manner.<sup>163</sup> The BEPS Project main purpose is to "provide countries with instruments, domestic and international, aiming at better aligning rights to tax with real economic activity."<sup>164</sup>

Another example of an internationally coordinated effort is the Anti Tax Avoidance Package introduced by the European Commission in early 2016.<sup>165</sup> The Anti Avoidance Package includes a proposed anti-tax-avoidance directive (the Proposed Directive), addressing "an urgent need to advance efforts in the fight against tax avoidance and aggressive tax planning, both at the global and European Union (EU) levels."<sup>166</sup>

The analysis of the LuxLeaks documents offers a unique opportunity to assess the potential efficacy of some of the international proposals currently being discussed. It is beyond the scope of this paper (in fact, of any single paper) to assess international projects of such magnitude.<sup>167</sup> Instead, this subpart discusses the current international proposals that seem to be most relevant to the findings presented in this article. This subpart discusses separately the proposals that address tax arbitrage in substance and proposals that are aimed at improving tax procedure and administration.

<sup>160</sup> See Brauner, *supra* note 55, at 56–58 (describing the process that has led to a "perfect storm" culminating in current efforts to curtail tax avoidance).

<sup>161</sup> *Id.* at 57–58.

<sup>162</sup> *Id.* at 58.

<sup>163</sup> An equally important previous attempt was made in 1998. See ORG. FOR ECON. COOPERATION AND DEV., HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE (1998). However, this attempt at preventing international tax avoidance is viewed as a failed effort. See JASON C. SHARMAN, HAVENS IN A STORM: THE STRUGGLE FOR GLOBAL TAX REGULATION 1 (2006) ("By 2002 the small state tax havens had prevailed, and the campaign to regulate international tax competition had failed.").

<sup>164</sup> BEPS Project, *supra* note 90, at 8.

<sup>165</sup> *Anti Tax Avoidance Package*, EUROPEAN COMMISSION (Jan. 2016), [http://ec.europa.eu/taxation\\_customs/taxation/company\\_tax/anti\\_tax\\_avoidance/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/company_tax/anti_tax_avoidance/index_en.htm).

<sup>166</sup> *Commission Proposal For a Council Directive: Laying Down Rules Against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market*, COM (2016) 26 final (Jan. 28, 2016) [hereinafter *Proposed Directive*], <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1454056979779&uri=COM:2016:26:FIN>.

<sup>167</sup> As an example for how extensive current international efforts are, the final reports of the BEPS project are about 1,600 pages long.

The argument put forward is that while international proposals seem to address some of the issues identified in this Article, they fall short of preventing arbitrage manufacturing. The main reason for the shortfall is that international proposals are largely focused on taxpayers' induced schemes of income shifting. Administrative bodies are seen as passive participants, who merely interpret domestic laws or, at the most, passively cooperate with taxpayers. The analysis presented in this article, however, suggests that tax administrations play an active role in the facilitation of tax avoidance by MNCs, and that there is a synergistic relationship between tax administrations and MNCs. Current efforts fail to address the administrative mechanisms that support this synergy and facilitate arbitrage manufacturing.

### 1. *Substantive International Proposals to Curtail Tax Arbitrage*

International tax arbitrage is central to both BEPS and the Anti Avoidance Package. Action 2 of the BEPS project<sup>168</sup> is aimed to “[n]eutralise the effects of hybrid mismatch arrangements.”<sup>169</sup> Hybrid mismatch arrangements are schemes that “exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation . . . .”<sup>170</sup>

Action 2 of BEPS specifically targets debt/equity arbitrage of the types discussed in this article. For example, Action 2 recommends the adoption of a “Hybrid Financial Instrument Rule” (HFIR). Under the rule, deduction is denied in respect of a cross-border payment if the payment is not included in income in the jurisdiction in which it is received.<sup>171</sup> Referring back to our discussion, HFIR would require Luxembourg to deny deduction in respect of any payments made by Luxembourg intermediaries to the jurisdictions of residence, resulting in the imposition of 29% tax in Luxembourg. If such payment is nonetheless deducted (for example, due to Luxembourg’s refusal to cooperate), the recipient jurisdiction will be required to include the payment as income, resulting in tax imposed by the residence jurisdiction.<sup>172</sup>

The Anti Avoidance Package contains similar rules under Article 10 of the Proposed Directive. It stipulates that “[w]here two Member States give a different legal characterisation to the same payment (hybrid instrument),” both member states must follow the characterization adopted by the jurisdiction “in which the payment has its source.”<sup>173</sup> The result would be that if Luxembourg classifies an instrument as “debt,” any EU recipient would

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<sup>168</sup> See *BEPS Action 2*, *supra* note 91.

<sup>169</sup> OECD, *Action Plan on Base Erosion and Profit Shifting* 15 (2013) [hereinafter *BEPS Action Plan*], <https://www.oecd.org/ctp/BEPSActionPlan.pdf>.

<sup>170</sup> *BEPS Action 2*, *supra* note 91, at 11.

<sup>171</sup> *Id.* at 23.

<sup>172</sup> *Id.*

<sup>173</sup> *Proposed Directive*, *supra* note 166, at Art. 10.

have to classify payment from the instrument as “interest” and, as such, include the payment in income of the recipient.

