tax notes international
Volume 71, Number 8 ■ August 19, 2013

Structuring M&As in Uncertain Times

by Gaetano Pizzitola

Reprinted from *Tax Notes Int'l*, August 19, 2013, p. 709

Structuring M&As in Uncertain Times

by Gaetano Pizzitola

Gaetano Pizzitola is a cross-border tax partner with Crowe Horwath in Rome. E-mail: gaetano.pizzitola@crowehorwath.it

Globalization is compelling more entrepreneurs to look overseas for expansion and growth, following the path of large multinationals and early movers.

Low-tax countries have been used for decades as holding company locations for greenfield investments and mergers and acquisitions expansion abroad.

Treaty-protected countries have generally been preferred for M&A deals. Each region has its usual gates: Luxembourg and the Netherlands within the European Union, Mauritius for China and India, Singapore for the wider Asian region, and so forth. Participation exemption, foreign investors' protection, stability of legislative environment, and exit strategy have been the key pillars on any foreign investment structuring from a tax standpoint.

Financing M&A investments has also been based on the use of low-tax jurisdictions that generate double-dip benefits, either by maximizing return to equity investors or reducing the cost of external borrowing.

Furthermore, intellectual property (IP) companies have been widely used to consolidate ownership of intangibles in low-tax jurisdictions and to shelter income from taxation in high-tax jurisdictions.

Holding, financing, and IP companies all share similar tax attributes: low or nil taxation, legislative stability, certainty, and protection of foreign investors. Small countries have attracted huge amounts of mobile capital but not much human and infrastructure resources. Capital investment management may not require the level of staff necessary to conduct manufacturing, service, or sales activity. Low-tax entities have been structured as passive investment vehicles. The shopping of locations has damaged the image of tax professionals and multinational investors. Bad examples are easy targets for complaints, but a majority of investments are supported by sound business reasoning.

With the beginning of the global financial crisis in 2007-2008, the use of passive company structures has increasingly been front and center on the political agenda. The G-20 leaders at the meeting in London on April 2, 2009, stood against the use of tax havens for not complying with internationally agreed tax standards.

The G-20 meeting in Moscow on July 17-19, 2013, saw the OECD unveiling its action plan on base erosion and profit shifting (BEPS) for the next two to three years.[1]

The OECD action plan identified 15 actions purporting to:

> develop a new set of standards to prevent double nontaxation. Closer international cooperation will close gaps that, on paper, allow income to ''disappear'' for tax purposes by using multiple deductions for the same expense and ''treaty-shopping.''[2]

The underlying goal of the action plan is:

> aligning tax with substance — ensuring that taxable profits cannot be artificially shifted, through the transfer of intangibles (e.g. patents or copyrights), risks or capital, away from countries where the value is created.[3]

The 15 actions in the plan are the digital economy, hybrid mismatch arrangements, strengthening controlled foreign corporation rules, interest deductions,

---

[1] *Available at* http://www.oecd.org/tax/closing-tax-gaps-oecd-launches-action-plan-on-base-erosion-and-profit-shifting.htm.

[2] OECD, ''Closing tax gaps — OECD Launches Action Plan on Base Erosion and Profit Shifting,'' *available at* http://www.oecd.org/newsroom/closing-tax-gaps-oecd-launches-action-plan-on-base-erosion-and-profit-shifting.htm.

[3] *Id.*

harmful tax practices, treaty abuse, permanent establishments, intangibles, risks and capital, high-risk transactions, BEPS data, mandatory disclosure rules, transfer pricing documentation, mutual agreement procedures, and developing a multilateral treaty.

This is quite a busy agenda — an ambitious plan of rebalancing the international tax rules to cope with the development of globalization and the digital economy as the framework of the world financial system. It will certainly stir a wide debate in the business community.

After the BEPS action plan, any M&A structuring will have to take into account the increased level of risk and uncertainty about foreign investments being targeted for tax audits by tax authorities from various countries.

We have already seen the *Vodafone* case in India; the U.S. Senate holding up Apple, Hewlett-Packard, and Microsoft as examples of bad tax structures; the U.K.'s public commissions challenging Amazon's tax planning; Starbucks volunteering a £20 million tax payment by forgoing some tax reliefs in the U.K.; Google being audited in France; and so forth.

The relationship between local politicians and multinationals is presented in the media as strained as never before. There is no room in such a hostile environment to remember the role of multinationals in the industrialization of countries and regions that would otherwise have remained undeveloped.

In such a political environment, M&A structuring will require a more thorough and thoughtful process to identify the most efficient and safest strategies. Debt push-down, IP migration, profit maximization in low-tax jurisdictions, withholding tax optimization, and exit strategies will remain the key pillars of any good tax structuring. However, careful consideration of the reputation of chosen investment countries and of the feasibility of an active management structure of financing, IP, and investments will be necessary to prevent an attack by the tax authorities of such investment structures within a few years of being set up.

The above is true both for public companies and private equity investments. While the former will increasingly have to manage pressure from auditors with FIN 48-type accruals for tax risks, the latter may face price discount claims at exit by potential buyers because tax due diligences may have identified critical gray areas of exposure if not a history of tax audit adjustments for lack of substance, treaty shopping, abuse of law, business purpose, transfer pricing, PE, blacklisting, withholding taxes, and all similarly complex and sophisticated tax challenges.

