

**TAX STRUCTURING WITH
BILATERAL INVESTMENT TREATIES**

**KIEV ARBITRATION DAYS: THINK BIG CONFERENCE
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INTRODUCTION TO BILATERAL INVESTMENT TREATIES

- There are more than 2,500 Bilateral Investment Treaties (“BITs”) in force around the world.
- These BITs protect investors residing in one jurisdiction against the actions of a government in another jurisdiction that may deprive those investors of either property (e.g., expropriation) or other rights.
- Most BITs provide foreign investors with the opportunity to file their arbitration claims in various international dispute-resolution venues including the International Centre for the Settlement of Investment Disputes (“ICSID”), an independent arm of the World Bank devoted to the resolution of investor-government disputes.
- Depending on the particular scope and wording of a BIT, foreign investors can generally use BITs to secure the following rights:
 - Fair and equitable treatment (e.g., protection against arbitrary treatment and fair access to the courts).
 - Nondiscrimination against the passage of a new law that treats host-country investors more favorably than foreign investors (e.g., “Most Favored Nation” treatment).
 - Fair compensation in the event of direct or indirect taking.
 - Full protection and security, free transfer of funds and assets, and protection against the breach by a government of its contractual responsibilities to an investor.

PROPER USES OF BITS (AND MISPERCEPTIONS)

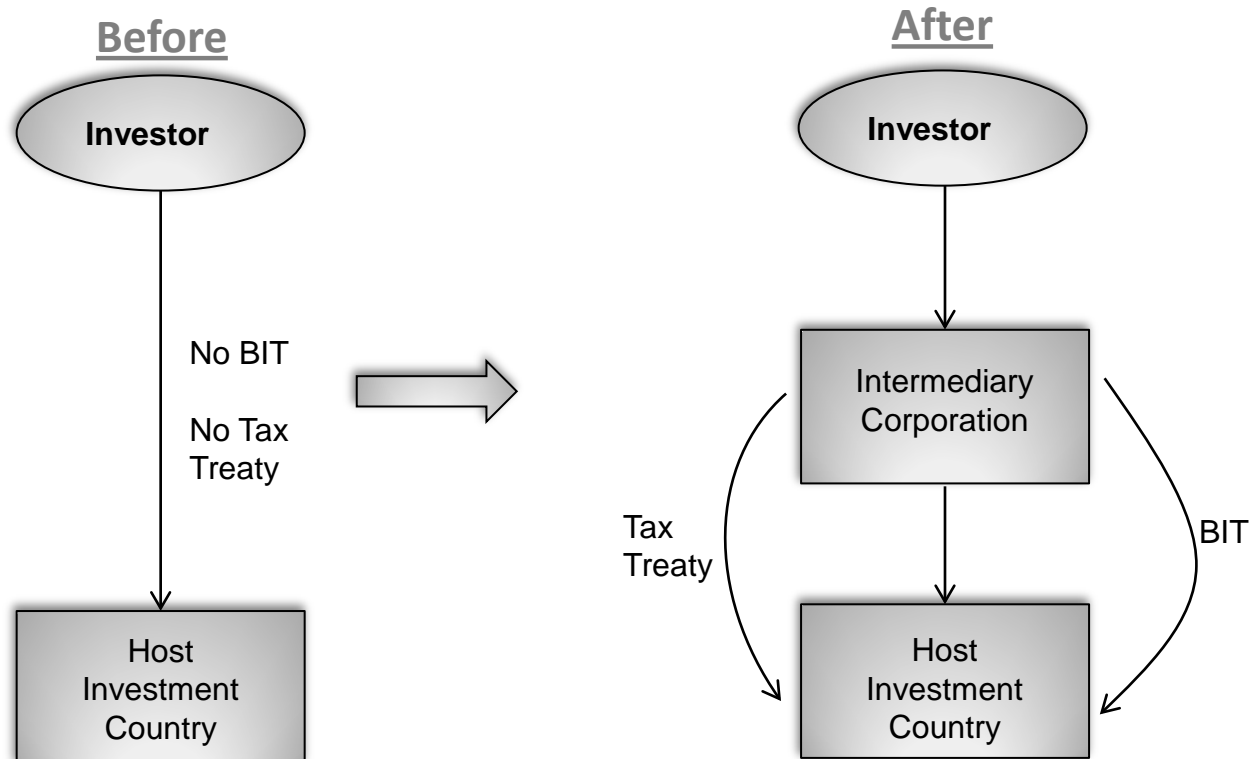
- The common misperception about BITS is that they protect foreign investors only against direct “takings” (e.g., expropriations) by a government.
 - BITS can also protect investors against various “indirect” government actions that cause substantial damage to the value of the investors’ property.
 - For example, a BIT can be used to challenge a new tax regulation that has the effect of a “confiscation” of the foreign investors’ property (vis-à-vis domestic companies).
- If a foreign investor could not rely on a BIT when damaged by a government, the investor would be required to pursue claims against the government in a potentially unfavorable local court.
 - Even if a local court agrees that the government is responsible for damages, the court may undercompensate the investor for its claims.
 - Investors who bring claims against a government in ICSID (and other similar bodies) can ensure themselves a neutral forum to decide the proper compensation for all valid claims made against a government.