Another important action in the BEPS project is Action 4, which is aimed at preventing “base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income.”<sup>174</sup> Action 4 lays out a series of “best practice” rules under which interest deduction is denied if the leverage ratio of the deducting entity exceeds certain thresholds. Similarly, Article 4 of the Proposed Directive provides that full deduction for interest expense “will only be deductible up to a fixed ratio based on the taxpayer’s gross operating profit.”<sup>175</sup> Presumably, these rules would limit interest deductions to Luxembourg intermediaries that are overleveraged.

None of these substantive proposals addresses the core problem identified herein: The fact that tax administrators use their authority to circumvent substantive tax rules for the benefit of multinational taxpayers. As noted above, Luxembourg tax law is not typical of a tax haven.<sup>176</sup> Nonetheless, using administrative rulings taxpayers regularly avoided the need to have “substantive presence” in Luxembourg,<sup>177</sup> or to substantiate the level of intercompany interest pricing.<sup>178</sup> All that was needed was a ruling from a friendly administrator that the taxpayer is compliant.

There is no reason to expect that new rules of substance (even if adopted verbatim by all OECD members)<sup>179</sup> would make much of a difference if administrative behavior is left unchecked. Consider for example, the interest limitation rule proposed under BEPS Action 4 and Article 4 of the Proposed Directive. Luxembourg already has an interest deduction limitation in place, under which interest deduction is denied if a corporation’s debt-to-equity ratio exceeds 85:15. Luxembourg regularly ignored this limitation by issuing ATAs that sidestepped the 85:15 threshold.<sup>180</sup> Applying a tougher threshold will help little if administrators can simply ignore the new threshold.

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<sup>174</sup> *BEPS Action Plan*, *supra* note 169, at 17.

<sup>175</sup> *Proposed Directive*, *supra* note 166, at 1.

<sup>176</sup> *See supra* notes 6–8 and accompanying text.

<sup>177</sup> *See* POSITION PAPER ON TAX TRANSPARENCY, *supra* note 8.

<sup>178</sup> *See* discussion *supra* Part III.B.2.

<sup>179</sup> This is a big “if.” OECD guidelines are by no means mandatory, and there is no assurance OECD members will adopt them verbatim. However, on Nov. 24, 2016 the OECD announced the conclusion of a multilateral instrument (MLI) that will effectively implement certain BEPS standards through the adoption of one treaty in place of amending the numerous bilateral tax treaties of countries that will sign the instrument. More than 100 countries announced they intend to sign the MLI. *See Countries Adopt Multilateral Convention to Close Tax Treaty Loopholes And Improve Functioning Of International Tax System*, OECD (Nov. 24, 2016), <http://www.oecd.org/ctp/treaties/countries-adopt-multilateral-convention-to-close-tax-treaty-loopholes-and-improve-functioning-of-international-tax-system.htm>.

<sup>180</sup> *See* discussion *supra* Part III.B.3.

ATAs that counter hybrid mismatch arrangements—like in BEPS Action 2, or Article 10 of the Proposed Directive—may be somewhat more cumbersome to achieve. But they too would not require much creativity from an administrator trying to accommodate MNCs’ demands. By way of illustration, under HFIR a payment on a hybrid instrument in Luxembourg may not be deducted unless it is included in the country of destination. Theoretically, a friendly administrator could easily use administrative rulings to offset this unfortunate result. For example, any resulting income (due to the deduction being denied) could be offset by the generation of losses in Luxembourg, the existence of which will be approved by an ATA (regardless if losses were indeed generated in substance). Thus, denying the deduction would not generate additional income. In the alternative, any income created in Luxembourg could be ruled, under an ATA, to qualify for a special low tax rate under a preferential regime.<sup>181</sup>

The bottom line is that there is no substantive-rule remedy to rogue administrative behavior because any such rule can be functionally nullified. The problem with rules of substance, as currently advanced in BEPS and the Anti Avoidance Package, is that they seem to focus on harmonization or coordination. Primarily, such rules try to take the arbitrage opportunity away from taxpayers. Unfortunately, it does not matter how harmonized the laws of jurisdictions are. Any small jurisdiction could insert itself as an intermediary between the jurisdictions of source and residence, and generate synthetic arbitrage instruments.

## 2. *International Proposals Addressing Tax Administration*

While substantive rules are an important part of current anti-avoidance projects, they fall short if tax administrators are willing to help taxpayers circumvent such rules. Global efforts to target tax avoidance should therefore target the administrative process of arbitrage manufacturing itself, not only the particular instruments used by taxpayers in tax arbitrage schemes. Some of the current initiatives are aimed at addressing such issues.

For example, BEPS Action 5 specifically tackles “harmful tax practices”<sup>182</sup> and seeks to prevent “preferential regimes that risk being used for artificial profit shifting . . . .”<sup>183</sup> Action 5 is two-pronged. First, Action 5 requires taxpayers to have a substantial nexus to a jurisdiction as a prerequisite to being eligible to benefit from preferential tax regimes in that jurisdiction (for example, special subsidies for specific types of activity).<sup>184</sup>

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<sup>181</sup> For example, many countries offer specific tax incentive and subsidies for research and development activities.

<sup>182</sup> OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5: 2015 Final Report* (2015) [hereinafter *BEPS Action 5*].

<sup>183</sup> *Id.* at 9.