In the current environment, business strategies and their documentation will be critical factors of success with any offshore tax structuring. As participation exemption methods have been increasingly adopted in many countries, the use of local holding companies rather than regional ones may be a good alternative to minimizing risks of treaty-shopping claims. The adoption of regional principal models may still be implemented but conversion to those structures will have to be carefully considered and implemented to minimize risks.

Recourse to advance ruling clearances and advance pricing agreements will be beneficial to foreign investors to avoid aggressive challenges by tax inspectors.

Attention will be needed to balance the use of special purpose vehicles for holding investments, equity funds, and IP in low-tax jurisdictions with the need to ensure an adequate level of substance. There will likely be years of confusion and uncertainty on this point.

The OECD BEPS action plan specifically targets:

> the involvement of third countries in the bilateral framework established by treaty partners . . . in particular when done via shell companies that have little or no substance in terms of office space, tangible assets and employees.[4]

It is hoped that the OECD will take a substance-over-form approach on that point. We have seen multinationals being unreasonably challenged by tax inspectors claiming that their foreign subsidiaries in Switzerland, for example, are shell companies because they do not rent office space directly from landlords but instead sublease them from other group companies using the same space. Or, even worse, multinationals may be challenged because they only have a few employees or none on their payroll and tax inspectors claim that secondments or outsourcing of functions do not provide an adequate level of substance for their operations.

The BEPS action plan also targets:

> tackling the use of intangibles, risks, capital and other high-risk transactions to shift profits.[5]

Centralized business models will increasingly face questions from tax authorities claiming that the main or sole reason for their implementation is tax avoidance. The iPhone/iPad can be seen as a paradigmatic example. They are designed in Cupertino, Calif., and their success was driven by the hard work of a genius — one single man. Years of investments were necessary to develop the products, and Apple took significant risks to develop them by investing capital into low-tax countries. They are manufactured in Asia and sold everywhere in the world. Should Apple stores be allocated most of the profits because customers purchase locally? Would the U.S. and the store/customer countries be happy to take the loss if the products were, or will ever be, unsuccessful under Samsung or others' competition? Does anyone remember PalmPilot? Which countries have welcomed and accepted its losses?

---

[4]OECD Publishing, ''Action Plan on Base Erosion and Profit Shifting,'' p. 13 (2013).

[5]*Id.* at 14.

This is precisely the challenge being presented to Amazon and Google by tax authorities. Their headquarters are in the U.S., while IP and capital are invested in low-tax jurisdictions where profits from IP contribution to the value chain are taxed at a lower rate. However, if profits do not arise, the centralization of tax losses in one low-tax jurisdiction will conversely imply a high effective tax rate.

Meanwhile, in France and other European countries, Amazon may have established logistic centers and customers happily purchase products locally at a discount. Is there any major difference between Amazon's logistic centers and the ones established by many businesses to centralizing supply-chain for product delivery?

The adoption of regional principal models may still be implemented, but conversion to those structures will have to be carefully considered and implemented to minimize risks.

Part of the problem is the complexity of a real substance-over-form approach, which in our audit experience is often only a recharacterization of form with another form. The discussion about substance over form may be affected by the risk of misunderstandings on what substance means in a business environment. Tax inspectors often look for quantity and paper evidence of it, which may not be the real substance. In the modern global and digital economy, substance is not necessarily a matter of quantity. It is quality of key decision-making business authority to manage the operations. Intangibles, capital, and risk management do not require hundreds or thousands of employees. Control over the functions and risk is the key attribute of a substance-over-form analysis about the value chain and implementation of investment strategies. Risks are taken by decision-makers rather than by those executing strategies. Functions may be executed in different roles, that is, as a decision-maker or as an advisory service supplier or agent executing instructions.

In the current environment, M&A structuring through the use of passive vehicles will be more critical for the above reasons. Multinationals and private equity investors may wish to take into account the need of an active management of functions as a protective measure to minimize the risk of challenge and advance ruling clearances as tools for tax risk management, and seek appropriate professional advice to ensure that structures can withstand fiscal audits and challenges.

The qualitative analysis of the level of substance needed to get into a safe harbor position will be a necessary exercise for tax-effective structuring of any investment.

Given that the current international tax climate is uncertain, as is the economic environment in most regions, tax authorities throughout the world are looking for extra cash to support public expenditures. Auditors are striving for profits and, therefore, any strategy by multinationals to minimize profits locally will be increasingly scrutinized.

Case-by-case implementation of the most appropriate investment structures based on specialist professional advice together with an active management function are the most critical factors to defend profits from attack.

Rethinking and reassessing sustainability of existing structures will also be a top priority in the action plan of any multinational.

But what's next? Maybe the low-tax, small countries will start attracting not only capital and intangible assets but also human resources and infrastructures. Will high-tax countries pushing for the BEPS action plan ever be able to counteract delocalization and migration of valuable assets abroad, without developing any positive fiscal policy to attract foreign investors and multinationals with benefits and incentives as, indeed, they may have done in the past? ◆