“TREATY SHOPPING (BIT AND TAX)”

- What is “treating shopping?”
 - The use of a treaty by a person (whether or not a resident of a contracting state) acting through a legal entity created in a state with the main or sole purpose of obtaining treaty benefits that would not otherwise be available directly to such person.
- When does a company “treaty shop?”
 - There is no treaty between the nonresident investor and the jurisdiction where the investment will be made.
 - A treaty between the nonresident investor and the jurisdiction where the investment will be made is less favorable than alternative treaties between the jurisdiction where the investment will be made and other possible “conduit” jurisdictions.

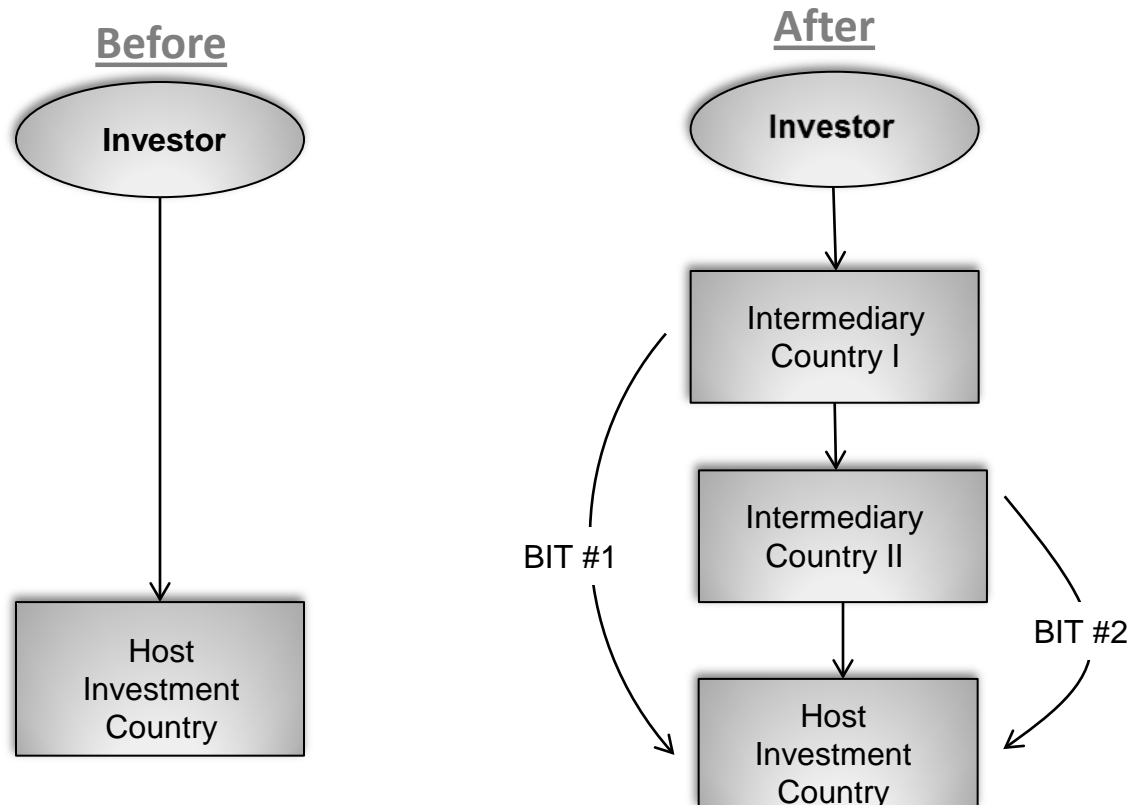
BIT "TREATY SHOPPING" OPPORTUNITIES

- Foreign investors who wish to enjoy the protections of a BIT must ensure that they are resident “investors” in a jurisdiction that has a BIT with the target jurisdiction (“host investment country”).
- If no such BIT exists, or the existing BIT does not present the proper language to provide adequate protection, the investor may select an intermediary jurisdiction (e.g., intermediary holding company) to channel the investment.
 - In these particular cases, it is critical to find a jurisdiction that offers **both the appropriate BIT protections and a favorable tax result.**



BIT "TREATY SHOPPING" OPPORTUNITIES

- Generally speaking, any company in an “ownership chain of companies” can use a BIT to bring a claim against a government in the host investment jurisdiction.
- Investors can often structure investments through multiple intermediary BIT jurisdictions, while “picking and choosing” the best BIT protections from those jurisdictions in the event that a future claim arises.



BIT "TREATY SHOPPING" OPPORTUNITIES (CONT'D)

- It is important for investors to consider the implementation of BIT structures at the earliest planning stages.
 - Most BITs are enforceable against a government only if an investor can prove that its qualifying entity held an “investment” in the host investment country for more than a transient period.
 - Thus, investors who insert intermediary entities into a structure to claim last-minute BIT relief will not likely succeed with their BIT claims.