<sup>184</sup> This part of Action 5 is mainly aimed at making sure that MNCs that benefit from subsidies related to the development of intangible property actually perform substantive activ-

However, since the determination of whether sufficient nexus exists is left to tax administrators, such requirement changes little that is relevant to analysis herein. Luxembourg ATA rules already require significant nexus for purposes of a ruling request,<sup>185</sup> but as the analysis demonstrated, such requirement was ignored.<sup>186</sup>

Second, and more relevant to this Article, Action 5 imposes “compulsory spontaneous exchange of information on certain rulings.”<sup>187</sup> Six types of tax rulings are subject to Action 5 recommendations,<sup>188</sup> including “related party conduit rulings,” which are defined as rulings in respect of “arrangements involving cross-border flows of funds or income through an entity in the country giving the ruling.”<sup>189</sup> The Luxembourg ATAs discussed herein fall squarely within this definition.

Under the information exchange requirement, a tax administration granting a private ruling (the “ruling administration”) must provide information regarding the rulings to tax administrations (the “receiving administrations”) in the residence jurisdiction of all related parties, as well as the residence jurisdiction of the ultimate parent of the sponsor. Action 5, however, only requires the ruling administration to provide basic details on the ruling sponsor and a summary of the ruling itself. Based on the information provided, the receiving administration may request the full ruling. The requirement that the ruling administration must summarize the ruling for the receiving administration leaves much discretion with the ruling administration.

The European Union has already adopted the Action 5 framework. In December of 2015, the European Council “adopted a directive aimed at improving transparency on tax rulings.”<sup>190</sup> Under this so-called “Rulings Directive,” a ruling administration must exchange information with a receiving administration in respect of a ruling within three months after the granting of the ruling.<sup>191</sup> The information subject to such automatic exchanges largely follows the Action 5 guidance.

These measures are important steps in the right direction but are far from adequate, given the analysis in this article. In order to understand why, it is helpful to consider the administrative issues that are the core of the problem in the Luxembourg ruling process.

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ity in the jurisdiction where they enjoy the benefit (rather than simply shifting the intangible resulting research into the jurisdiction with the beneficial regime). *See id.* at 23–44 (discussing the “Substantial Activity Requirement”).

<sup>185</sup> POSITION PAPER ON TAX TRANSPARENCY, *supra* note 8.

<sup>186</sup> *See* discussion *supra* Part III.B.1.

<sup>187</sup> BEPS Action 5, *supra* note 182, at 45.

<sup>188</sup> *Id.* at 47–51.

<sup>189</sup> *Id.* at 51.

<sup>190</sup> European Council Press Release 905/15, 1 Cross-border Tax Rulings: Transparency Rules Adopted (Dec. 8, 2015), <http://www.consilium.europa.eu/en/press/press-releases/2015/12/08-ecofin-cross-broder-tax-ruling/>.

<sup>191</sup> Council Directive 2015/2376, art. 1(5a), 2015 O.J. (L 332) 1, 7 (EU).

*The Single Administrator Problem.* One of the contributing factors to arbitrage manufacturing in the LuxLeaks context seems to have been that a single administrator controlled the process.<sup>192</sup> Even with the best intentions, it is unlikely that a single individual can substantively consider each submission. Moreover, in the LuxLeaks context, it seems that Marius Kohl's main motivation was to benefit Luxembourg financially, even though he realized his actions were viewed negatively outside Luxembourg.<sup>193</sup> A single administrator can avoid scrutiny and control the process as he or she sees fit.

Unfortunately, none of the current initiatives to combat tax avoidance addresses the institutional structure of ATA administration. This is a missed opportunity since it is clear that international effort could bring reform in this context. As a result of the mounting international criticism following LuxLeaks, Luxembourg has significantly revised its ATA review process.<sup>194</sup> For example, a commission, rather than a single individual, is now in charge of the process.<sup>195</sup> However, no similar pressure has been directed at other countries, and it is possible that in other tax havens a handful of people may or still be in control of the tax-ruling process. Current coordinated international efforts do nothing to advance standards for the institutional structure of tax-ruling administration.

*Tax Rulings Secrecy.* Another factor that contributed to arbitrage manufacturing was the fact that the rulings were never made public. This allowed the privately negotiated tax deals to remain free of public scrutiny, as well as the scrutiny of tax administrators in affected jurisdictions.

In fact, the European Commission did rule against Luxembourg under similar circumstances to those analyzed herein.<sup>196</sup> However, given that the ATAs were secret, there was no way for any affected jurisdiction to know that practice had continued. The automatic exchange of tax rulings under BEPS Action 5 (if adopted) and under the Rulings Directive may provide a remedy in this context.

However, none of the current initiatives require private tax rulings to be made public. This is an important shortcoming. In a recent article, Professor Joshua Blank developed a detailed argument explaining why *ex-ante* tax enforcement—such as advanced tax agreements—must be publically disclosed.<sup>197</sup> Absent transparency, tax administrators may be perceived as “creating secret tax law through the issuance of advance tax rulings.”<sup>198</sup> In fact, this seems to have been exactly the case in the context of the Luxembourg ATAs, which have overridden Luxembourg and European tax law.

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<sup>192</sup> See discussion *supra* Part II.A.

<sup>193</sup> See *supra* note 157 and accompanying text.

<sup>194</sup> See Patrick Mischo & Franz Kerger, *After 'Lux Leaks': Welcome Changes to Luxembourg's Tax Ruling Practice*, 77 TAX NOTES INT'L 1197 (2015).

<sup>195</sup> *Id.* at 1198.

<sup>196</sup> See discussion *supra* Part III.B.4.

