

THE STATE ADMINISTRATION OF INTERNATIONAL TAX AVOIDANCE

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Abstract

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 tax from the aided taxpayers. Such tax is functionally structured as a fee paid for government-provided tax avoidance services. Such behavior can be easily copied (and probably is copied) by other tax administrations. The implications are profound. On the normative front, the findings should fundamentally change our understanding of the concept 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 “bagger 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 misaimed. Current efforts are largely aimed at curtailing aggressive taxpayer behavior. Instead, the Article proposes that the focus of such efforts should be curtailing certain rogue practices adopted by national tax administrations.

To explain these arguments, the Article uses an original dataset. In November of 2014, hundreds of advanced 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. 172 of the documents are hand-coded and analyzed. The

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analysis demonstrates that LACD cannot be reasonably viewed – as some have suggested in LACD’s defense – a passive player in tax avoidance schemes of multinational taxpayers. Rather, LACD is best described as a for-profit manufacturer of tax avoidance opportunities.

I. INTRODUCTION

In November of 2014, The International Consortium of Investigative Journalists (“ICIJ”) made public hundreds of leaked, privately negotiated advanced tax agreements (“ATAs”).¹ These ATAs were issued by Luxembourg’s *Administration des Contributions Directes* (Luxembourg’s Inland Revenue, or LACD), primarily to multinational corporate taxpayers (MNCs).² This Article analyses an original dataset, generated from a hand-coded sample of 172 of the leaked ATAs. The analysis makes several important contributions – both descriptive and normative – to international tax law literature.

Descriptively, the 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, in order to attract investment.³ The analysis of LACD administrative practices shows a different pattern. LACD assisted multinational tax 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 source and residence. In return, LACD earned what is best described as fees for tax-avoidance services.

The Article also shows how a jurisdiction can become a tax-haven by *administrative practice*. While a formal definition of a “tax haven” is illusive,⁴ it is generally understood that tax haven jurisdictions possess two

¹ Advanced 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.

² *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>.

³ *See, infra* notes and 137-142, and accompanying discussion.

⁴ Dhamimika 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.”).

important characteristics: low statutory tax rates, and strict secrecy laws.⁵ 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.⁶ It has anti tax-avoidance measures in place,⁷ and requires taxpayers who seek favorable administrative rulings to have substantive presence in Luxembourg.⁸ Nonetheless, during the sample period, Luxembourg enabled taxpayers to eliminate their tax liabilities by administrative rulings. Luxembourg did this by issuing binding, yet unpublished agreements, without reviewing taxpayers' submissions,⁹ without asking taxpayers for information where information was obviously missing,¹⁰ while ignoring Luxembourg own administrative guidance,¹¹ binding intergovernmental legal procedures,¹² as well as well-established principles of international tax law.¹³

The Article labels Luxembourg's administrative behavior as "arbitrage manufacturing." Arbitrage manufacturing can generally be described as a process in which, in return for a fee, a jurisdiction issues a regulatory instrument to a taxpayer who resides outside the jurisdiction, in respect of an investment located outside the jurisdiction. The 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.

⁵ *Id.*, at 662-663 ("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...").

⁶ Comparative corporate tax rates can be obtained at the OECD Tax Data Base, available at: http://www.oecd.org/tax/tax-policy/tax-database.htm#C_CorporateCapital. A comparison for the 2015 fiscal year can be found at <http://stats.oecd.org/Index.aspx?QueryId=58204>.

⁷ Of particular relevance is Luxembourg's thin-capitalization guidance. *See infra* Part IV.B. 3.

⁸ Press Release, Luxembourg Ministry of Finance Position Paper on Tax Transparency and Rulings 1 (Oct. 12, 2014), http://www.mf.public.lu/publications/divers/gov_position_rulings_101214.pdf (stating that "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.").

⁹ *See*, discussion *infra* at Part III.C.

¹⁰ *See*, discussion *infra* at Part IV.B.2

¹¹ *See*, discussion *infra* at Part IV.B.3

¹² *See*, discussion *infra* at Part IV.B.4

¹³ *See*, discussion *infra* at Part IV.B.2

On the normative front, the processes discovered in the Article are disconcerting. Luxembourg's behavior can be copied (and may indeed be copied) by any country that has an income tax. The expected result is a distorted form of tax competition.¹⁴ Proponents of tax competition view “interjurisdictional competition as a beneficent force that... compels public agents to make efficient decisions.”¹⁵ The Article argues that competition based on arbitrage-manufacturing 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.”¹⁶ The Article suggests that 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.¹⁷ Here also, scholars are divided.¹⁸ The “traditional view” of tax havens is a negative one.¹⁹ Tax-havens are viewed as “parasitic” in the sense that they poach revenue from other jurisdictions.²⁰ Tax havens “commercialize” their jurisdiction²¹ by allowing taxpayers from non-haven economies to “rent” residence in tax havens.²² The result is 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.”²³ On the other hand, the “new view” of tax havens is more sanguine. Under this view tax havens are “benign”²⁴ participants in 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

¹⁴ See, discussion *infra* at Part V.A.

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

¹⁶ *Id.*, at 334.

¹⁷ See, discussion *infra* at Part V.B.

¹⁸ For a summary of the academic debate on the role of tax havens in global economy, see Dharmapala, *supra* note 4.

¹⁹ *Id.*, at 662.

²⁰ 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”).

²¹ 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).

²² *Id.*

²³ Dharmapala, *supra* note 4, at 671.

²⁴ 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).

mobile capital, which they attract by offering low (or no) taxation on returns from such capital.²⁵ Moreover, tax havens may actually be beneficial to global economy, as they facilitate low-cost capital mobility, thus mitigating some of the distortive effects of high taxes imposed by industrialized economies.²⁶ In the process, tax havens also improve the welfare of their own citizenry.²⁷

Arbitrage manufacturing supports the “negative 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 is 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. Arbitrage manufacturing is classic example of rent seeking.

The Article also offers several practical observations.²⁸ Arbitrage manufacturing has real implications to international efforts to combat tax avoidance.²⁹ Current anti-avoidance efforts are largely aimed at coordinating the domestic tax laws of multiple jurisdictions, with the hope to prevent taxpayers from taking advantage of differences between national tax laws.³⁰ However, any jurisdiction can insert itself between the jurisdictions of source and residence, and create synthetic arbitrage opportunities by unpublished administrative rulings. The results indeed demonstrate that Luxembourg’s tax administrators functionally partnered with taxpayers from other jurisdictions to form a for-profits venture of arbitrage manufacturing.³¹ Luxembourg’s revenues were directly related to

²⁵ See Adam H. Rosenzweig, *Why Are There Tax Havens?*, 52 WM. & MARY L. REV. 923, 948-957 (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).

²⁶ See, e.g., Quin Hong & Michael Smart, *In Praise of Tax Havens: International Tax Planning and Foreign Direct Investment*, 54 EUR. ECON. REV. 82 (2010) (concluding that tax havens present planning opportunities that allow non-haven countries to maintain high business tax rates, while preventing an outflow of foreign direct investment).

²⁷ See James. R. Hines, *Do Tax Havens Flourish?*, 19 TAX POL’Y & ECON. 65 (2005). (finding that tax havens economies are doing better than comparable non-havens in terms of economic growth and public spending).

²⁸ See, discussion *infra* at Part V.C.

²⁹ This article only addresses tax havens in the context of “tax avoidance,” which refers to schemes to reduce ones 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.”

³⁰ See *infra* Subpart VI.C. for further discussion.

³¹ At least one commentator portrayed Luxembourg’s relationship with taxpayers as a

the amount of taxes saved by the taxpayers in other jurisdictions. Since the interests of the taxpayers and the haven-jurisdiction are aligned in such context, there are good reasons to expect other jurisdictions to engage in similar behaviors. This suggests that international coordinated efforts to combat tax avoidance should shift some of their focus away from tax-schemes designed by taxpayers, towards tax-reducing administrative practices.

The article is structured as follows: Part I briefly described 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 gleaned from the sample. Such practices enable arbitrage manufacturing to take place. Part III explains the substantive aspect 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 to our understanding of tax competition as well as the role of tax havens in global economy. The Article concludes with a brief discussion of the implications that the findings have to current international efforts to combat tax avoidance.

II. 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.³² Publically dubbed “LuxLeaks,”³³ the leak allegedly exposed a systemic practice by which LACD aided MNCs to dramatically cut their tax bills in jurisdictions other than Luxembourg.

for profit partnership. See Allison Christians, *Lux Leaks: Revealing the Law, One Plain Brown Envelope at a Time*, 76 Tax Note 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.”).

³² *Luxembourg Whistleblower Says He Acted out of Conviction*, 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. See, Teri Sprackland, *Antoine Deltour -- The LuxLeaks Whistleblower*, 80 TAX NOTES INT’L 967 (Dec. 21, 2015).

³³ 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>.

Following the leak, MNCs were blamed for “channeling hundreds of billions of dollars through Luxembourg [and saving] billions of dollars in taxes.”³⁴ News reports suggested that MNCs were “helped” by LACD who “rubber-stamped tax-avoidance to an industrial scale.”³⁵ The revelations triggered a special review by the European Parliament,³⁶ as well as fierce public criticism, characterizing Luxembourg as a “global tax haven.”³⁷ LuxLeaks eventually materialized to an investigation by the European Commission into the tax ruling practices of all EU member states.³⁸

In its own defense, Luxembourg forcefully asserted that its administrative tax ruling practices were legal, from both domestic and European law perspectives.³⁹ In an odd turn of events, the president of the European Commission, Jean-Claude Juncker, also defended Luxembourg’s practices at the same time that the Commission under his charge continued its investigation. Juncker, in the periods relevant to the leaked ATAs, 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.”⁴⁰ In tax jargon, Juncker’s defense refers to

³⁴ James Kanter, *Hundreds of Companies Seen Cutting Tax Bills by Sending Money Through Luxembourg*, NEW YORK TIMES (Nov. 5, 2014), http://www.nytimes.com/2014/11/06/business/international/hundreds-of-companies-seen-cutting-tax-bills-by-sending-money-through-luxembourg.html?_r=0.

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

³⁶ See *European Parliament Begins ‘Lux Leaks’ Review*, 16 TAX NOTES INT’L 939 (2015).

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

³⁸ European Commission Press Release, IP/14/2742 (Dec. 17, 2014).

³⁹ See Ministry of Finance Press Release, *The Ministry of Finance Comments on the Practice of Advance Tax Decisions* (Jun. 23, 2015), 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 Karintsching & Robin Van Daalen, *Business Friendly Bureaucrat 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>.

⁴⁰ See Bruno Waterfield, *Juncker Defends Luxembourg’s Tax Arrangements as Legal*, TELEGRAPH (Nov. 12, 2014, 4:00 PM), <http://www.telegraph.co.uk/news/worldnews/europe/eu/11225662/Juncker-defends->

what is known as “international tax arbitrage.” International tax arbitrage is the ability of MNCs to exploit differences (i.e., 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.⁴¹ The United States defines the tax-residence of corporations based on the place of incorporation.⁴² Before Ireland changed its law, it was possible to incorporate a corporation in Ireland, but have its management located in the U.S., thereby creating an entity that is “foreign” from the point of view of both Ireland and the U.S. If such tax arbitrage scheme is successful, no country asserts tax jurisdiction over the corporation.⁴³

Juncker’s defense, therefore, 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.