TAX TREATY PLANNING

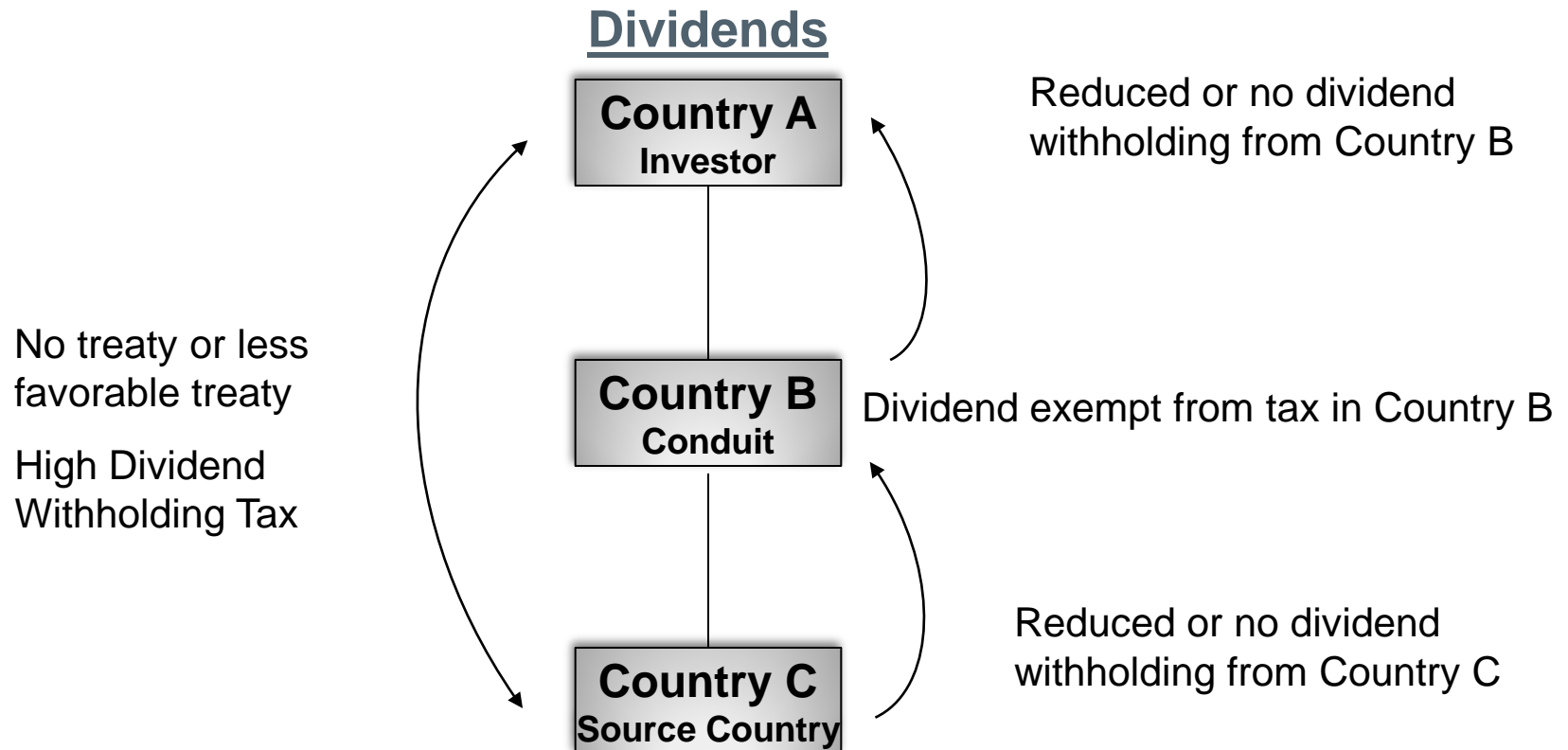
- Most governments negotiate “bilateral” tax treaties that follow the so-called “OECD model” (Organization for Economic Cooperation and Development).
 - Over the years, the OECD has provided extensive commentary on nearly every provision of a standard tax treaty.
 - Investors who rely on OECD model tax treaties generally enjoy a sense of consistency and predictability when making an investment in another country.
 - In most countries, the rules found in a tax treaty will override (or supersede) domestic law.
- Because tax treaties are generally uniform in content (and they supersede domestic tax laws), practitioners generally can plan and structure investments from any country in the world into any other country with a fair sense of the final results.

WHAT DO TAX TREATIES ACCOMPLISH FOR INVESTORS?

- Tax treaties are generally referred to as “double tax conventions” because their primary use is to avoid double taxation.
 - General theory: the same taxpayer should not be subject to taxation on the same income in two countries.
 - The rules found in tax treaties are generally intended to provide for the proper allocation of income and taxes between the treaty partners (favoring an allocation of income and taxes to the investor’s home country).
 - The goal of a tax treaty is to reduce “double taxation.”
 - The goal is not to allow for zero taxation or tax avoidance.
 - We see very few tax treaties where one of the parties is a “tax haven” jurisdiction (because few high-tax countries wish to facilitate the shifting of income to a tax haven).
 - High-tax countries generally enter into comprehensive tax treaties only with other high-tax jurisdictions.
 - In theory, taxpayers are less likely to engage in tax avoidance transactions when shifting of income between two high-tax countries.