<sup>197</sup> Joshua D. Blank, *The Timing of Tax Transparency*, 90 S. CAL. L. REV. (forthcoming 2017), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2756629](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2756629).

<sup>198</sup> *Id.* at 34.

Secrecy of tax rulings, Blank argues, may hurt the social legitimacy and integrity of tax administration as a whole.<sup>199</sup> Moreover, “taxpayers are justified in expecting [tax administrators] to treat similarly situated taxpayers equally.”<sup>200</sup> In the absence of disclosure of privately negotiated tax agreements, the public is unable to judge whether such standard is met.<sup>201</sup> Finally, Blank suggests that “[l]ack of transparency in the advance ruling context can also encourage suspicions of impropriety, as taxpayers may perceive that [tax] officials favor specific taxpayers.”<sup>202</sup>

To summarize, under the analysis presented herein, Luxembourg tax administrators were not enforcers but culprits. Thus, sharing information only among tax administrators may fall short of remedying corrupt administrative practices.

As far as international efforts are concerned, this is once again a missed opportunity. The domestic reform adopted by Luxembourg in response to the pressure following LuxLeaks included a change in law under which “tax rulings will be published under the form of anonymous summaries in the annual report of the Luxembourg tax administration.”<sup>203</sup> The momentum following LuxLeaks provided a perfect (yet missed) opportunity to adopt an international standard that would force publication of private tax rulings.

*Unreasoned Decisions.* None of the decisions in the sample contain any reasoning. In all instances, taxpayers’ positions are accepted verbatim. Under such circumstances, it is impossible to stipulate what the administrator’s considerations were in issuing the ATAs. Reasoned decisions, one might expect, would force careful analysis by the administrators of all relevant laws, guidance, and facts.

Current international anti-avoidance initiatives contain no requirement that tax administrators document their decision-making process or provide any reasoning for their ruling decisions. It is exactly this lack of administrative rigor that enabled Marius Kohl to issue decisions within less than a day and without considering the submissions’ merits.

*Unsubstantiated Submissions.* Similarly, the analysis of the ATAs demonstrates gross indifference on behalf of Marius Kohl to the fact that taxpayers frequently failed to substantiate their positions. For example, in the context of substantial presence in Luxembourg, taxpayers in multiple instances provided no evidence that the Luxembourg sponsor was more than a mailbox or an address in which a board meeting will nominally be held.<sup>204</sup> Another example is the taxpayers’ failure to provide documentation on financial instruments in respect of which the ATA was sought.<sup>205</sup> Again, the re-

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<sup>199</sup> *Id.*

<sup>200</sup> *Id.* at 36.

<sup>201</sup> *See id.*

<sup>202</sup> *Id.* at 38.

<sup>203</sup> Mischo & Kerger, *supra* note 194, at 1200.

<sup>204</sup> *See supra* Part III.B.1.

<sup>205</sup> *See supra* Part III.B.2.

quirements that taxpayers substantiate their factual claims are largely absent from current anti-avoidance initiatives.<sup>206</sup>

*Lax or No Substantive Standards.* The analysis of the LuxLeaks submissions shows that arbitrage manufacturing is sometimes possible due to the lack of administrative standards or inconsistent application of such standards. For example, the characterization of financial instruments as debt or equity seems to have been decided according to the demand of sponsors, rather than based on a clear set of standards.<sup>207</sup> Even when instruments were classified as debt, Kohl was quick to reclassify them as “capital contribution” once the instruments became nonperforming. In the context of Luxembourg’s own administrative guidance on thin capitalization, Kohl simply ignored the guidance. Current initiatives do not address consistency of standards in tax rulings.

*Tax Advisors as Brokers.* Another observation stemming from the analysis relates to the role of tax advisors. In the context of the leak, it seems that tax advisors’ sole function was to broker the private tax arrangements between sponsors and tax authorities in Luxembourg. Tax advisors have had no risk in the process, since they have never had to opine on the legality of the arrangements addressed in the ATAs. Once the ATA was reached, the tax advisors were free from any professional risk associated with their advice. In other words, tax advisors have had no “skin in the game.” They never functioned as gatekeepers, preventing abusive tax arrangements. Nor did they have any incentive to function as gatekeepers. If anything, under the system ran by Kohl, tax advisors had the absolute incentive to push aggressive planning as far as they could because advisors were effectively paid for soliciting Kohl’s agreement, which in turn would free the advisors of any professional risk. Current international tax initiatives lack any discussion on the role of tax advisors as gatekeepers.

*Problematic Fee Structures.* Luxembourg tax collections resulting from the ATAs were directly related to the tax avoided in other jurisdictions.<sup>208</sup> Luxembourg’s coffers benefited when other jurisdictions suffered. This was not a result of a competitive process, but rather a result of poaching revenue from other jurisdictions.

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<sup>206</sup> The one exaction to such requirements is the OECD guidelines for intercompany pricing arrangements. See OECD, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS 181–89 (2010) (describing taxpayers’ documentation that should be sought by tax administrators for purposes of making intercompany pricing decision). Most countries adhere (or at least suggest they adhere) to the OECD intercompany pricing guidelines in rulings related to intercompany pricing. See HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 530 (3rd ed. 2010) (“The general framework of analyzing intercompany pricing issues in the OECD Transfer Pricing Guidelines seems to be widely followed.”). However, no similar requirement of substantiation is found in current initiatives in respect of factual issues addressed by rulings that are not in respect of intercompany pricing.