This Article finds that, 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 tax arbitrage opportunities for taxpayers. Luxembourg, however, functioned as a jurisdictional conduit between the source and residence jurisdictions, with the effect of creating arbitrage opportunities that would not have been available had an investor invested directly in the source jurisdiction. The Article explains this process in detail.

[Luxembourgs-tax-arrangements-as-legal.html](#).

⁴¹ See BNA MANAGEMENT PORTFOLIO 965-4TH: BUSINESS OPERATIONS IN THE REPUBLIC OF IRELAND V.B.

⁴² I.R.C. § 7701(a)(4). All references to the I.R.C. are to the Internal Revenue Code of 1986, as amended.

⁴³ 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 of 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 S. Comm. on Investigations, 114th Cong. Exhibit 1-A, at 2 (2013) (memorandum of Sen. Carl Levin, Chairman on Permanent S. Comm. on Investigations and Sen. John McCain, Ranking Minority Leader) (“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”).

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 of 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.⁴⁴ The second batch of documents – significantly smaller than the first one – was made public in December of 2014 by unnamed sources, and included ATAs as well as other documents issued to 33 MNCs. Multiple tax advisory firms were involved in the second batch of documents. All the documents leaked by the ICIJ are publically available online.⁴⁵

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 the second batch of documents has not been explicitly stated by the ICIJ. Moreover, the 548 figure attached to the first batch is not accurate for 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 the order of appearance in the online database, which is arranged alphabetically according to the name of the taxpayer sponsoring the submission.⁴⁶

C. Sampling Problems

The ICIJ database, and hence the original dataset, suffer from several inherit shortcomings. To begin with, the absolute majority of the

⁴⁴ Some documents attached to the PwC submission, in particular copies of past ATAs, were drafted by other tax advisory firms.

⁴⁵ The database is available at <http://www.icij.org/project/luxembourg-leaks/explore-documents-luxembourg-leaks-database>.

⁴⁶ One caveat is that the dataset only contains ATAs submitted in English. The absolute majority of the ATAs, however, are issued in English. During the coding we came across 11 non-English ruling; nine were in French and two were 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, we believe a sample of English-only rulings is still suitable for a non-generalizable exploratory analysis, intended to identify administrative practices.

submissions were drafted by the PwC Luxembourg's office. 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 it is clear that the dataset is 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 the PwC's Luxembourg office. 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. For such purpose, the sample is appropriate. 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.⁴⁷ PwC Luxembourg's office employs 660 tax professionals,⁴⁸ more than any other tax advisory firm in Luxembourg.⁴⁹ Thus, the findings cover a significant part of Luxembourg's tax advisory market. Moreover, studies in organizational sciences have shown that path dependence plays central role in the operations of elite firms that compete for the same clientele.⁵⁰ For example, Rostein and Regan provide a detailed account of such process in the U.S. tax-advisory industry during the tax-shelter era of the late 1990s.⁵¹ They describe an institutionalization process in which "lax regulatory environment and a highly competitive market for professional services," led to a "widespread and *systemic* episode of professional wrongdoing."⁵² It is therefore expected that PwC's practices are, at the minimum, reminiscent of practices of other large tax-advisory firms in Luxembourg and as such representative of Luxembourg's common tax-advisory practices.

Another problem of the database is that it only covers a specific time

⁴⁷ PwC Luxembourg prides itself as being "the largest professional services firm in Luxembourg with 2,450 people employed from 55 different countries." See <http://www.pwc.lu/en/about-us/index.jhtml> (last visited Jun. 25, 2015).

⁴⁸ See *Tax Services*, PWC LUXEMBOURG, <http://www.pwc.lu/en/tax.html>.

⁴⁹ For example, per the International Tax Review, PwC's 660 tax professional compares favorably to other Big 4 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 *World Tax Market Overview: Luxembourg*, INT'L TAX REV., <http://www.itrworldtax.com/Jurisdiction/78/Luxembourg.html>.

⁵⁰ See, eg, Marcel Kahan & Michael Klausner, *Path Dependence In Corporate Contracting: Increasing Returns, Herd Behavior And Cognitive Biases* 74 WASH. U. L. REV. 347 (1996) (explaining that economic efficiencies and behavioral biases lead to standardization in legal practice of corporate contracting).

⁵¹ TANINA ROSTAIN & MILTON C. REGAN, JR., *CONFIDENCE GAMES: LAWYERS ACCOUNTANTS AND THE TAX SHELTER INDUSTRY* (2014).

⁵² *Id.* at 4 (emphasis added). For a summary of this institutionalization process, see *id.* at 332-37.

period. The sample covers ATAs issued between March 7, 2003 and September 29, 2010. It is possible that the practices identified are particular to such period. Legislative and economic considerations may create certain tax planning needs and opportunities that are not available at 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. It is therefore arguable that the practices identified herein are particular to an environment of a financial crisis, and are not representative of standard tax planning behavior.

The limited timeframe covered by the database is not harmful to the validity of the results, however. 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.⁵³ 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 that were executed under the assumption that profits will be generated are faced with a reality of financial losses, taxpayers scramble and revisit their planning schemes. Testing administrative response to taxpayers' requests to change previously issued ATAs is particularly telling of the nature 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 ATAs process throughout the sample period was also in charge of the process for the two-decades preceding the sample period.⁵⁴ 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 ATA is an advanced tax ruling, which “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

⁵³ 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).

⁵⁴ See discussion *infra* Subpart III.A.

the transaction.”⁵⁵

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 the 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 the submissions (such as articles of association, purchase agreements, valuation reports, term sheets for financial instruments, and so on).

LACD’s approval comes either in the form of an approval stamp, or as 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. Once approved, an ATA secures the Luxembourg tax treatment of the transaction in respect of which the ATA is sought.⁵⁶

2. Variables and Observations

All ATAs contained in the sample were hand-coded. The coded variables can broadly be divided to 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.

⁵⁵ Yonatan Givati, *Resolving Legal Uncertainty: The Unfulfilled Promise of Advanced Tax Rulings*, 29 VA. TAX REV. 137, 139 (2009).

⁵⁶ Rulings provide “visibility and legal certainty, which is legitimately sought by companies.” See Press Release, Luxembourg Ministry of Finance Position Paper on the Luxembourg’s Government Position on the Practice of Issuing Tax Rulings (Nov. 11, 2014), http://www.mf.public.lu/publications/divers/position_rulings_eng_101214.pdf.

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 note,⁵⁷ but concern issues such as withholding tax, tax residence status, financial instruments characterization (debt or equity), the application of favorable tax regimes (such as "participation exemption" or "patent boxes"),⁵⁸ 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.⁵⁹

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-

⁵⁷ Overall, the coding documented more than 780 requests for various substantive assurances sought by taxpayers.

⁵⁸ Under Luxembourg's "participation exemption" regime, certain dividends received from foreign subsidiaries of certain Luxembourg corporations are exempt from corporate taxes in Luxembourg. *See*, Peter Moons, *Business Operations in Luxembourg (Tax Management Portfolio 971)*, BLOOMBERG BNA, Part IV.A.3(a) [hereinafter: *LUXEMBOURG BNA*]. 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).

⁵⁹ Rather than the Luxembourg entity officially submitting this request. The Luxembourg entity submitting the request is required to have substantive presence in Luxembourg. The Article questions the significance of this requirement below, at *infra* Subpart IV.B. 1.

secret constraints that prevent them from seeking ATAs to the same extent as private entities.⁶⁰ On the other hand, public entities may be pressured by their shareholders to aggressively seek high after-tax return.

Chart 1 observes the location of the headquarters of each ATA sponsors in respect of which data is available, as a percentage of the sample of sponsors (n = 174).⁶¹ An attempt to code the sponsor's tax residence was made, but such an attempt 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.⁶² If the submission does not contain a discussion of the factors according to which tax residence is determined 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 (for example, private equity funds that are not publicly traded are generally treated as partnerships for tax purposes).⁶³ 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 funds (even though some do so).

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 from.⁶⁴ This is of particular importance in the case of

⁶⁰ See generally Michelle Halon & 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 (2006) (discussing the effect of reputational considerations on the structuring of tax-savings schemes).

⁶¹ Some ATAs are sponsored by more than one taxpayer, and therefore *n* is larger than the sample size.

⁶² For a survey of such rules, see Omri Marian, *Jurisdiction to Tax Corporations* 54 B.C. L. REV. 1613, 1619-28 (2013).

⁶³ Most U.S.-based private equity funds are structured as partnerships. Generally, partnerships are transparent for U.S. tax purposes, unless publically traded, in which case they are treated as corporations and as such subject to corporate-tax. See I.R.C. § 7704.

⁶⁴ See Omri Marian, *Home Country Effects of Corporate Inversions*, 90 WASH. L. REV. 1 (2015) (finding no clear evidence that the location of substantive corporate operation are

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.”⁶⁵

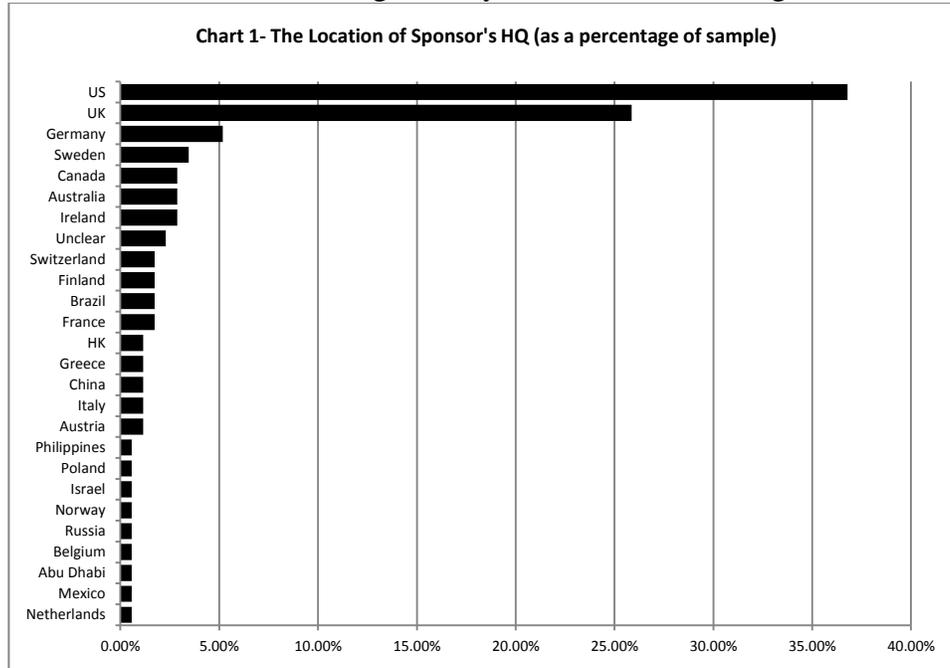


Chart 1 demonstrates that two jurisdictions completely dominate the sample: the U.S. and the UK. This is consistent with previous research on the Lux Leaks affair.⁶⁶ Taken together, UK and U.S. headquartered sponsors account for almost two-thirds of all ATA entity-sponsors. While one might be tempted to explain such finding by the size of the economies involved, such a conclusion may be hasty. For example, some jurisdictions are extremely underrepresented relative to the size of their economies (China, Japan, Russia, Brazil, not to mention India, which is completely absent), while others (such as the UK and Ireland) are overrepresented.

associated with the place of corporate tax residence); Kimberly A. Clausing, *Should Tax Policy Target Multinational Firm Headquarters?*, 63. NAT'L TAX J. 741 (2010) (finding little relationship between multinational firms' headquarters' locations and tax policy variables).