WHAT ARE THE TYPICAL TAX BENEFITS FOUND UNDER TAX TREATIES?

- Reduction of withholding taxes when income is earned in one country and paid to another country.
 - Generally speaking, most tax treaties provide for reduced rate of withholding taxes when *dividends, interest, and royalties* are paid from the country of investment to the country where the investor is located.

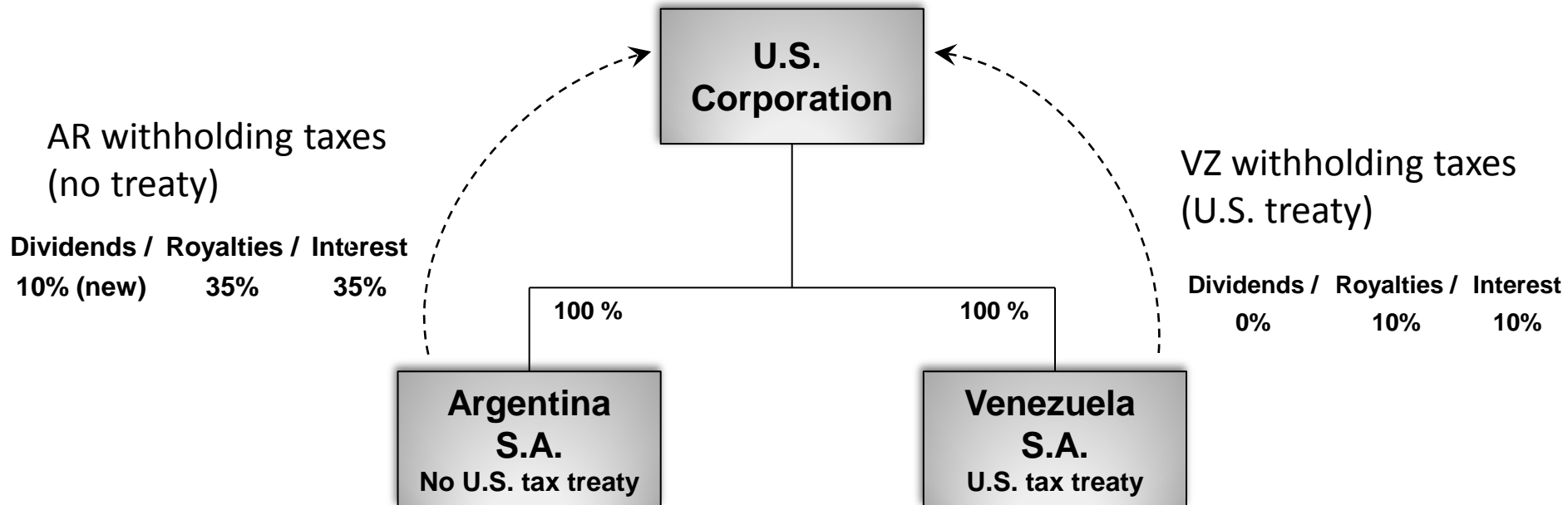


IS TAX TREATY SHOPPING ALLOWED?