<sup>207</sup> See *supra* Part III.B.2.

<sup>208</sup> See *supra* Part IV.

Such a fee structure creates an extremely problematic incentive for tax administrators. Tax administrators in one jurisdiction have no accountability to the public in other jurisdictions and cannot be sanctioned by the other jurisdiction. On the other hand, poaching revenue from other jurisdictions enhances the administrator's success in the jurisdiction in which they operate. There is currently no international discussion on fee and tax collection structures in the context of advanced tax agreements.<sup>209</sup> Since one jurisdiction cannot sanction the tax administration of another jurisdiction, the international community must play a central role in uprooting fee structures that incentivize tax administrations to behave as rent-seekers.

To summarize, current coordinated initiatives to tackle MNC's tax avoidance largely fail to address the administrative mechanisms that make arbitrage manufacturing possible. This is a missed opportunity. Even before LuxLeaks, Luxembourg tax practices were subject to close scrutiny by the European Commission, including several investigations on possible state-aid practices.<sup>210</sup> Such pressure kept on mounting after the revelations, and eventually resulted in meaningful reforms in Luxembourg tax law.<sup>211</sup> But those were targeted efforts, focused on Luxembourg. What is lacking is the attempt to systematically address the problem of arbitrage manufacturing, and create global standards controlling the issuance of private tax rulings.

#### CONCLUSION

The ICIJ's leak of hundreds of secretive tax rulings issued by LACD to MNCs is investigative journalism at its best. It induced a meaningful debate on tax policies, which resulted in real changes. More importantly, however, it allowed a rare opportunity to explore the day-to-day operations of a tax haven. Public discussion on international tax avoidance is very much preoccupied by what taxpayers do. The leaks enabled one of the first meaningful inquiries into the role played by tax administrators.

Using a sample of the leaked documents this Article explains the potential role of tax administrators in facilitating international tax avoidance. This Article identified the mechanism of arbitrage manufacturing; that is, the issuance of regulatory instruments intended to synthetically generate legal differences between source and residence jurisdictions even though no such differences exist. Such processes enable the jurisdiction that issues the in-

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<sup>209</sup> Again, intercompany pricing agreements are an exception, because they are often subject to mutual agreement procedures between tax authorities.

<sup>210</sup> See Commission Decision State Aid SA.38944 Alleged Aid to Amazon, 2015 O.J. (C 44) 13 (explaining the European Commission's recently issued decision concluding that Luxembourg may have indeed been engaged in state aid, though not in the context of debt/equity arbitrage as explained herein, but rather in the context of intercompany pricing). See generally Werner Haslechner, *Advance Rulings and State Aid: Investigative Powers of the EU Commission*, in ECJ – RECENT DEVELOPMENTS IN DIRECT TAXATION 2014 89, 90–92 (Michael Lang et al. eds., 2015) (summary of European Commission procedures).

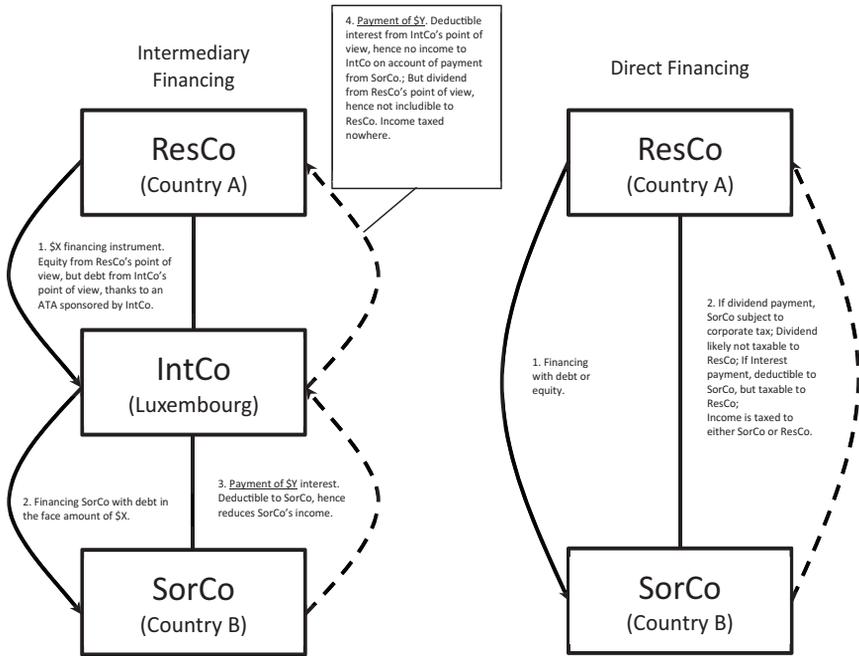
<sup>211</sup> Mischo & Kerger, *supra* note 194.

strument to make a claim for revenue streams generated by immobile investments in other jurisdictions. At the same time, the instrument eliminates the tax liability in the jurisdiction in which income is created, thus benefiting the taxpayer. The arbitrage manufacturer and the taxpayer operate in tandem to deny tax revenues from the jurisdictions that have the infrastructure that supports the profitable investment.

Such a process distorts tax competition and supports a negative view of tax havens' role in the global economy. Arbitrage manufacturing does not induce competition for mobile capital. Rather, arbitrage manufacturing can be described as a *competition for revenue*, irrespective of the location of capital.