⁶⁵ Press Release, Luxembourg Ministry of Finance Position Paper on Tax Transparency and Rulings (Oct. 12, 2014), http://www.mf.public.lu/publications/divers/gov_position_rulings_101214.pdf.

⁶⁶ Birgit Huesecken & Michael Overesch, *Tax Avoidance through Advance Tax Rulings - Evidence from the LuxLeaks Firms*, 20 (2015), available at <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”).

It is therefore 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 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 UK or U.S. MNCs face higher effective tax burdens than their foreign counterparts.⁶⁷

Alternatively, it is possible that lenient tax rules in certain jurisdictions make taxpayers from such jurisdictions more likely to seek Luxembourg rulings, simply because they can. 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 U.S. determines the place of tax residence of entities based on the place of incorporation.⁶⁸ 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.⁶⁹ 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

⁶⁷ See, e.g., Gabriel Zucman, *Taxing Across Borders: Tracking Personal Wealth and Corporate Profits*, 28 J. ECON. PERSPECTIVES 121, 130-133 (2014) (describing the decline of U.S. effective corporate tax rate over time, concluding 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 US 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”).

⁶⁸ IRC § 7701(a)(4).

⁶⁹ See Klaus Sieker, *Business Operations in Germany (Tax Management Portfolio 7140)*, BLOOMBERG BNA, Part V.A.

laws of sponsors' jurisdictions may play an important role in explaining why some jurisdictions are over- 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.

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

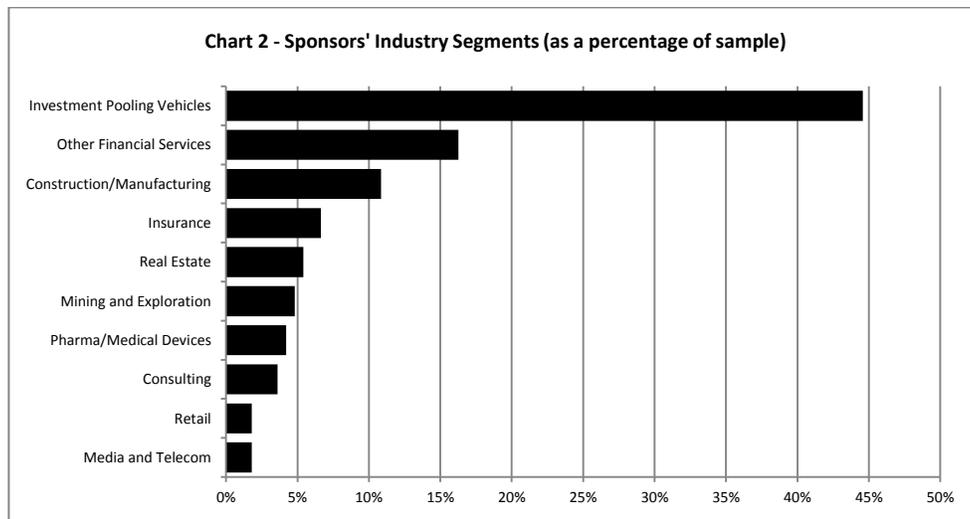


Chart 2 demonstrates the central role that financial intermediaries play in tax avoidance through Luxembourg. Of particular note is the fact that private capital-pooling vehicles (such private equity, venture capital and hedge funds) sponsor almost half of the ATAs. Equally interesting is the relatively 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 high-tech.⁷⁰ The findings suggest that the focus on research-dependent industries may be somewhat unjustified.

⁷⁰ 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”).

III. THE ADMINISTRATIVE PROCESS

The Article now turns to describe the findings as they pertain to the administrative process. Subparts A and B describe the individuals controlling the process. Subpart C explains the timing of the process. The results presented herein suggest that no or little substantive consideration is accorded to the submissions. Rather, the process seems like a negotiation of equals between parties who are well familiarized with each other.

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

This Subpart starts with a description of the individuals involved. At the end of the day, individuals execute the process, and by doing so shape and create practices.⁷¹ In Luxembourg, the administrative agency in charge of the ATA process is called Sociétés 6. Sociétés 6 was – during the relevant period – a one man show. Marius Kohl – who headed of Sociétés 6 for 32 years until his retirement in 2013⁷² – “had sole authority... to approve or reject”⁷³ 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.”⁷⁴ After the revelation of the leaks, Kohl was included in “The Global Tax 50” for 2014, which is an annual list of the 50 most influential individuals and organizations in the tax profession, selected by the International Tax Review.⁷⁵

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

⁷¹ See, eg., 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”). Specifically in the tax context, see Philipp Genschel & Thomas Rixen, *Settling and Unsettling the Transnational Legal Order of International Taxation*, in HALLIDAY & SHAFFER *id.*, at 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.”).

⁷² Karintsching & Van Daalen, *supra* note 39 (“In 2013, Mr. Kohl took early retirement, after 37 years at the tax office”).

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ See, *Global Tax 50 2014: Marius Kohl*, INT’L TAX REV. (Dec. 16, 2014), <http://www.internationaltaxreview.com/Article/3406724/Marius-Kohl.html>.

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 11 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,⁷⁶ about 40% of the ATAs were approved the same day they were submitted (some of these submissions were hundreds of pages long). It is unlikely that Kohl was able to give substantive consideration to such submissions before approving them.⁷⁷

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 the written legal analysis by the sponsor, followed by Kohl's acceptance of such analysis verbatim. Kohl's approval decisions come in a cookie-cutter format that read 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, all that is evident is that at some point after the submission Kohl approached the sponsor's advisor with a request for additional information.

If, as is evident from the data, Kohl could not have possibly considered the merits of each submission, important questions arise. For example,

⁷⁶ See discussion *infra* Subpart III.C.

⁷⁷ See also Lee E. 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”).

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.

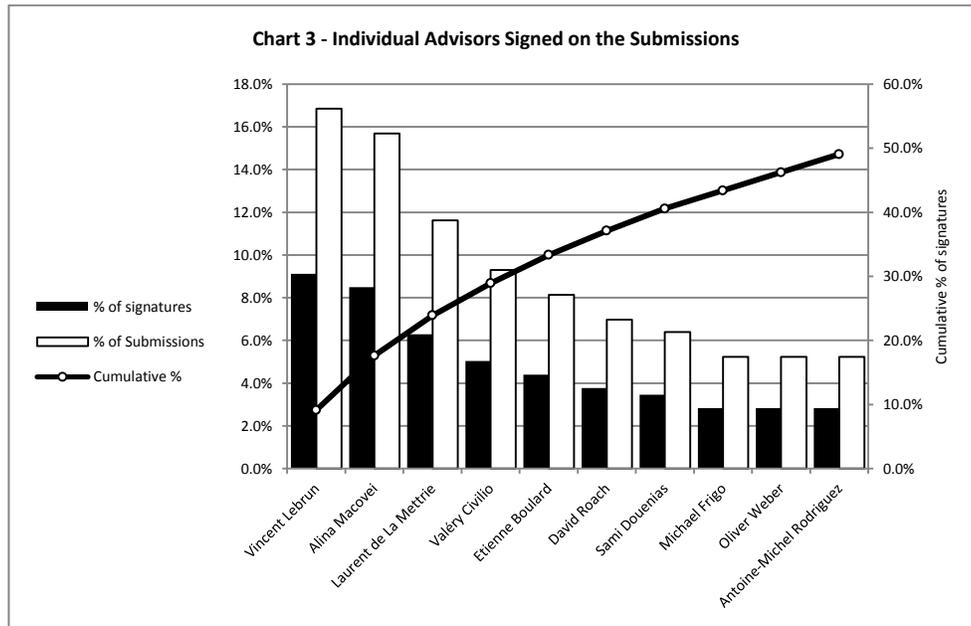
B. The Tax Advisors

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 the practice."⁷⁸ This is particularly true in this case, where a single individual official completely controlled the process. For example, if individual advisors are repeat actors, they may create close relationships with the official. This may affect the process and its outcomes.

The individuals who advised taxpayers in their ATA process are identified by name in each ATA submission.⁷⁹ Most ATA submissions are signed by two individual advisors. Few are signed by one advisor, or by more than two advisors. Overall, 71 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 is summarized in Chart 3.

⁷⁸ Rostain & Regan, Jr., *supra* note 51, at 7.

⁷⁹ 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 represent the facts as understood by the individual advisors, and that their legal conclusions accurately represent their opinion on the matter at hand.



Consider, for example, Vincent Lebrun, who during the relevant period was the leader of the private equity tax advisory group at PwC Luxembourg’s office. He is signed on almost 17% of the submissions (the white bar). Of all advisors signed on the submissions, he accounts for about 9% of all signatures (the black bar). The five top practitioners in the sample account for a third of the total sample of signatures (the plotted line). The ten practitioners most frequent to appear 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

The period (in days) from the time LACD was first engaged by the advisors, until the time a submission was made, and an approval was granted, has been measured. Descriptive data is summarized in Table 2.

	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)	<u>0 (68)</u>
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
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The striking fact about the timing data is the frequency of instances in which LACD's approval was granted the day of the submission. About 40% of the ATAs (count = 68) in respect of which data is available, were approved the same day of the submission. 11.22% of the ATAs (count = 11) in respect of which data is available, were approved the same day as 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.

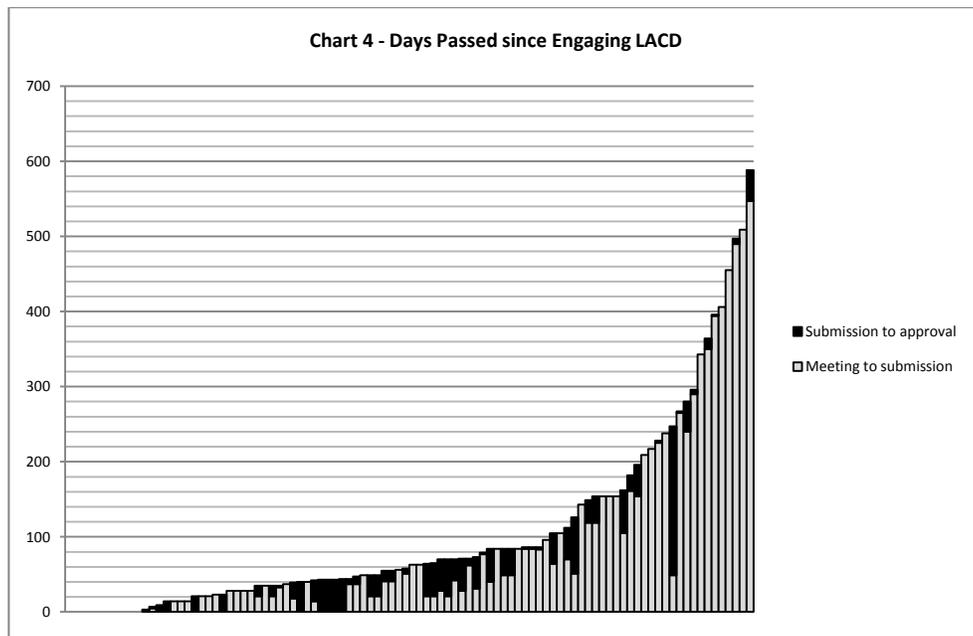


Chart 4 graphically displays the length of the process from initial engagement until formal submission (light gray), and formal submission until approval (black) for each of the 98 ATAs for which data is available (ATAs with a value of "0" were approved the same day LACD was first engaged). Quite clearly, much time is spent before any formal submission is made (the lighter area in the graph). 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 (the darker area in the graph). This further exacerbates the suspicion that the process of an ATA approval is a mere formality.