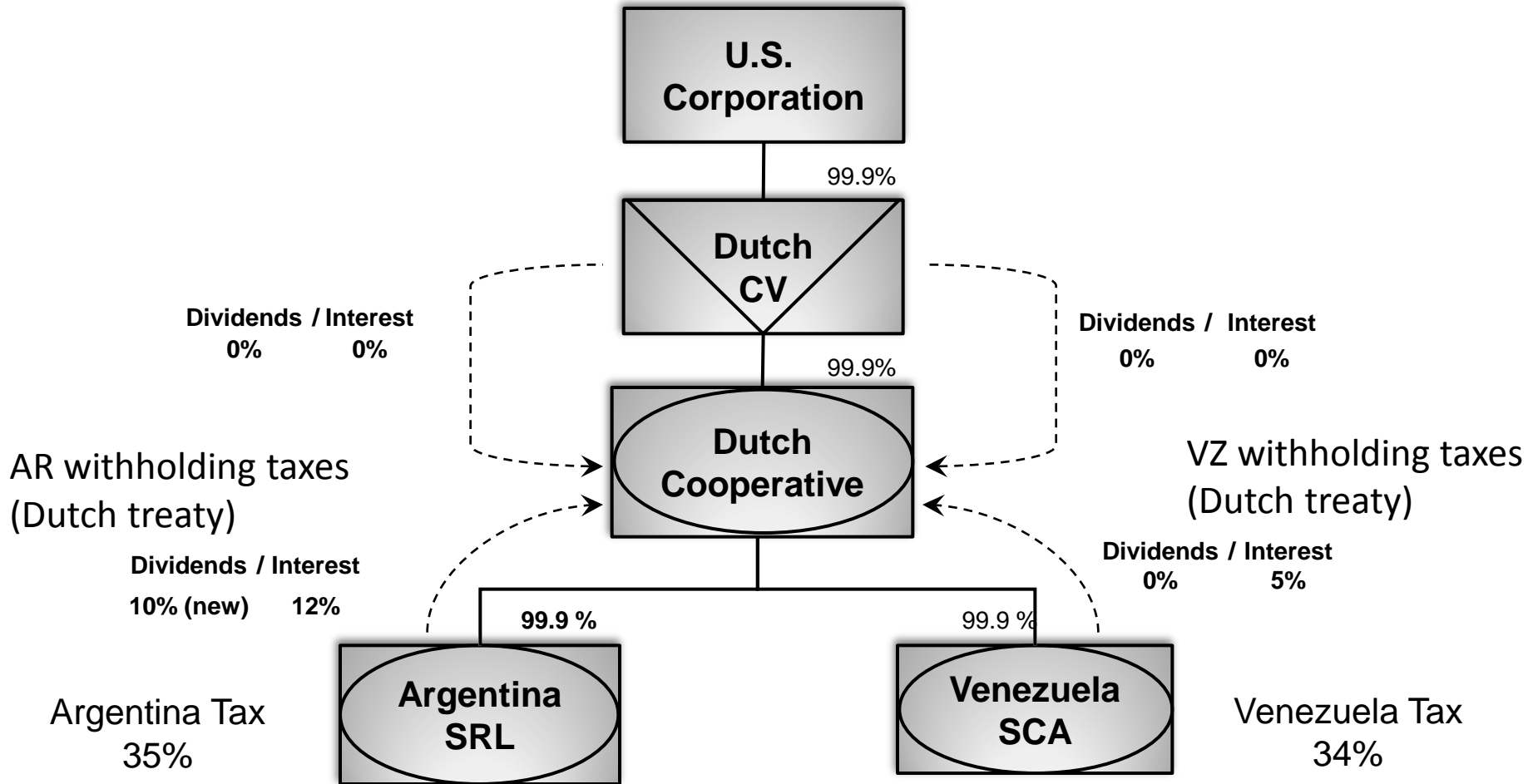
- Most host investment countries will generally not question whether the corporate owner of an investment company is a corporate “fiction” (“form over substance” approach).
- It is very easy to form intermediary companies in most countries, and it is fairly easy to insert an intermediary company into a tax structure.
- Most tax treaties provide merely that the corporate owner of an investment company must “beneficially own” the income received by the investment company.
 - The standard for “beneficial ownership” is fairly low (e.g., the corporate owner may not be a “nominee” for another true owner).
 - The United States has very strict “limitation on benefits” (LOB) clauses in nearly all of its treaties.
 - The LOB provisions prohibit third party investors from obtaining tax treaty benefits unless they satisfy certain strict standards.
 - Countries like India have judicially challenged large taxpayers who have tried to “treaty shop.” (e.g., Vodafone case).
 - Attacks on “treaty shopping” are on the rise, but the general practice still thrives.