If such a practice is prevalent, then the attempt to harmonize the tax laws of the source and residence jurisdictions is not an effective response to international tax arbitrage. There will always be a jurisdiction willing to act as an intermediary-for-fee, and help taxpayers to artificially create arbitrage opportunities. This Article therefore suggests that coordinated international efforts should target arbitrage-manufacturing practices.

APPENDIX A – A SIMPLISTIC DEPICTION OF INTERMEDIARY FINANCING WITH DEBT/EQUITY ARBITRAGE



## APPENDIX B – A CASE STUDY: ABRY’S PARTNERS’ PURCHASE OF Q9

A. *The Financing Structure*

In August 2008, ABRY Partners (ABRY)—a Boston, MA based private equity firm—purchased Q9 Networks (Q9)—a Canadian provider of outsourced data center infrastructure—for approximately \$361 million.<sup>212</sup> ABRY financed the purchase using an intermediary Luxembourg structure in respect of which it sought, and secured, an ATA. The structure chart below is taken from ABRY’s submission to LACD.<sup>213</sup>

The explanation below addresses how the tax-reducing scheme through Luxembourg worked while ABRY held Q9. ABRY disposed of Q9 in 2012 at a gain of approximately CAD 740 million.<sup>214</sup> Since the ATA does not specifically address the disposition of Q9 by ABRY, it is difficult to quantify the tax effect of the ATA on the disposition.

The figures herein are based solely on the assessment of the ATA. The figures should therefore be interpreted as relevant to the amount of taxes potentially avoided in Canada, on profits channeled through Luxembourg. This discussion does not provide an overall assessment of the total taxes incurred by ABRY in respect of its Q9 investment. It is likely that ABRY and its investors incurred other tax liabilities, in Canada and other jurisdictions, in respect of the Q9 investment.

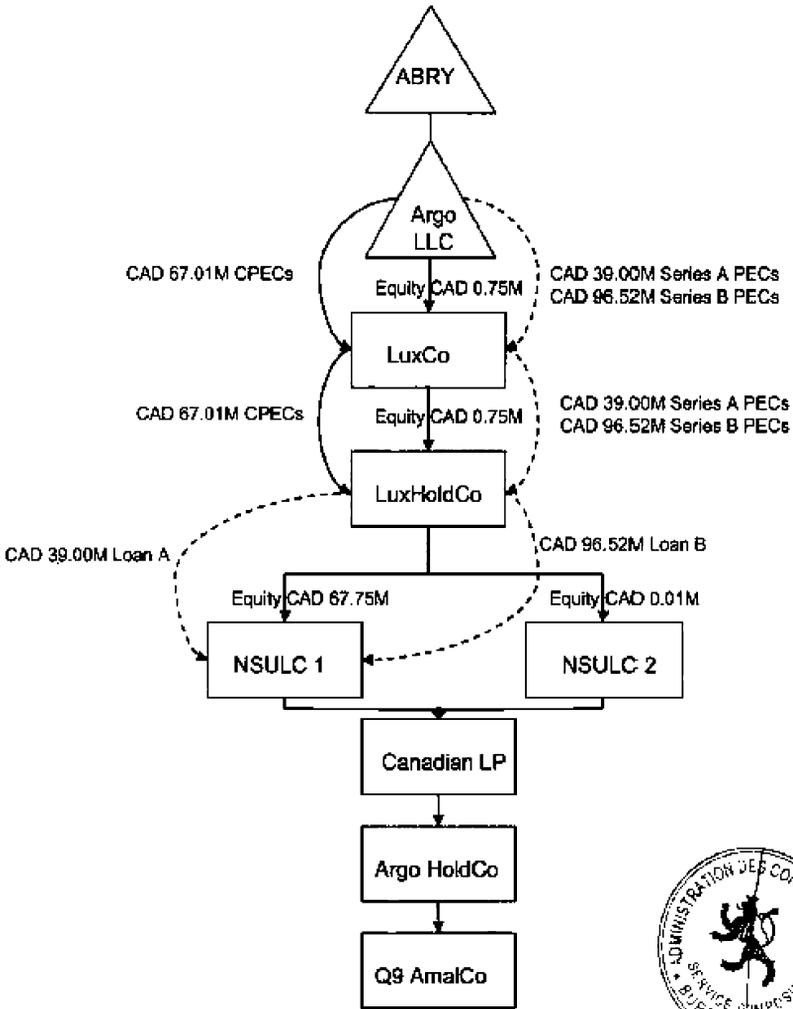
Finally, as can best be inferred from the ATA, it seems that ABRY’s tax scheme was perfectly legal from the points of view of the jurisdictions involved. The scheme, however, would not have been possible without an ATA from LACD.

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<sup>212</sup> *ABRY Partners Agrees to Acquire Q9 Networks Inc.*, ABRY PARTNERS (Aug. 24, 2008), [http://www.abry.com/News/08-08-24/ABRY\\_Partners\\_Agrees\\_to\\_Acquire\\_Q9\\_Networks\\_Inc.aspx](http://www.abry.com/News/08-08-24/ABRY_Partners_Agrees_to_Acquire_Q9_Networks_Inc.aspx).

<sup>213</sup> Advance Tax Agreement Submission from ABRY Partners – Project Argo to LACD (Nov. 28, 2008) at 2 [hereinafter ABRY ATA], <https://assets.documentcloud.org/documents/1345263/abry-partners-2009-tax-ruling.pdf>.