Luxembourg Ministry of Finance addressed related issues after LuxLeaks broke, stating that "because 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 pre-filing 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.”⁸⁰ This explanation, however, does not address the fact that very little time (if 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 would dictate 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 U.S. equivalent of an ATA) are always supported by detailed substantive explanation of the IRS’s position to approve or deny the submission. Moreover, redacted versions of the PLRs are made public.⁸¹ 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.

IV. THE SUBSTANCE OF ARBITRAGE MANUFACTURING

The lack of administrative rigor described in the previous part 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.

A. International Tax Arbitrage: Background and an Example

In its most basic definition, International Tax Arbitrage (“ITA”) “refers

⁸⁰ Press Release of Nov. 11, 2014, *supra* note 56.

⁸¹ I.R.C. § 6110.

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 benefit....⁸² 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 (as explained above),⁸³ or in both jurisdictions (such corporations are known as Dual-Residence Corporations, or DRCs). Interest paid by the DRC to a third party lender can potentially be claimed as a deductible expense twice – once in each jurisdiction – and reduce tax liability in both jurisdictions.⁸⁴ The trademark characteristic of an ITA scheme is “full compliance with the laws of both jurisdictions while achieving a net tax savings.”⁸⁵

In recent years, there seem to be an emerging consensus that ITA is a critical policy problem.⁸⁶ 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- and middle-income domestic taxpayers; and a revenue-loser that heavily burdens national fiscal deficits.⁸⁷ ITA has also been singled out by the Organization of Economic Cooperation and Development (OECD): The OECD is currently engaged in The BEPS Project, which is one of the most remarkable attempt to-date at a coordinated international effort to combat tax avoidance. The founding document of the BEPS Project decries MNCs' exploitations of “differences in domestic tax rules and international standards that provide opportunities to eliminate or significantly reduce taxation.”⁸⁸ One of the action items of the BEPS Project is specifically aimed at eliminating arbitrage opportunities.⁸⁹

⁸² Diane Ring, *One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage*, 44 B.C. L. REV. 79, 80 (2002).

⁸³ *Supra* notes 42-43 and accompanying text.

⁸⁴ For a discussion of DRC-related arbitrage, see, e.g., Ring, *supra* note 82, at 95-96; Adam. H. Rosenzweig, *Harnessing the Costs of International Tax Arbitrage*, 26 VA. TAX. REV. 555, 561-562 (2007).

⁸⁵ Rosenzweig, *id.*, at 562.

⁸⁶ The OECD identified international tax arbitrage as a policy issue in 2012. See Org. Econ. Cooperation & Dev. [OECD], *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (2012).

⁸⁷ For a discussion of such negative aspects of international tax arbitrage, see Reuven S. Avi-Yonah, *Commentary*, 53 TAX. L. REV. 167, 170-173 (2000). *But cf.*, H. David Rosenbloom, *The David R. Tillinghast Lecture: International Tax Arbitrage and the "International Tax System"*, 53 TAX. L. REV. 137 (2000) (questioning whether international tax arbitrage is indeed an urgent policy problem).

⁸⁸ OECD, *Addressing Base Erosion and Profit Shifting*, 5-6 (2013) [hereinafter: BEPS PROJECT].

⁸⁹ 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).

The theoretical panacea to the ITA problem is full harmonization of tax laws. In the absence of difference in national tax laws MNC taxpayers 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.⁹⁰ 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.⁹¹

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, the 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.⁹² If the tax laws of the source and residence

⁹⁰ 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. 249 (2003). Examples for more recent multilateral projects that addressed, among others, harmonization of tax laws include: *Commission Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCTB)*, COM (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) (a project aimed to establish a harmonized approach to tax reporting and exchange of tax information).

⁹¹ For example, in the context of DRCs discussed above, the I.R.C. denies a DRC the ability to deduct in the U.S. loss or other expense that is potentially deductible elsewhere. See I.R.C. § 1503(d).

⁹² Some differences will always exist, obviously. There will always be 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").

jurisdictions are harmonized, compliance with the laws of both jurisdictions would yield no tax benefit. Referring back to our DRC example above – if both source and residence jurisdiction define corporate tax-residence 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 jurisdiction of source, nor the jurisdiction of residence – inserts itself as an intermediary between 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. The Article argues that 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 magnificent canard, 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.⁹³ 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 at 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

⁹³ Debt/Equity arbitrage financing involving Luxembourg is frequently mentioned by tax advisors as a primary reason to establish Luxembourg structures. *See, e.g.*, Julien Bieber, Gaëlle Auger & Linda Taing (all from KPMG's Luxembourg's office), *Private Equity Structuring In Luxembourg – Key Tax Aspects*, BNA TAX PLANNING INT'L REV. (2011) (“Many [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) (explaining that hybrid instruments issued by Luxembourg entities “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”).

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.⁹⁴ Thus, the dividends will not be taxed to ResCo in Country A upon receipt. To summarize, in the case of equity financing, the earnings are only taxed once – in the jurisdiction of source, that is, 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, eliminating SorCo's corporate-tax liability.⁹⁵ 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 – either in Country B or in Country A – depending on whether the investment is financed with debt or equity.⁹⁶

It would be great for the investor if it 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

⁹⁴ 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, *Special Report: A Global Perspective On Territorial Taxation*, 202 TAX FOUND. 1, 3 (2012), http://taxfoundation.org/sites/taxfoundation.org/files/docs/sr202_0.pdf (concluding that “[o]verwhelmingly, developed economies are turning to the territorial approach”). Few countries, including the United States, 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, payment 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.

⁹⁵ 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). 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.

⁹⁶ This result is the expected outcome of “The Single Tax Principle” of international customary law of taxation, under which income from cross-border transaction is taxed not more, but also not less, than once. See REUVEN S. AVI-YONAH, *INTERNATIONAL TAX AS INTERNATIONAL LAW: AN ANALYSIS OF THE INTERNATIONAL TAX REGIME* 8-10 (2007) (discussing the Single Tax Principle).

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.

Under the debt, SorCo makes deductible interest payments to IntCo and by doing so reduces SorCo's tax obligation in Country B.⁹⁷ 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, and therefore eliminates any potential Luxembourg taxation of IntCo. This aspect of an ATA is particularly important, since Luxembourg corporate tax rate is nominally set at about 29.00%.⁹⁸

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 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 on-sent it to Country A as a non-includible dividend. This short example is obviously very much simplified. Appendix B contains an actual example

⁹⁷ 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 intangibles property owned by IntCo.

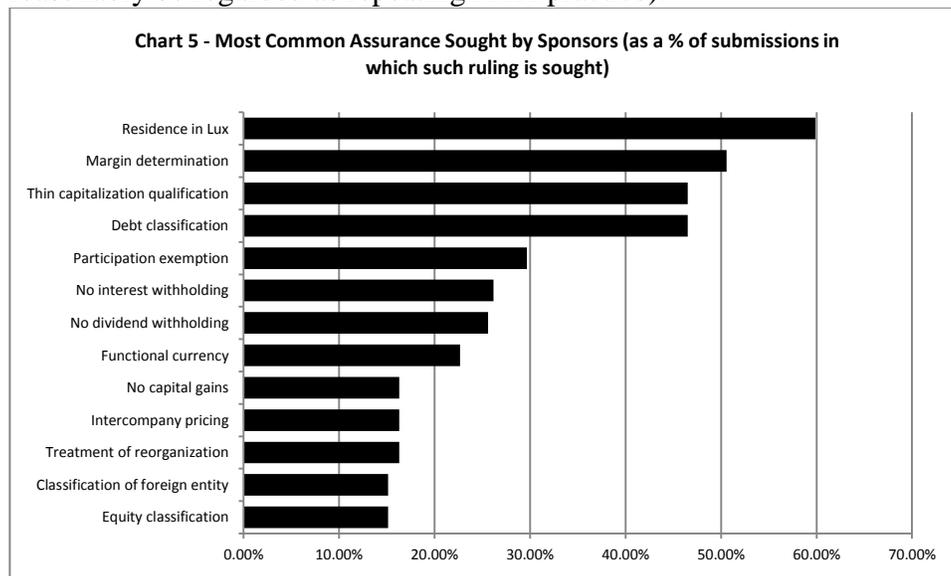
⁹⁸ To be exact, for 2010 (the most current year in the dataset) Luxembourg statutory corporate tax rate was 21.00%. Combined with surtax and local corporate taxes of 6.75%, the rate was 28.59%. See OECD Tax Database, *supra* note 6.

from the dataset, which explains how such 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 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.⁹⁹ The data is presented as a percentage total ATAs in the sample in which such assurance is sought.¹⁰⁰ Chart 5 shows the most common requests made by sponsors, defined as requests that appear in at least 15% of the submissions (thus can reasonably be regarded as repeating ATA practice).



The four most common assurances sought by taxpayer 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

⁹⁹ Meaning, for example, that if even residence determinations were sought in respect of multiple entities in a single submission, the submission is coded for residence only once.

¹⁰⁰ For example, if a taxpayer requested assurances in respect of withholding rate on interest paid by multiple entities, the ATA will nonetheless be coded once with the observation "IntWh", to note the fact that the ATA deals with interest withholding issues.

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 the 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 dividend in the residence jurisdiction, and is granted a 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 (the ruling is required since the instrument resembles equity, and taxpayers seek assurances the LACD will nonetheless treat it as debt).

The 45% figure understates the frequency of debt/equity arbitrage schemes since there are additional ways to generate debt/equity arbitrage 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 such type of arbitrage. The idea that manufacturing debt/equity arbitrage is central to Luxembourg's ATA practice¹⁰¹ seems to be supported by the data.

Third, having achieved a hybrid debt/equity treatment for a financing instrument is not enough. Most jurisdictions in the world 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

¹⁰¹ See *supra* note 93.

completely eliminated by excessive deductible payments to foreign affiliates.¹⁰² Luxembourg indeed has thin capitalization rules, promulgated by administrative guidance.¹⁰³ Under these rules, a Luxembourg corporation's debt/equity ratio must not exceed 85/15.¹⁰⁴ If the threshold is crossed, interest payments are re-characterized as dividend, 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).¹⁰⁵ 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 schemes relies on the deductibility of payments made from IntCo to ResCo, it is crucial to make certain that IntCo 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

¹⁰² See J. Clifton Fleming, Jr., Robert J. Peroni, & Stephen E. Shay, *Getting Serious about Cross Border Earning Stripping; Establishing an Analytical Framework*, 93 N.C. L. REV. 673, 680-684 (2015) (explaining how source taxation is eliminated by way of excessive intra-group interest payments). In the U.S., I.R.C. § 163(j) 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, which is paid to a foreign related party, if such foreign party is subject to reduced taxation in the U.S. on such interest receipts.

¹⁰³ See LUXEMBOURG BNA, *supra* note 58, at IV.A.3(b)(2).

¹⁰⁴ Such a rule is extremely lenient compared with similar rules of other developed jurisdictions. See Jennifer Blouin et. al., *Thin Capitalization Rules and Multinational Firm Capital Structure*, 23-24 (2014) (Int'l Monetary Fund, Working Paper 14/12) (a table describing thin capitalization rules in multiple jurisdictions. Luxembourg 85:15 debt/equity allowance (column 5 in the table) would amount to 5.66, which is higher than all jurisdictions in the table other than one (Switzerland)).

