COORDINATION RULES AS A SOLUTION TO TAX ARBITRAGE

Victor Thuronyi[2]

I. Introduction

International tax arbitrage refers to a situation where a given transaction is treated for tax purposes differently by the countries concerned by the transaction, and the taxpayer or taxpayers involved take advantage of that inconsistent treatment to reduce their overall tax burden. There is a considerable discussion in the literature as to whether tax arbitrage represents a problem or not.[3] The basic argument that there is no problem is that, as long as all the taxpayers involved are complying with the law, no state involved has reason for complaint. Moreover, given the fact that tax systems of different states differ from each other, arbitrage is bound to arise as part of normal tax planning.

Inconsistency in tax rules can also lead to the opposite problem: double taxation. A simple example of this is the treatment of an individual as a resident by two countries, each of which taxes the individual on worldwide income.

A more practical approach than discussing whether arbitrage or double taxation is undesirable in the

Inconsistent characterization of entities and transactions facilitates cross-border tax planning and leads to complexity in international taxation as countries try to deal with what they perceive as abusive transactions. As long as national tax systems differ, there will always be scope for tax arbitrage, and it would be impossible to remove it completely. This article suggests, though, that the adoption of coordination rules for basic tax building blocks would go a long way to both simplifying international tax rules and minimizing abuse.

treaty were negotiated, it might take a long time for individual countries to sign and ratify the treaty. Importantly as well, in such a technical area, there is a risk that a treaty would end up suffering from technical errors. These might be difficult to correct given that the consent of the treaty signatories would be required.

Instead of a legally binding rule, a more flexible mechanism to adopt a coordination rule would be a non-binding recommendation made by an expert body, such as the OECD's Committee on Fiscal Affairs or the UN's Committee of Experts on International Cooperation in Tax Matters. Both groups enjoy the advantage of access to numerous country representatives who are familiar with the technical issues and who could debate and agree on a recommendation. Governments would then be free to adopt the recommendation or not as they choose. If the nature of the coordination rule is such that it would provide benefits even in the absence of universal adoption, this might be the most attractive route.

III. Entity classification

A. In general

An important and pervasive cross-border arbitrage issue involves entity classification, and arises because countries classify business entities inconsistently. The consequences of the inconsistent classification differ depending on the nature of the transaction. This article is not the place for a discussion of the specifics; I am assuming that readers are familiar with various transactions that raise problems – there might for example be an issue in applying tax treaties or determining foreign tax credits, there might be payments treated by one country as deductible interest paid by one entity to another, which are ignored by another country. As a simple example,[7] suppose that a Country B corporation sets up a Country A entity as the 100% owner of a Country A corporation. Suppose that the Country A entity is treated as a corporation by Country A but as a pass-through entity by Country B. Suppose further that the Country A corporation pays a dividend to the Country A entity, and that the Country A entity pays the dividend in the form of interest on a loan from the Country B corporation. Country A allows a deduction for the interest, while Country B treats the payment received by the Country B corporation as a dividend which qualifies for a participation exemption (Country B disregards the loan because the country A entity is not treated as a separate entity). The interest paid by the Country A entity may further qualify for a zero or low tax rate under the tax treaty between Country A and Country B.

A solution to the general problem of inconsistent classification would be for countries to adopt a rule that classifies an entity as a corporation for income tax purposes if it is a per se corporation (i.e. an entity of a type included on a list of per se corporations) or is treated as a resident corporation for corporate income tax purposes in any country.[8] In the above example, Country B would treat the Country A entity as a corporation, because that is what Country A does, and would accordingly treat the payment received from this entity as fully taxable interest.

---

[7] The example is borrowed from Ring, *supra* note 2, at 99-100.

[8] I make no claim to the originality of this idea. A similar general approach was suggested, for example, in John Avery-Jones et al., Characterization of Other States’ Partnerships for Income Tax, 56 Bull. Int’l Fiscal Doc. 288, 314-20 (2002). An ABA Tax Section report proposed to “classify a foreign business entity as a corporation if the en

Exactly how classification of an entity as a corporation would be expressed for purposes of a country's tax laws depends on the terminology used by the specific country. For most common law countries, it will suffice to say that the entity is considered a corporation. In many civil law countries, it will be appropriate to say that the entity is treated as a "legal person." The specific wording needs to be worked out in the context of each country's corporate income tax law. Colloquially, one can refer to an entity being treated as "opaque". The references in this article to treatment as a corporation are intended to be synonymous to treatment as opaque.

Note that this proposed rule creates a bias in favor of an entity being treated as a corporation: all it

that a particular type of entity formed in that state will be treated as a resident for corporate income tax purposes and will in all cases be subject to corporate level tax.

Per se corporation treatment should extend only to en

from capital) are subject to final withholding tax, that should not lead to treatment of the entity as opaque.)

Sometimes taxation as a corporation is elective. In France, certain partnerships can elect to be subject to corporate income tax. This is a well-defined situation: if an entity makes the election, it should be treated as opaque under the proposal because it is in fact subject to entity-level tax. Likewise, a U.S. entity that makes a check-the-box election to be treated as transparent should be treated as transparent by other countries (unless it is considered as resident for tax purposes in another country and treated by that country as opaque).

Another possibility is that a country treats an entity as a corporation, but transparent at the election of the shareholders (S corporation in the U.S.). Such entities should not be regarded as subject to corporate tax, and therefore should be treated as transparent by other countries, unless they are treated as a resident company in another jurisdiction. This is because even though they may have a corporate label, taxation is effectively at the shareholder level; the flow-through treatment of the entity for tax purposes (hence, the absence of a corporate-level tax) should be the determining factor.

Another situation is that the entity's home country treats it as partially opaque. For example, in the Czech Republic, limited partnerships are treated as opaque only to the extent of the limited partners' interests; the interests of general partners are taxed at the level of the partners. There are similar entities in Germany and France. It should be feasible for other countries to treat such entities as opaque only to the extent that they are so treated in their home country. This treatment (i.e. as partially opaque and partially pass-through) seems appropriate because it reduces the differences between different tax systems and hence reduces the scope for arbitrage.

for the vast majority of countries. Moreover, the resulting inconsistency in treatment would not give rise to arbitrage opportunities.

E. Tie-breaker rule in treaties

The entity classification rule should be applied before the application of any tie-breaker rules in

The approach is to some extent a negative one: an entity that is not treated as a resident corporation by any jurisdiction will be considered transparent. This

shows that the removal of inconsistent treatment by different countries is not in all cases to be viewed

The rule will not deal with all questions concerning cross-border transactions involving corporate equity. For example, it does not deal with the question of who is treated as the owner of particular shares. Nor does it deal with derivatives.

From a procedural point of view, taxpayers could be subject to reporting requirements and consistency rules, i.e. the two sides to a transaction (the issuer and holder of an instrument) should be required to characterize it consistently and perhaps report this characterization to the other party and the other party's tax authorities. Similar consistency rules should apply to cross-border leases (see below).

V. Cross-border leases

In the case of a cross-border lease, I suggest a rule under which treatment of the transaction as a finance lease (whereby the lessee is treated as the owner of the property for tax purposes) prevails over classification according to legal form. In such a case, a country applying a legal form rule generally for domestic law purposes would reclassify a lease according to the treatment in the country where the other party to the lease is resident for income tax purposes, if that country characterizes the lease as a finance lease. This means that a lease involving two legal form jurisdictions would be unaffected.

On a technical level, the rule coul