<sup>214</sup> See Hugo Miller & Andrew Mayeda, *BCE, Ontario Teachers to Purchase Q9 Networks for C\$1.1 Billion*, BLOOMBERG (Jun. 2, 2012, 10:27 AM), <http://www.bloomberg.com/news/articles/2012-06-02/bce-ontario-teachers-to-purchase-q9-networks-for-c-1-1-billion>.



ABRY contributed CAD 203,281,918 to Argo LLC (Argo), a Delaware limited liability company, which was a special purpose vehicle used by ABRY to finance the investment. Rather than investing directly in the Canadian operating companies, Argo used the entire amount received from ABRY to finance an intermediary Luxembourg structure with four different instruments, as follows:

- 1) CAD 750,000 of common equity;
- 2) CAD 67,010,639 in Convertible Preferred Equity Certificates (CPECs);

- 3) CAD 39,000,000 in Preferred Equity Certificates (PECs) Series A; and,
- 4) CAD 96,521,279 in PECs Series B.

Within Luxembourg the instruments were used to finance two Luxembourg entities, back-to-back, by identical instruments. For purposes of simplification, we will refer to both entities as the “Luxembourg Structure.”

The bottom entity in the Luxembourg structure, LuxHoldCo, then used the total amount of proceeds received from Argo, to finance the Canadian structure used for the purchase of Q9, as follows:

- 1) CAD 67,760,500 in equity (this figure is the aggregate equity amount to finance both Canadian entities at the top of the structure, NSULC 1 and NSULC 2);
- 2) Shareholder Loan A in the face amount of CAD 39,000,000; and
- 3) Shareholder Loan B in the face amount of CAD 96,521,279.

Note that the aggregate amount invested in the source jurisdiction, Canada, is identical to the amount financed from ABRY (but for a negligible difference of CAD 139). This makes apparent the back-to-back nature of the arrangement. Also note the following matching amounts:

- 1) The face amount of the Series A PEC (financing from Argo to Luxembourg), matches the face amount of Loan A (financing from Luxembourg to Canada): CAD 39,000,000.
- 2) The face amount of the Series B PEC (financing from Argo to Luxembourg), matches the face amount of Loan B (financing from Luxembourg to Canada): CAD 96,521,279.
- 3) The face amount of the CPECs (financing from Argo to Luxembourg), together with the minimal equity in Luxembourg (respectively, CAD 67,010,639 + CAD 750,000 = 67,760,639), equals the equity financing from Luxembourg to the Q9 structure in Canada.

### *B. The ATA*

Among others, ABRY secured the following assurances from LACD:

1. *Both Luxembourg entities are tax resident in Luxembourg.*

The only justification given for treating these entities as tax residents in Luxembourg is that they have a “statutory seat” in Luxembourg and that they will have “their place of central administration in Luxembourg to the extent that their shareholders’ meetings and their board meetings will be held in Luxembourg, that the main management decisions will be effectively

taken in Luxembourg and that their accounting will be done in Luxembourg.”<sup>215</sup>

The submission contains no evidence of any employees, officers or any operational offices in Luxembourg. Apparently, the Luxembourg entities were nothing more than incorporated shells. Even if they are not, it does not seem that LACD was troubled by the fact that ABRY did not substantiate any presence in Luxembourg.

## 2. Debt Classification for the PECs and CPECs.

ABRY requested that both PECs as well as the CPEC be classified as debt for Luxembourg tax purposes. This is the main reason that taxpayers seek LACD’s ruling and is the heart of LACD’s arbitrage manufacturing. Financially speaking, both types of instruments generate equity-like returns.

For example, the PECs were subordinated to all securities except for the CPECs (with which they ranked the same) and were redeemable at the option of the holder (Argo). The ability to demand immediate redemption favors equity treatment since equity owners usually have the ability to liquidate the investment at will (unlike bondholders).

The term to maturity of the PECs was forty-nine years, which is unusually long for a debt obligation. Under such circumstances the net present value of the principal amount is minimal compared to interest payments, which can only be sustained from operational profits (and hence are similar to equity return, rather than compensation for credit risk). In the United States, for example, a rule of thumb among practitioners is that financial instruments with a term to maturity longer than thirty years will generally *not* be treated as debt for tax purposes, unless other considerations strongly support debt characterization.<sup>216</sup>

The PECs’ term to maturity is particularly curious in the context of this transaction. As a private equity fund, ABRY’s investment horizon cannot extend to more than seven to ten years.<sup>217</sup> Clearly, ABRY’s original intention was to redeem the PECs long before maturity. It seems that the only reason to attach an artificially long term to maturity of forty-nine years was to gain *equity* treatment from the jurisdictions of residence of ABRY’s investors, thus completing the arbitrage scheme.

The interest payment of the PECs was set at a rate of 14.00% (Series A) and 13.4982% (Series B). This is an unusually high interest rate. For comparison, at the time of the submission the long-term yield of a Canadian

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<sup>215</sup> ABRY ATA, *supra* note 213, at 3.

<sup>216</sup> Though longer term debts have been issued and respected as debt. *See* GARLOCK, *supra* note 114, at 1034.

<sup>217</sup> THOMAS MEYER & PIERRE-YVES MATHONET, BEYOND THE J-CURVE: MANAGING A PORTFOLIO OF VENTURE CAPITAL AND PRIVATE EQUITY FUNDS 11 (2005) (“The fund usually has a contractually limited life of 7-10 years.”).

government bond was hovering around 4.00%.<sup>218</sup> Even if one takes into account the subordination, it is difficult to imagine that such a rate represents a true credit risk. Nonetheless, the high interest rate was considered under the ATA to be an arm's length interest.