¹⁰⁵ For example, under the Luxembourg-Canada income tax treaty, withholding tax on dividend payment 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)(a), Sep. 10, 1999 [hereinafter: CANADA-LUXEMBOURG TAX TREATY].

transfer – demands that the taxpayer leaves 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/equity arbitrage is the major 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, the Article defines an intermediary financing arrangement as any financial structure in which Luxembourg is neither the jurisdiction of source, nor the jurisdiction of residence, and where the submission does not evidence any significant substantive presence of the sponsor in Luxembourg. 140 submissions, or about 81.40% of the sample, can be classified as such.

Given the centrality of financing arrangements to the findings, the Article further investigates the practices concerning each of the building blocks of such arrangements: Gaining Luxembourg tax residence; Debt/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.”¹⁰⁶ A company’s “principal establishment” is “the center from which the activities of a company are directed.”¹⁰⁷ The analysis in the ATA submissions in this regard 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. All one needs to theoretically do to meet such interpretation, is to fly (or drive) once a year to Luxembourg and have a “board meeting” there. Investigative journalistic inquiries indeed found that several Luxembourg entities named in LuxLeaks had little substantive presence in

¹⁰⁶ LUXEMBOURG BNA, *supra* note 58, at VI.A.

¹⁰⁷ *Id.*

Luxembourg.¹⁰⁸ 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),¹⁰⁹ and the Luxembourg offices of huge multinational corporations are sometimes located in small residential apartments, staffed by a single person.¹¹⁰

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.¹¹¹ Rather, LACD's view of residence seem 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/Equity Classification at the Whim of the Sponsor

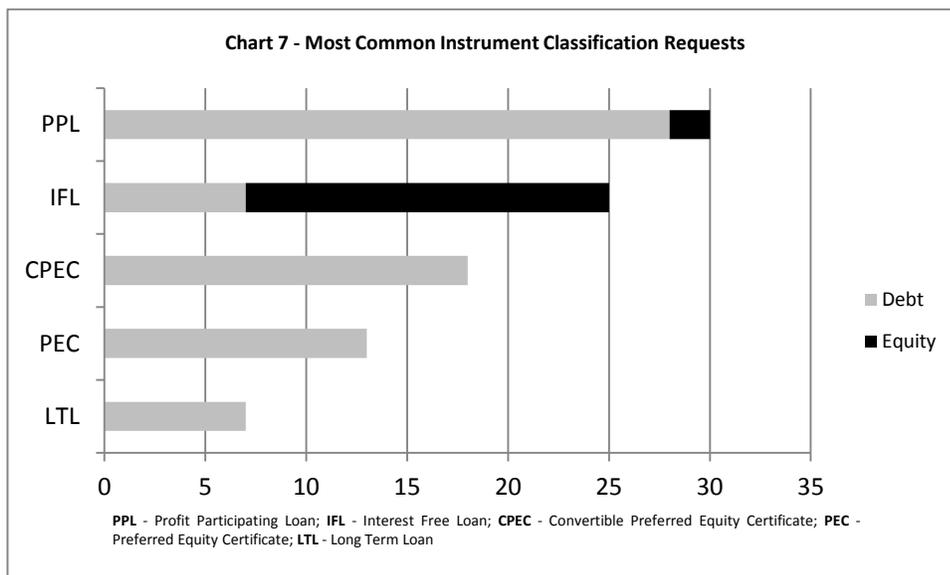
Overall, the sample contains 24 different types of instruments in respect of which debt/equity classification has been requested. Chart 7 depicts the five most common instruments, and whether the request in respect thereof has been for debt or equity classification.

¹⁰⁸ The ICIJ reported "a Luxembourg office can be just a mailbox. Office buildings throughout the city are filled with brand-name corporate nameplates and little else." See *supra* note 2.

¹⁰⁹ *Id.*

¹¹⁰ 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 apartments, where a single employee serves as an officer in multiple companies).

¹¹¹ 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.¹¹² If ResCo finances IntCo with a PPL, “interest” paid from Luxembourg may be viewed by the jurisdiction of residence 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.¹¹³ Thus, all payments on the PPL made from Luxembourg are deductible to IntCo, but generally not includible to ResCo.¹¹⁴ Had such payments been made directly from SorCo to ResCo, they would probably be characterized as dividends by the source

¹¹² 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, *FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS*, Ch. 1 (2011).

¹¹³ Reading the submissions, it seems that the small fixed interest component is the most important factor in qualifying such instruments as “debt.”

¹¹⁴ 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 94.

jurisdictions and would not be deductible.¹¹⁵

Interest Free Loans (IFL), 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 be also 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.

CPECs are Convertible Preferred *Equity* Certificates. In the sample, 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 investment pooling 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 the performance of the underlying investment (like

¹¹⁵ 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 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 nonetheless are viewed as "dividends" that entitle the recipient for a credit. Thus the payment generates a double tax benefit: deduction at the jurisdiction of source, and a credit at the jurisdiction of residence. In 2010, Congress enacted I.R.C. § 909 to combat such perceived abuse. *See* Act of Aug. 10, 2010, Pub. L. No. 111-226, 124 Stat. 2394.

in the case of PPLs). Upon maturity of the investment, CPECs are converted to equity, which then produce equity related returns that are favorably taxed to ResCo. Any conversion payments are nonetheless treated as deductible interest in Luxembourg.

PECs, or Preferred *Equity* Certificates, are similar to CPECs, but usually lack the conversion feature. PECs therefore generally pay a higher interest payment than CPECs. PECs' interest payments are frequently only made out of available funds (though deductions in respect thereof continues to accrue to IntCo). Since IntCo will only have funds available if SorCo is profitable, PECs' return seem very much 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 the Luxembourg is always willing to classify instrument that produce 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 an extent a parent will enforce debt obligations against a non-performing subsidiary. A lack of enforcement may evidence the fact the parties never truly regarded the instrument as debt.

Indeed, the sample contains 13 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 contribution of additional capital, which is not a taxable event.¹¹⁶ This

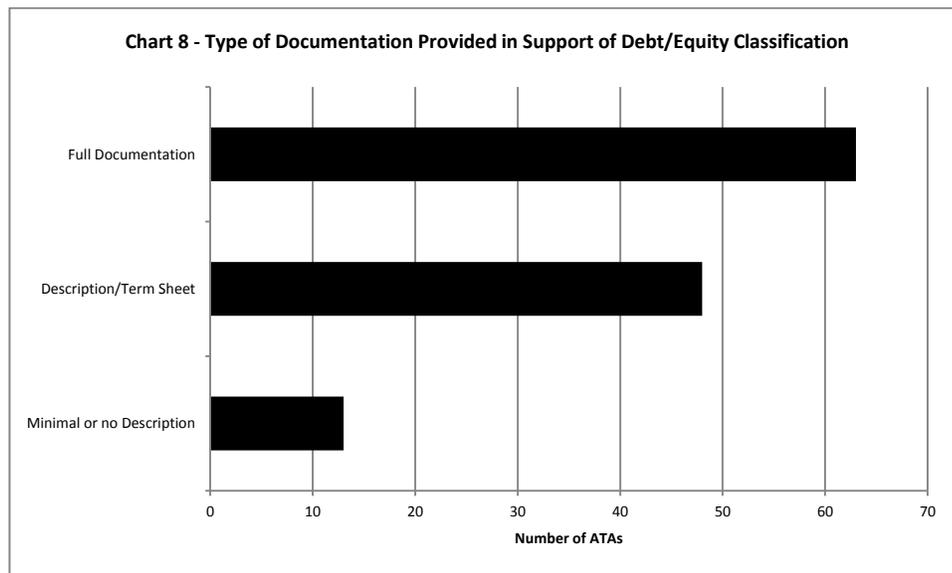
¹¹⁶ See, e.g., Advanced Tax Agreement Submission of Jan. 28, 2010, Mold-Masters Luxembourg Acquisitions S.a.r.l. - 2007 2453 371, at (3) (requesting that "accrued interest on the sub-debt will be waived and the holders of the sub-debt will each forgive part of their respective share of the sub-debt," 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); Advanced Tax Agreement Submission of Nov 11, 2009, Belfor Luxembourg S.a.r.l. - 2006 2434 679, at (2) (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

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, yet to still treat 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.

Another obvious observation that emerges from Chart 7 is that LACD is not always consistent in its characterization of financial instruments. Interest Free Loans (IFLs), 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 LACD lenient 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 determination regarding the 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 in respect of which data is available (50.81%; n = 63) seem

corporate income tax and a municipal business tax perspective.”) (emphasis added).

to provide LACD with the full documentation of the instruments. About 38.71% (n = 48), only describe the terms of the instruments in the submission itself, but provide no actual documentation of the instrument. 10.48% (n = 13) provide almost no description of the terms. In all cases LACD was willing to rule on the classification of the instruments.

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 have yet to be determined. The taxpayer promised to provide such documentation in the future (without committing to a specific date). Yet, an ATA has been 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).¹¹⁷

3. Ignoring Luxembourg's Own Thin Capitalization Guidance

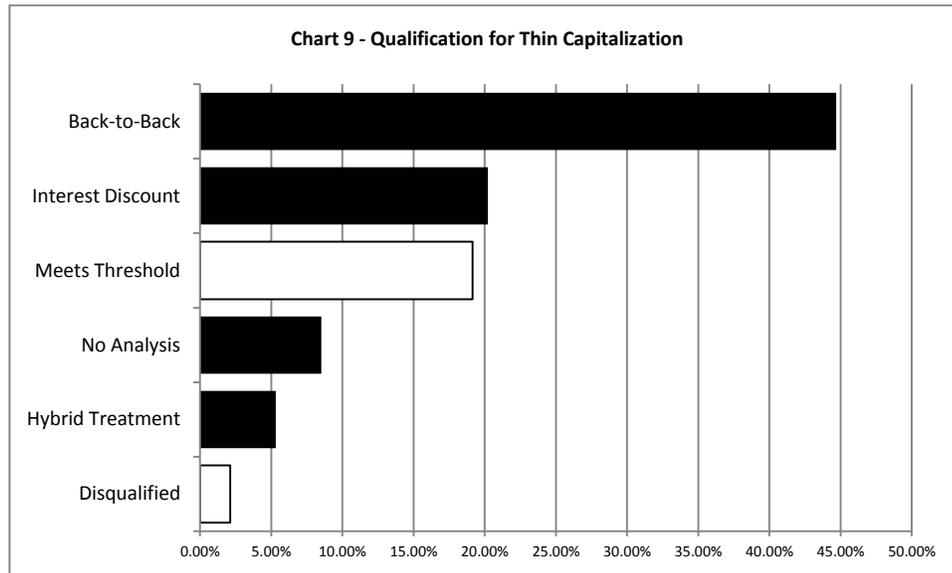
Luxembourg has no statutory thin capitalization law. As a matter of administrative practice, Luxembourg applies a 85/15 debt-to-equity threshold.¹¹⁸ The existence of such practice is supported by the fact that ATA sponsors frequently seek an assurance that that 85/15 threshold is not violated.

However, a close look into LACD's ruling practices teaches that the 85/15 ratio is a lip service. In fact, of the 94 Luxembourg entities in the sample in respect of which thin capitalization assurance was sought, only 18 (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.¹¹⁹ 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.

¹¹⁷ See Advanced Tax Agreement Submission of Mar. 20, 2010 - Dean Foods Europe.an Holdings S.a r.l., at 3 (“A copy of the executed MFA [Master Facility Agreement] will be provided to you at a later date... The MF A 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.