FINANCE STRUCTURE

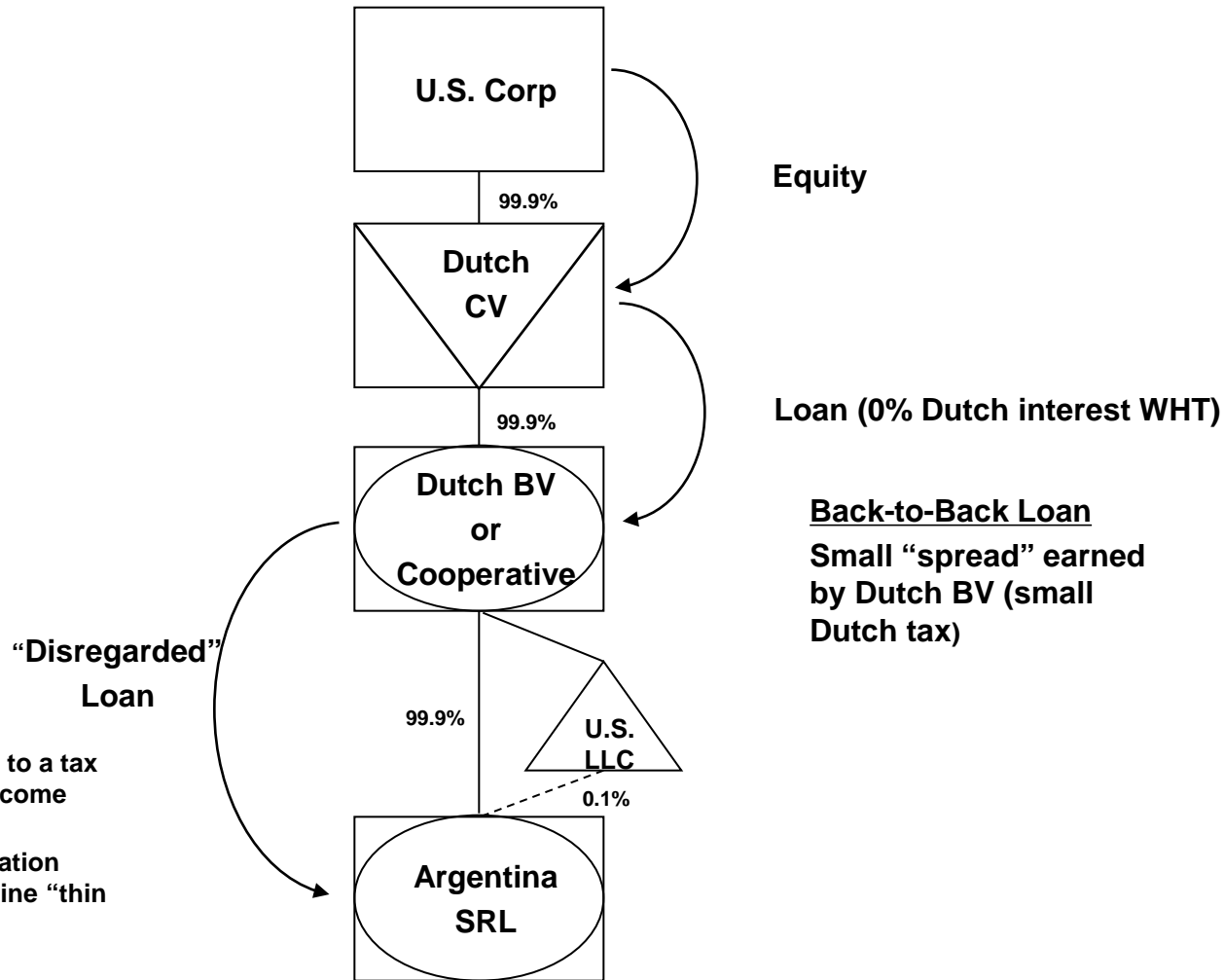
No Planning



FINANCE STRUCTURE



INTEREST-STRIPPING STRUCTURE



Argentine WHT
--Interest 12% (gives rise to a tax deduction against 35% income tax).
--Tax treaty nondiscrimination clause may defeat Argentine "thin cap" interest rules.

OTHER IMPORTANT BENEFITS PROVIDED BY TAX TREATIES

- Tax treaties often provide more favorable rules to allow an investor to avoid a taxable permanent establishment in the host investment country.
 - Tax treaties generally prohibit taxation against foreign investor companies unless those foreign companies have a physical presence or dependent agents in the host investment country.
 - For example, the provisions of tax treaties often protect companies from local income taxation if they sell products (or services) via the Internet into other countries.
- Tax treaties may allow an investor to avoid all tax on capital gains when the investor sells its shares in its host country investment.
- Tax treaties generally also provide that foreign investor should not be taxed in an investment country merely because the foreign investor maintains other operations in the country through an affiliated entity.
- Tax treaties generally have “nondiscrimination” clauses that prevent countries from treating their own domestic taxpayers more favorably than a foreign treaty beneficiary (similar to the nondiscrimination clauses found in BITs).
- Tax treaties generally provide only income tax benefits
 - Value Added Tax (“VAT”) concepts are generally not discussed in tax treaties, and investors generally cannot rely on tax treaties to avoid VAT.
 - Some taxpayers, however, have successfully used the nondiscrimination clause in BITs to provide protections against VAT (e.g., Ecuador).

HYPOTHETICAL INVESTMENT INTO THE COUNTRY OF BOLIVIA

CASE STUDY: THE "PROCESS" TO SELECT THE RIGHT STRUCTURE

LIST OF BOLIVIAN BITs		
Argentina	Belgium	Chile
Cuba	Ecuador	France
Germany	Peru	United States of America (termination announced)
Netherlands	Italy	Spain
Sweden	Republic of Korea	Switzerland
United Kingdom	China	Austria

TAX WITHHOLDING RATES FOR BOLIVIAN INVESTMENT WITH AND WITHOUT A TAX TREATY

	Dividends		Interest[1]	Royalties
	Individuals, companies	Qualifying companies		
	(%)	(%)	(%)	(%)
Domestic Rates				
<i>Companies:</i>	25	25	25	25
<i>Individuals:</i>	25	n/a	25	25
Treaty Rates				
<i>Treaty With:</i>				
Argentina	25	25	25	25
Colombia [2]	25	25	25	25
Ecuador [2]	25	25	25	25
France	15	15	15	15
Germany	15	15	15	15
Peru[3]	25	25	25	25
Spain	15	10 [3]	15	15
Sweden	15	0 [3]	15	15
United Kingdom	15	15	15	15

1. Some treaties provide for an exemption for certain types of interest, e.g. interest paid to public bodies and institutions or in relation to sales on credit. Such exemptions are not considered in this column.

2. In application of Decision 578 of the Andean Community.

3. The rate applies if the recipient company owns at least 25% of the paying company's capital.

Question: Can the MFN clause of the German BIT with Bolivia require Bolivia to provide better tax treaty rates to Germany (to match Sweden)?

COMPARING BOLIVIAN BIT "NONDISCRIMINATION CLAUSES" WITH RESPECT TO TAX ISSUES

■ Sweden:

■ Article 3

- Section (1): Each Contracting Party shall grant investments made in its territory by investors of the other Contracting Party treatment that is no less favorable than that granted in respect of investments made by investors of third States...
- Section (4): The provisions of paragraph 1 of this article shall not be construed so as to obligate one Contracting Party to extend to investors of the other Contracting Party the benefit of any treatment, preference or privilege deriving from an agreement or international arrangement relating wholly or mainly to taxation or from domestic legislation relating wholly or mainly to taxation.