Moreover, interest payments on the PECs were only to be made from available funds. If funds were not available and the interest went unpaid, interest would nonetheless accrue. This causes the payment on the PECs to look like preferred dividends.

The CPECs also represented clear equity features. Their term to maturity was forty-nine years. They were convertible to equity at the request of the holder. They only paid a nominal amount of interest (0.375% per annum) which was seemingly enough to qualify them as debt. This makes little financial sense. An instrument with such a long term to maturity and minimal interest has a minimal net present value. This implies that the bulk of the instrument's value was attributable to the equity conversion feature.

Both PECs and CPECs were nonetheless ruled to be debt for Luxembourg tax purposes, with the effect that all payments on the instruments (including any redemption payments) were deductible as interest in Luxembourg.

### 3. *Thin Capitalization Qualification*

The Luxembourg Structure clearly fails the 85:15 debt equity threshold. The Luxembourg Structure was financed with CAD 202,531,918 in debt instruments (PECs and CPECs), and only CAD 750,000 of common equity. This generates a debt/equity ratio of 99.63:0.37. On its face, the excess debt (99.63% - 85% = 14.63% for a face amount of CAD 29,630,420) should have been recharacterized as equity.

Payment in respect of such amount should not have been deductible in Luxembourg. In absolute terms, this would have generated an additional corporate tax in Luxembourg of CAD 1,202,995, calculated as follows: 14.00% (interest paid on the instruments now classified as dividend) *times* 29,630,420 (face amount re-characterized as equity) *times* 29.00% (Luxembourg corporate tax rate). In addition, all payments characterized as dividends would have been potentially subject to a 15.00% withholding tax in Luxembourg. This would have generated an additional tax in Luxembourg of CAD 622,239. In other words, had the Luxembourg thin capitalization rules been followed, ABRY would have been subject to an additional *annual* tax in Luxembourg as high as CAD 1,825,234.

The ATA, however, determined that Luxembourg's thin capitalization rules were inapplicable. The justification provided in the submission was that the interest paid on the CPECs (0.375%) represents a 15% discount on a

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<sup>218</sup> Canadian bond yields are available at *Canadian Bond Yields: 10-Year Lookup*, BANK OF CAN., <http://www.bankofcanada.ca/rates/interest-rates/lookup-bond-yields/>.

market rate of 0.5%, and therefore the CPECs should not be taken into account in calculating the debt to equity ratio. In such a case the ratio for the Luxembourg Structure would indeed be about 67/33, well above the threshold.

However, the submission provided no justification to set the market rate for the CPEC at 0.5%. Also, if the CPECs are not taken into account for debt/equity ratio determination, it is completely illogical to characterize them as debt in the first place. In fact, the submission itself explicitly acknowledges that the “[Luxembourg Structure] do[es] not bear any currency and credit risk (or the credit risk is very low) . . . .”<sup>219</sup>

Interestingly, the absence of credit risk implies that interest on the PECs is *not* an arm’s length interest. Even if the PECs were properly characterized as debt (which they should not have been), it is difficult to accept that a debt instrument with no credit risk (as ABRY readily admits) justifies such a high rate of interest payment (14.00%). Of course, if the 14.00% return is due to something other than credit risk, the instrument should not have been classified as “debt.”

#### 4. Margin Determination

The ATA provides that a spread of 0.125% will remain in Luxembourg and be subject to tax there. There seems to be no justification for such determination other than blanket statements that such margin is justified considering “the amounts involved and the risk profile.”<sup>220</sup> At no point in the submission does ABRY explain what the Luxembourg Structure does, other than to function as a conduit for the transfer of funds. In fact, the submission readily admits that the Luxembourg Structure has no other functions, when it states that the structure carries no credit risk and is simply in a back-to-back position in respect of identical financing instruments.<sup>221</sup>

Assuming all payments from the operating companies in Canada to the Luxembourg Structure were deductible (which was probably the case), it is possible to calculate the amount of tax saved in Canada.

The total amount of debt financing in Canada is CAD 135,521,279 (Loan A and Loan B). At 14.00% interest, the deduction amounts to CAD 18,972,979. At the time, the corporate tax rate in Canada was about 31.4% (federal and local tax rate combined).<sup>222</sup> Thus, the total amount of corporate tax avoided in Canada annually (assuming Q9 was profitable) was approximately CAD 5,957,515.

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<sup>219</sup> ABRY ATA, *supra* note 213, at 18.

<sup>220</sup> *Id.* at 17.

<sup>221</sup> *See id.* at 17–18.

<sup>222</sup> OECD Tax Database, *supra* note 6.

In Luxembourg, the income was subject to a taxable margin of 0.125%, at a rate of 29.00%. Thus, the total amount paid in Luxembourg was 18,972,979 *times* 0.125% *times* 29.00%, or about CAD 68,777.

The bottom line is that ABRY paid Luxembourg an annual payment of CAD 68,777, for an instrument that enabled ABRY to legally avoid taxes of CAD 5,957,515 in Canada, annually.

The effective tax rate that ABRY paid on its annual, Canadian-generated profits that were financed through Luxembourg was thus 68,777 *divided* by 18,972,979, or about 0.36%.