¹¹⁸ Linda Brosens, *Thin Capitalization Rules and EU Law*, 13 EC TAX REV. 188, 200 (2004).

¹¹⁹ 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.¹²⁰ 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 calculating the debt-to-equity ratio.¹²¹

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 return on investments rather than a credit risk, why in the first place did LACD agree to treat such financing as debt? There seems to be no reason for such classification other than to generate deductible

¹²⁰ See, e.g., Advanced Tax Agreement Submission of Jul. 29, 2009 - RREEF Global Opportunities Fund II, LLC, at (22) (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).

¹²¹ *Id.*

payments.

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 that thin capitalization rules are not triggered. This defies basic financial logic. Thin capitalization rules and debt/equity rules are aimed at the same purpose: prevent 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 ATAs practice effectively allows for lenient debt classification while at the same time eliminating the safeguard against lenient debt classification.

The second most popular way by which sponsors ask for qualification of thin capitalization rules is by discounting the interest paid by the Luxembourg entity.¹²² For example, even if an entity is financed 100% with debt, there will be no excessive deduction if the interest paid is discounted by 15% compared to market rate. In such a case, the amount of interest deduction would be the same as if the 85/15 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).¹²³

¹²² See, e.g., Advanced Tax Agreement Submission of Mar. 10, 2010 - Ace Group - Luxembourg Restructuring, at (5) (“Given that the fixed and variable interest on the PPL will be discounted by 15%, Lux Co 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.

¹²³ An example is warranted. In a 2009 ATA issued to Baring, a private equity fund, interest-free CPECs issued by a Luxembourg entity have been classified as debt. This

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, Luxembourg's administrative thin capitalization rules are not followed by LACD. At best, one can view them as leverage at the hand of LACD used to draw taxpayers to seek 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:¹²⁴

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%

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." See Advanced Tax Agreement Submission of Mar. 18, 2009 - Baring Private Equity Asia IV Holding (7) S.a r.l. - 2008/24/27008, at (3).

¹²⁴ Advanced Tax Agreement Submission of Dec. 3, 2008 - Project Doughty Hanson & Co Real Estate Fund II, at 28.

187.5 to 500	0.09357%
500 to 1,250	0.0625%
1,250 to 6,250	0.03125%
> 6,250	0.015625%

Luxembourg 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 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, 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 particular egregious agreement, LACD agrees 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.¹²⁵ In that case, the Luxembourg entity derived a profit of 0.269% of the face amount of financing. Notwithstanding that fact, the ATA assures that only a margin 0.125% will be taxed. Simply put, in that case Luxembourg agreed to exempt more than half the income *actually earned* in Luxembourg.

One curious aspect of such a fee structure is that it had already been subject to scrutiny by the European Commission. A 2002 investigation 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.¹²⁶ As explained in the Commission's decision on the matter, Luxembourg used to determine taxable spreads on financing activity based on an official circular issued in 1989.¹²⁷ Under the circular, an intra-group spread of 0.25% at the minimum has been considered appropriate, and

¹²⁵ Advanced Tax Agreement Submission of Oct 22, 2008 - Argan Capital - Project H at (10) ("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%.")

¹²⁶ The terms of the circular are discussed in Commission Decision on the aid scheme. See European Commission Decision 2003/438, 2002 O.J. (L 153) [hereinafter: The Commission's Decision].

¹²⁷ Circular LIR No. 120 of 14 July 1989, repealed by Circular LIR No. 1120 of 20 February 1996. Cited in the Commission's Decision, *supra* note 115.

would under certain circumstance be reduced to 0.125%.¹²⁸ This circular, however, was withdrawn in 1996. One of Luxembourg's main arguments in the procedure has indeed been precisely that: that since the circular has been withdrawn and no longer practiced, the procedure is moot.¹²⁹ Nonetheless, Luxembourg made lengthy arguments to the Commission as to why such margin determination procedure should not be regarded as an illegal state aid.

The Commission rejected most of Luxembourg's arguments, and concluded that the 1989 circular indeed constituted state aid,¹³⁰ mostly on the basis that the margin determination seemed to be determined arbitrarily, and had no link to the substance of operations in Luxembourg.¹³¹ 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."¹³²

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 spread based solely on the amounts financed through Luxembourg, and in complete disconnect 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 inconsistent with the representations Luxembourg made to the Commission in the context of the 2002 decision.

V. 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 the how shocking the outcome of such 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

¹²⁸ The terms of the circular are discussed in Commission's Decision, *supra* note 115.

¹²⁹ Commission's Decision, *supra* note 115, at ¶16.

¹³⁰ *Id.*, at Conclusion.

¹³¹ *Id.* at ¶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.").

¹³² *Id.*, at Conclusion.

is:¹³³

$$F \cdot i \cdot T_s$$

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 instead the taxpayer pays Luxembourg an amount based on the margin determined in the ATA. This amount can be expressed as follows:

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

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 € 10,000,000 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 represent the expected return on the investment. In such a case the tax saved in France would be:

$$€10,000,000 \cdot 0.05 \cdot 0.34 = €1,700,000$$

On the €10,000,000 financing scheme, Luxembourg would charge a margin of 0.25%.¹³⁴ The cost to the taxpayer in Luxembourg would be:

$$€10,000,000 \cdot 0.0025 \cdot 0.29 = €7,250$$

¹³³ This assumes no withholding taxes on deductible payments from the source to the residence jurisdiction.

¹³⁴ See *supra* note 124 and accompanying text.

Thus, the taxpayer is paying Luxembourg €7,250 for a regulatory product (the ATA) that eliminates a €1,700,000 French tax liability. The effective tax rate (which is in this case is also the marginal rate, given that 0.25% is the first and last margin level) the taxpayer paid on its profits in France that were financed through Luxembourg is:

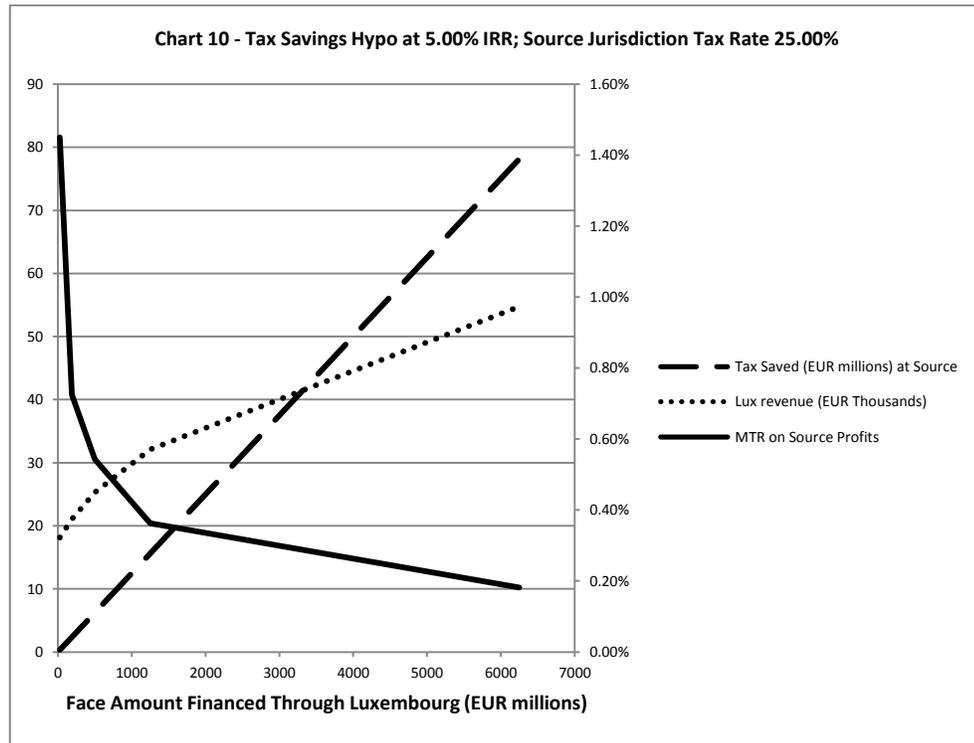
$$\frac{0.0025 \cdot 0.29}{0.05} = 1.45\%$$

An effective tax rate of 1.45% is by all measures drastically low. Moreover, such law tax is paid to 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, and hence the effective tax rate. In addition, if the taxpayer is able to generate a higher intercompany deductible payment, the effective tax rate would be further diminished. Indeed, some intercompany payments in the dataset are in the double-digits zone.¹³⁵

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. The graphic display assumes a return on the investment at an annual rate of 5.00%, and a source-jurisdiction corporate-tax rate of 25.00% (which is roughly the non-weighted average rate for OECD jurisdictions).¹³⁶

¹³⁵ See, e.g., *infra* Appendix B. In that case the intercompany payments are made at a rate of about 14.00%.

¹³⁶ See TAX FOUND., PUTTING A FACE ON AMERICA'S TAX RETURNS: A CHART BOOK 44 (Scott A. Hodge, ed., 2nd ed. 2013).



The chart tells a simply story: The more tax is avoided in the source jurisdiction (where activity actually takes place), the higher the benefit is for Luxembourg (where no activity takes place), and the lower the marginal tax rate for taxpayers is. 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 marginal rate of, say, 1.00% to Luxembourg, than 25.00% to the jurisdiction where income has been substantively created.

VI. 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

The idea that tax competition may be welfare enhancing leans on the

seminal Tiebout model¹³⁷ (and its multiple extensions), according to which “the level of expenditures for local public goods... reflects the preferences of the population.”¹³⁸ The model “links citizen mobility with preference revelation and predicts that locational decisions will reveal individual preferences for public goods and levels of taxation.”¹³⁹ Over the years the model has been extended to include multiple areas of law,¹⁴⁰ in the context locational investment decisions by business entities.¹⁴¹ 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.”¹⁴²

Arbitrage manufacturing as depicted in this Article does not fit the basic premise of the model. The reason is that arbitrage manufacturing is not aimed at creating 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 need with very little tax collection, because there is no need to finance public outlays that might be needed to support investment. The infrastructure-related expenditure is still borne by the other jurisdiction, where the investment is located. This is not the standard story of international competition for capital. This is, at best, competition for *revenue*. At worst, it is government-sanctioned revenue-poaching from other governments.

Under such conditions, 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 that tax charge is (to support such infrastructures). Arbitrage manufacturing enables taxpayers to unbundle costs and benefits. They can locate their real activity in

¹³⁷ John Douglas Wilson, *Theories of Tax Competition*, 52 Nat’l Tax J. 269, 270 (1999) (“Tiebout argues that competition for mobile households is welfare enhancing, and subsequent work has applied similar ideas to competition for mobile firms.”)

¹³⁸ Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. OF POL. ECON. 416 (1956). For a discussion of the vats 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, 207-217 (1997)

¹³⁹ *Id.*, at 208

¹⁴⁰ *Id.*, at 209-212.

¹⁴¹ Wilson, *supra* note 137.

¹⁴² Bratton & McCahery, *supra* note 138, at 209.

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, namely, a tax haven.¹⁴³

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-based 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 rate, and at the same time maintain their developed infrastructure. On the other hand, small tax havens jurisdiction such as Luxembourg, can do perfectly well with a single-digit tax rate, when such rate applies 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.