■ Spain:

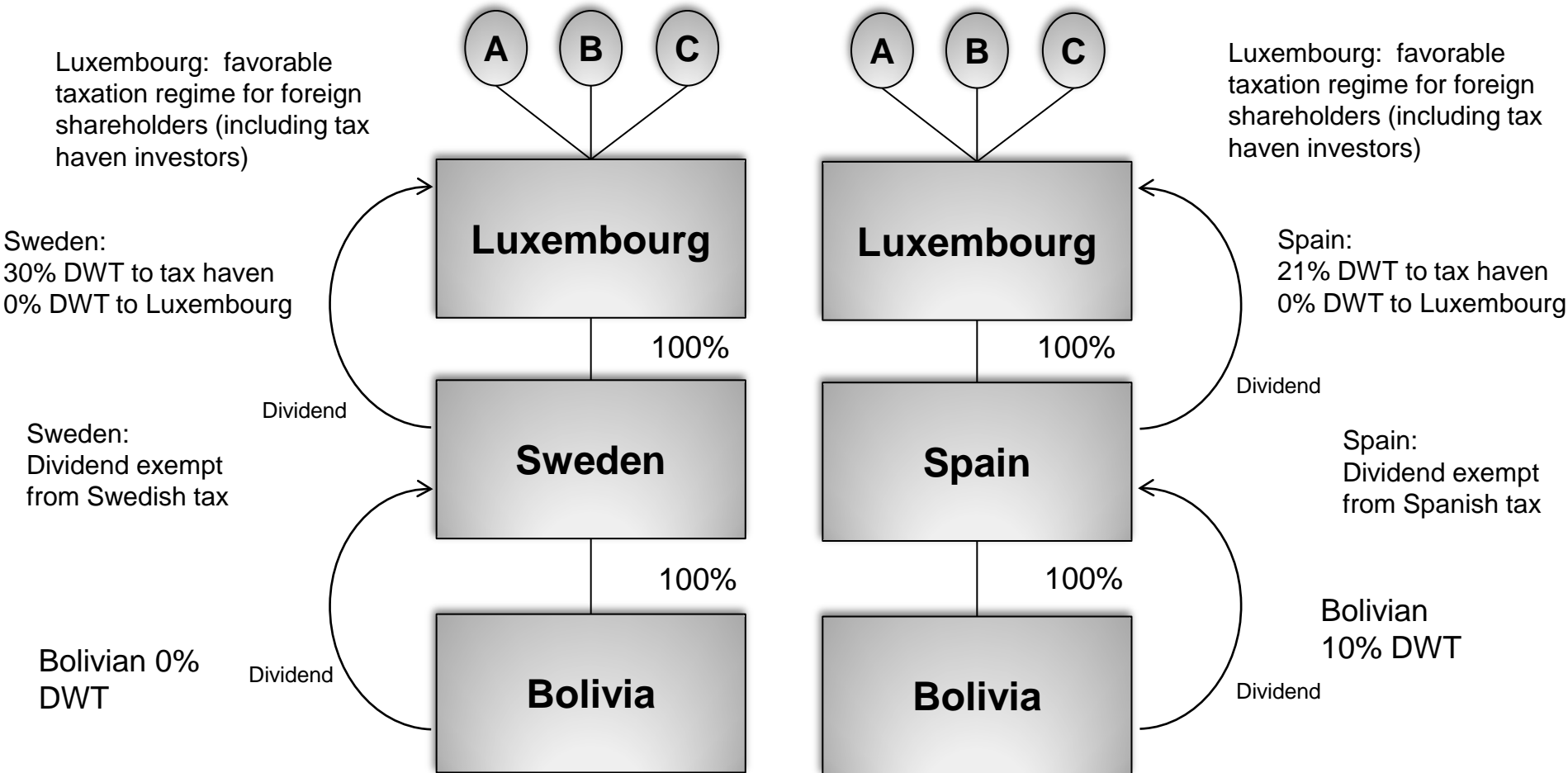
■ Article 4

- Section (1): Each Contracting Party shall in its territory accord to investments of investors of the other Contracting Party treatment no less favorable than that accorded to investments of its own investors or to investments of investors of any third State, whichever is more favorable to the investor...
- Section (4): Treatment granted under paragraphs 1 and 2 of this Article shall not refer to the advantages that Contracting Party accords to investments or investors of third States as a result of an agreement to avoid double Taxation Agreements or other fiscal matters.

■ Article 12

- Section (2): Treatment under this Agreement shall not apply to tax matters.