The forgoing discussion demonstrated that arbitrage manufacturing is unlikely to bring about “welfare enhancing” tax competition. Moreover, this Article argues, 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.”¹⁴⁴

As explained above, industrialized jurisdictions cannot compete with arbitrage manufacturers, while at the same time maintaining a developed level of infrastructure. Since industrialized jurisdictions cannot “compete” with tax havens, they are faced with two alternatives. One, 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 derives most of their

¹⁴³ For similar views, see Palan, *supra* note 21, at [x]

¹⁴⁴ Wilson, *supra* note 137, citing WALLACE E. OATS, FISCAL FEDERALISM 143 (1972).

income from labor. There is a limit to the extent to 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.”¹⁴⁵ 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.¹⁴⁶

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.¹⁴⁷ 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 guises 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 ATA, Luxembourg is hardly an attractive tax-haven. It has a high corporate tax rate (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. All that – for a small fee.

To summarize, at least during the sample period, Luxembourg was a tax-haven made *by administrative practices*, not by law. This enabled Luxembourg officials to maintain a façade of a legitimate tax regime, when Luxembourg’s was anything but. Marius Kohl in fact provided a half-

¹⁴⁵ Reuven S. Avi-Yonah, *Globalization Tax Competition and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1578 (2000).

¹⁴⁶ Such efforts are discussed below, at Part IV.B. *infra*.

¹⁴⁷ See *supra* notes 20-21 and accompanying text.

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.”¹⁴⁸

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 administrators’ 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,¹⁴⁹ 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 MNCs *worldwide* effective tax rate by about 4.00%, on average, in the absolute (meaning, for example, from 20% to 16%).¹⁵⁰ 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.

C. Arbitrage Manufacturing and Global Efforts to Prevent Tax Avoidance

Lux Leaks came at a crucial moment in international tax policy-making. Recent years saw a dramatic increase of interest in tax avoidance by MNCs.¹⁵¹ While international tax avoidance is hardly a new phenomenon, recent media exposures of tax avoidance schemes created what one

¹⁴⁸ Colm Keena, ‘Letters of Comfort’ Show Agreement on Interpretation of Luxembourg Law, IRISH TIMES (Nov. 5, 2014, 11:06 PM), <http://www.irishtimes.com/business/economy/letters-of-comfort-show-agreement-on-interpretation-of-luxembourg-tax-law-1.1989497>.

¹⁴⁹ *We Set Up an Offshore Company in a Tax Haven*, NPR, (Jul. 27, 2012, 6:04 PM), <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).

¹⁵⁰ See Huesecken & Overesch, *supra* note 66, 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* (2016). 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).

¹⁵¹ See Brauner, *What the BEPS*, *supra* note 53, at 56-57 (describing the process that have led to a “perfect storm” culminating in current efforts to curtail tax avoidance).

commentator referred to as “a perfect storm.”¹⁵² Together with the world economic downturn that affected many developed economies, demands for action were soon to follow.¹⁵³ This process climaxed in a charge imposed by the G20 leaders on the OECD to find solutions.¹⁵⁴ The result was the BEPS Project discussed above, launched by the OECD in early 2013. 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.”¹⁵⁵

International tax arbitrage (“ITA”) is central to BEPS. ITA is one of the primary ways by which MNCs erode the tax base and shift income. In fact, several action items of the BEPS Project specifically target ITA schemes. For example, Action Item 2 of the BEPS project is specifically aimed to “[n]eutralise the effects of hybrid mismatch arrangements,”¹⁵⁶ which refer to the ability of taxpayers to take advantage of arbitrage opportunities.¹⁵⁷ Action Item 4 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.”¹⁵⁸ Such excessive interest expense can be achieved, for example, by taking advantage of hybrid arrangements that would prevent deductible interest from being included in income by the recipient (as in the case of conduit financing with debt/equity arbitrage). LuxLeaks came at a time when efforts to prevent MNCs’ tax avoidance was in full force, and the prevention of ITA is central to these efforts.

Unfortunately, current discourse on international tax avoidance in general and ITA in particular, including in the BEPS Project, is largely focused on taxpayers’ exploitation of legal differences. Administrative bodies are almost seen as passive participants, who merely interpret domestic laws, or at the most, passively cooperate with taxpayers. The analysis herein suggests that tax administrations may have an active role in the facilitation of tax avoidance by MNCs, and that there is a synergic relationship between tax administrations and MNCs.

If this is indeed the case, efforts for harmonization seem to miss the mark. It does not matter how harmonized the laws of industrialized jurisdictions are. Any small jurisdiction could insert itself as an

¹⁵² *Id.*, at 57-58

¹⁵³ *Id.*, at 58.

¹⁵⁴ *Id.*

¹⁵⁵ BEPS PROJECT, *supra* note 88, at 8.

¹⁵⁶ ORGANIZATION OF ECONOMIC COOPERATION AND DEVELOPMENT, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING 15 (2013) [hereinafter: BEPS ACTION PLAN].

¹⁵⁷ Brauner, *What the BEPS*, *supra* note 53, at 79-80.

¹⁵⁸ BEPS ACTION PLAN, *supra* note 156, at 17.

intermediary between the jurisdictions of source and residence, and generate synthetic arbitrage instruments. Global efforts to target tax avoidance should therefore target the administrative process of arbitrage manufacturing, not the particular instruments used by taxpayers in tax arbitrage schemes. One possible solution is to devise rules that allow source and residence jurisdictions to ignore legal structures in intermediary jurisdictions, if such jurisdictions have no role in generating the economic return from the investment.

In any case, any coordinated effort would have to systematically address the practices that make arbitrage manufacturing possible. As describe in this article, these include among others, the secrecy of arrangements between tax administrators and MNCs; the concentration of administrative power in the hands of a few administrators; the lack of substantive consideration of taxpayer requests; ignorance of missing documentation; substantive inconsistency in rulings; ignorance of the jurisdiction's own laws and administrative guidance; ignorance of previously issued judicial decisions; and, most importantly, financial interest in supporting tax avoidance in other jurisdictions. Some of these issues are addressed in the current BEPS project,¹⁵⁹ as well as in the European Parliament,¹⁶⁰ but in a piecemeal manner, and not as a part of a concentrated effort to prevent arbitrage manufacturing.

Importantly, international coordinated pressure seems like a promising course of action. In fact, the legal landscape in Luxembourg had changed significantly since the period of the sample. Even before Lux Leaks,

¹⁵⁹ It is beyond the scope of this article to discuss at length the relevance of the findings to the voluminous BEPS project (the final BEPS Report is in excess of 1,000 pages long. See OECD, BEPS FINAL REPORTS (2015), available at <http://www.oecd.org/ctp/beps-2015-final-reports.htm>). Most relevant for purposes of battling administrative practices of arbitrage manufacturing, however, is Action Item 5 dealing with so called "harmful tax practices." Unfortunately, Action Item 5 focus is on eliminating specific *substantive* preferential tax regimes. As argued herein, the focus of such coordinated action should be to eliminate *administrative practices*. See ORGANIZATION OF ECONOMIC COOPERATION AND DEVELOPMENT, COUNTERING HARMFUL TAX PRACTICES MORE EFFECTIVELY, TAKING INTO ACCOUNT TRANSPARENCY AND SUBSTANCE 10 (2015) ("The main focus of the FHTP's work has been on agreeing and applying a methodology to define the substantial activity requirement to assess preferential regimes, looking first at intellectual property (IP) regimes and then other preferential regimes. The work has also focused on improving transparency through the compulsory spontaneous exchange of certain rulings that could give rise to BEPS concerns in the absence of such exchanges.").

¹⁶⁰ The EU is currently engaged in the development of tax transparency measures, including publication of advanced tax agreements. See, European Council, Press Release, 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/>

Luxembourg tax practices were subject to close scrutiny by the European Commission, including several investigations on possible state-aid practices.¹⁶¹ Largely as a result of the pressure that materialized after LuxLeaks, Luxembourg has significantly revised its ATA review process.¹⁶² For example, a commission, rather than a single individual, is now in charge of the process.¹⁶³ In addition, redacted versions of the ATA are now made public.¹⁶⁴ Another recent change to Luxembourg practices requires taxpayers to substantiate the level of margin to be taxed in Luxembourg.¹⁶⁵ Time will tell whether such measures bear fruit, but these changes at least imply that international coordinated effort targeting administrators, rather than taxpayers, may prove successful.

Unfortunately, as much as we know about Luxembourg (thanks to LuxLeaks), little do we know about the practices of other tax havens. Most tax havens administrative practices remain secretive. Also, few tax havens are subject to the jurisdiction of the European Commission, which may actually impose real sanctions against EU member states. Many tax havens are small island jurisdictions that have little incentive to expose their administrative practices to global scrutiny. Under such circumstances, coordinated international efforts against arbitrage manufacturing may be difficult. It seems that unilateral actions may still play an important role in combating arbitrage manufacturing.

The United States, for example, has anti-conduit financing regulations in place. Under the regulations, the IRS may ignore the existence of a conduit entity in a financing arrangement, if the primary role of the conduit entity is to reduce taxable income.¹⁶⁶ Unfortunately, these rules are subject to multiple exceptions. In addition, very few other jurisdictions have similar rules in place. Given that arbitrage manufacturing relies in its entirety on

¹⁶¹ For a summary of such procedures, see Werner Haslehner, *Advance Rulings and State Aid: Investigative Powers of the EU Commission*, in ECJ – RECENT DEVELOPMENTS IN DIRECT TAXATION 2014 89, 90-92 (Michael Lang, ed. 2015). The European Commission recently issued a 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 State aid SA.38944 (2014/C) – Luxembourg Alleged aid to Amazon by Way of a Tax Ruling (Oct. 7, 2015).

¹⁶² See Patrick Mischo & Franz Kerger, *After 'Lux Leaks': Welcome Changes To Luxembourg's Tax Ruling Practice*, 77 TAX NOTES INT'L 1197 (2015).

¹⁶³ *Id.*, at 1998.

¹⁶⁴ *Id.*, at 1200.

¹⁶⁵ See Oliver R. Hoor, *Luxembourg's New Transfer Pricing Circular on Intragroup Financing Activities*, 62 TAX NOTES INT'L 413, 413 (2011) (Under the new guidance – adopted after the sample period – “advance certainty on the tax treatment of intra-group financing transactions will only be granted if specific substance requirements and a real risk requirement are fulfilled.”).

¹⁶⁶ Treas. Regs. §1.881-3 (dealing with “conduit financing arrangements”).

conduit financing, industrialized jurisdictions should consider adopting such rules not only through coordinated efforts,¹⁶⁷ but also unilaterally.

CONCLUSION

The ICIJ's leak of hundreds of secretive tax rulings issued by LACD to MNC 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.

Using a sample of the leaked documents this Article explains the potential role of tax administrators in facilitating international tax avoidance. The article identified the mechanism of arbitrage manufacturing. That is, the issuance of regulatory instruments that are intended to synthetically generate legal differences between source and residence jurisdictions, even though no such differences exist. Such process enables the jurisdiction that issues the instrument to make a claim for revenue streams generated by immobile investments in other jurisdictions. At the same time, the tax liability in the jurisdiction in which income is created – is eliminated, thus benefiting the taxpayer. The arbitrage manufacturer and the taxpayer operate in tandem to deny tax revenues from the jurisdictions the infrastructure of which 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.

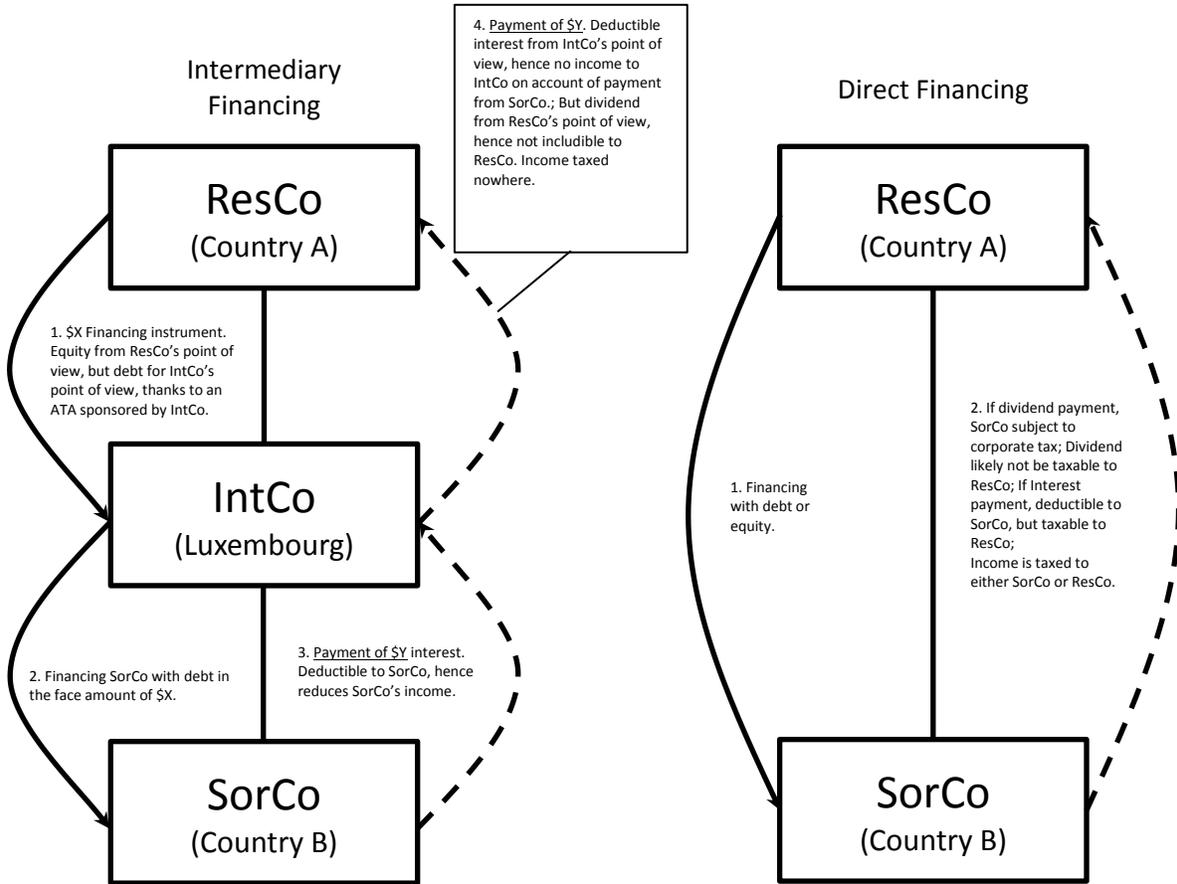
If such a practice is prevalent, then the attempt to harmonize the tax laws of the source and residence jurisdictions is not an effective response to ITA. There will always be a jurisdiction willing to act as an intermediary-for-fee, and help taxpayers to artificially create arbitrage opportunities. The Article therefore suggests that coordinated international efforts should target arbitrage-manufacturing practices. Specifically, the launching pad for such an approach would be to devise mechanisms that would allow source and residence jurisdictions to ignore intermediary jurisdictions in financing arrangements. Similarly, unilateral actions should abandon the cat-and-mouse attempt to shut down specific arbitrage arrangements, and instead attack arbitrage-manufacturing arrangements systematically.

¹⁶⁷ One commentator has suggested that BEPS misses the mark on conduit financing. See Sheppard, *supra* note 77, at 1076 (arguing the BEPS Action Item 2 is “weak on the issue of conduits”).

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



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

D. The Financing Structure

In August of 2008, ABRY Partner’s (“ABRY”) – a Boston, MA based private equity firm – purchased Q9 Networks (“Q9”) – a Canadian provider of outsourced data center infrastructure – for approximately \$361 million.¹⁶⁸ 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.¹⁶⁹

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 circa off CAD 740 million.¹⁷⁰ 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.

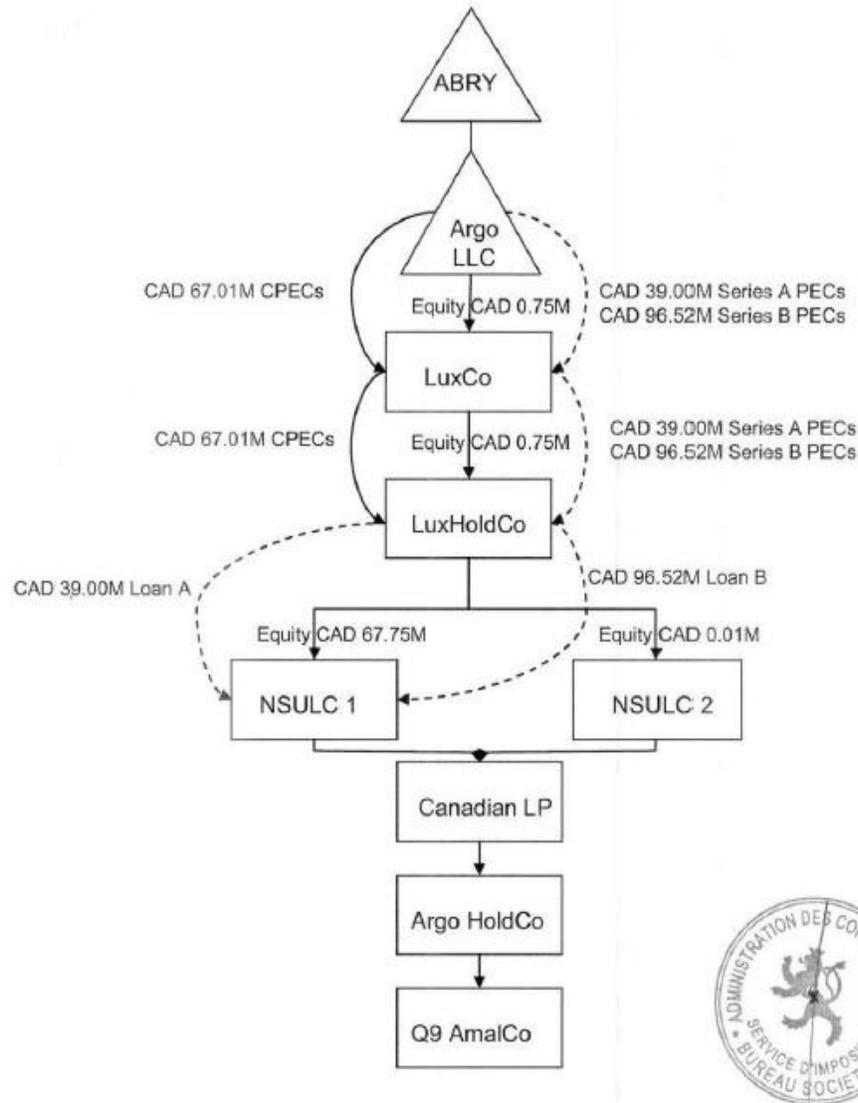
The figures herein are based solely on the assessment of the ATA. The figures should therefore be interpreted as relevant to the amounts of taxes potentially avoided in Canada, on profits channeled through Luxembourg. The discussion does not provide an overall assessment of the total taxes incurred by 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 be best 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.

¹⁶⁸ Press Release, ABRY Partners, ABRY Partners Agrees to Acquire Q9 Networks Inc. (Aug. 24, 2008), available at http://www.abry.com/News/08-08-24/ABRY_Partners_Agrees_to_Acquire_Q9_Networks_Inc.aspx

¹⁶⁹ Advanced Tax Agreement Submission of Nov. 28, 2008 - Q9 Luxembourg S.a r.l. - Tax number: 2008 24 42414 [hereinafter: ABRY ATA].

¹⁷⁰ 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 (“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 plus CAD 750,000 = 67,760,639), equals the equity financing from Luxembourg to the Q9 structure in Canada.

E. The ATA

Among others, ABRY secured the following assurances from LACD:

1. Both Luxembourg entities are tax resident in Luxembourg.

The only justification given to treating these entities as tax-residents in Luxembourg is that they have the “statutory seat” in Luxembourg and that they will have “their place of central administration in Luxembourg to the extent 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.”¹⁷¹

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 series as well as the CPEC will be classified as debt for Luxembourg tax purposes. This is the main reason that taxpayers seek LACD’s ruling, and 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 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 bond holders).

The term to maturity of the PECs was 49 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 30 years will generally *not* be treated as debt for tax purposes, unless other considerations strongly support debt characterization.¹⁷²

¹⁷¹ ABRY ATA, *supra* note 169, at (3).

¹⁷² Though longer term debts have been issued and respected as debt. *See* Garlock, *supra* note 112, at ¶102.01(A).

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.¹⁷³ 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 49 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 government bond was 3.96%.¹⁷⁴ Even if one takes into account the subordination, it is difficult to imagine that such a rate represent 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 therefore unpaid, they 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 49 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 Structures 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

¹⁷³ 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.")

¹⁷⁴ Canadian bond yields are available at: <http://www.bankofcanada.ca/rates/interest-rates/lookup-bond-yields/>

have been re-characterized 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 recharacterized as equity), *times* 29.00% (Luxembourg corporate tax rate). In addition, all payments characterized as dividend would have been subject to a 5.00% withholding tax in Luxembourg under Luxembourg's bilateral tax treaty with Canada.¹⁷⁵ This should have generated an additional tax in Luxembourg of CAD 207,413. In other words, had the Luxembourg thin capitalization rules been followed, ABRY would have been subject to an additional *annual* tax in Luxembourg in an amount of CAD 1,410,408.

The ATA, however, determined that Luxembourg's thin capitalization rules are inapplicable. The justification provided in the submission is that the interest paid on the CPEC's (0.375%) represents a 15% discount of a market rate of 0.5%, and therefore the CPECs should not be taken into account in calculating the debt/ equity ratio. In such a case the ratio for the Luxembourg Structure would indeed be about 67/33, way above the threshold.

However, the submission provided no justification to set the market rate for the CPEC at 0.5%. Also, if the CPEC 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".¹⁷⁶

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 "debt".

4. Margin Determination

The ATA provides that a spread of 0.125% will remain in Luxembourg and be subject to tax there. There seem to be no justification for such determination other than blanket statements that such margin is justified

¹⁷⁵ CANADA-LUXEMBOURG TAX TREATY, *supra* note 105.

¹⁷⁶ ABRY ATA, *supra* note 169, at 18.

considering “the amounts involved and the risk profile.”¹⁷⁷ At no point in the submission does ABRY explain what is it that 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.¹⁷⁸

Assuming all payment 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 face 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).¹⁷⁹ Thus, the total amount of corporate tax avoided in Canada annually (assuming Q9 was profitable) was about CAD 5,957,515.

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 annually generated Canadian-generated profits that were financed through Luxembourg was thus 68,777 *divided* by 18,972,979, or about 0.36%.

¹⁷⁷ *Id.*, at 17

¹⁷⁸ *Id.*, at Appendix 5.

¹⁷⁹ *Supra* note 6.