Sweden vs. Spain (Tax)



COMPARING SWEDISH AND SPANISH DOMESTIC TAX SYSTEMS

- It is equally important when performing tax and BIT planning to ensure that the jurisdiction where the intermediary entity is located also has a favorable “domestic” tax regime.
- **Sweden:**
 - Favorable: Sweden does not tax dividends received from a wholly-owned subsidiary that has a tax treaty with Sweden (including Bolivia)
 - Favorable: Sweden has a favorable tax regime when Swedish dividends are paid to an entity located in the European Union (“EU”) (or to an entity that has a favorable tax treaty with Sweden).
 - Unfavorable: Sweden has an unfavorable rule for taxing the offshore earnings of lower-tier subsidiaries located in low-tax jurisdictions (“CFC rules”).
 - This particular rule will often disqualify Sweden as a favorable country for BIT/tax planning.
- **Spain:**
 - Favorable: Spain does not tax dividends received from a wholly-owned subsidiary that is not “tax blacklisted.”
 - Favorable: Spain has a favorable tax regime when Spanish dividends are paid to an entity located in the EU (or to an entity that is not “tax blacklisted”).
 - Unfavorable: Spain has an unfavorable tax regime for shareholders located in a tax haven (additional “blocker” companies are usually needed to protect tax haven shareholders from these negative Spanish tax rules).

TAX AND BIT STRUCTURING GOALS

- (1) Minimize taxes in the “host” investment country.**
- (2) Choose the most favorable BIT that also provides the best tax results for moving funds from the host investment country to the intermediary (BIT) entity.**
- (3) Minimize taxes in the jurisdiction of the intermediary (BIT) entity.**
- (4) Efficiently move funds from the intermediary (BIT) entity to the investor’s home country.**

USING “FISCALLY TAX TRANSPARENT” ENTITIES RATHER THAN “TAX TREATY” ENTITIES AS BIT VEHICLES

- A “fiscally transparent entity” is generally defined as an entity whose owners (rather than the entity itself) are subject to tax on the income, profits, or gains derived by the entity.
- Fiscally transparent entities that are formed in high-tax jurisdictions by nonresidents can generally avoid all taxes in those high-tax jurisdictions if they do not conduct business in those jurisdictions.
 - Commonly used fiscally transparent entities located in high-tax jurisdictions include the U.S. LLC, the UK LLP, the “closed” Dutch CV (not technically an “entity”), and the Canadian (or U.S.) LP.
 - The mere ownership of a bank account by a fiscally transparent entity in a jurisdiction does not necessarily make the fiscally transparent entity “subject to tax” in that jurisdiction (a more formal permanent establishment is usually required).
- Fiscally transparent entities generally do not qualify for tax treaty benefits because they are not “subject to tax” in a treaty country.
- Many consider the Delaware LLC to be the “ultimate” worldwide fiscally transparent entity.
- If structured properly, the United States government will allow an investor using a single-member U.S. LLC for international investment to avoid all U.S. taxation (even avoiding any U.S. tax filings even though the LLC can have a proper U.S. taxpayer identification number).
- Even though fiscally transparent entities may not be subject to taxation, can those entities qualify as “investors” for purposes of a BIT?

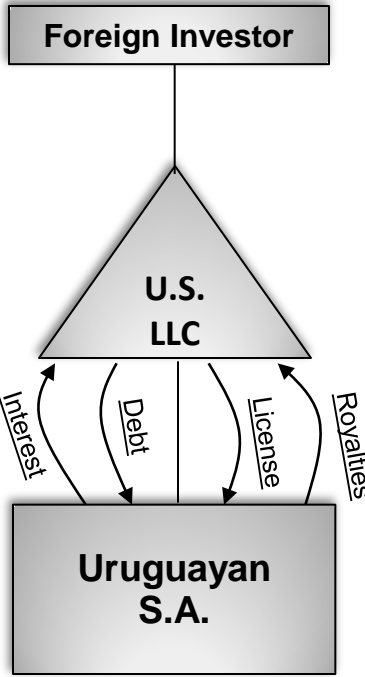
SAMPLE USES OF “FISCALLY TAX TRANSPARENT” ENTITIES IN TAX AND BIT PLANNING

- A fiscally transparent entity can be used (rather than a corporation) as an intermediary “blocker” company.
- Is a fiscally transparent entity still a qualifying “investor” for purposes of qualifying for BIT benefits (U.S.-Uruguay BIT)?

Article 17: Denial of Benefits:

Section (2): A Party may deny the benefits of this Treaty to an investor of the other Party that is an enterprise of such other Party and to investments of that investor if the enterprise has no substantial business activities in the territory of the other Party and persons of a non-Party, or of the denying Party, own or control the enterprise.

Deductible Payment Example



No U.S. taxes for U.S. LLC if no U.S. activity.

Interest Payment
(1) Deduction against 48% of 25% taxed income
(2) 12% withholding tax

Royalties Payment
(1) Deduction against 48% of 25% taxed income
(2) 12% withholding tax

SUBSTITUTION OF SPANISH ETVE FOR U.S. LLC

- What if the foreign investor uses a Spanish corporation rather than a U.S. LLC?
- Spain and Uruguay have a favorable BIT (1994).
- The Uruguayan withholding tax on **interest** is **reduced from 12% to 0/10%**, and the withholding tax on **dividends** is **reduced from 7% to 0%** (if the Spanish ETVE owns more than 75% of the Uruguayan S.A.).
- What happens to the interest paid to Spain? 35% Spanish corporate income tax?

Deductible Payment Example

