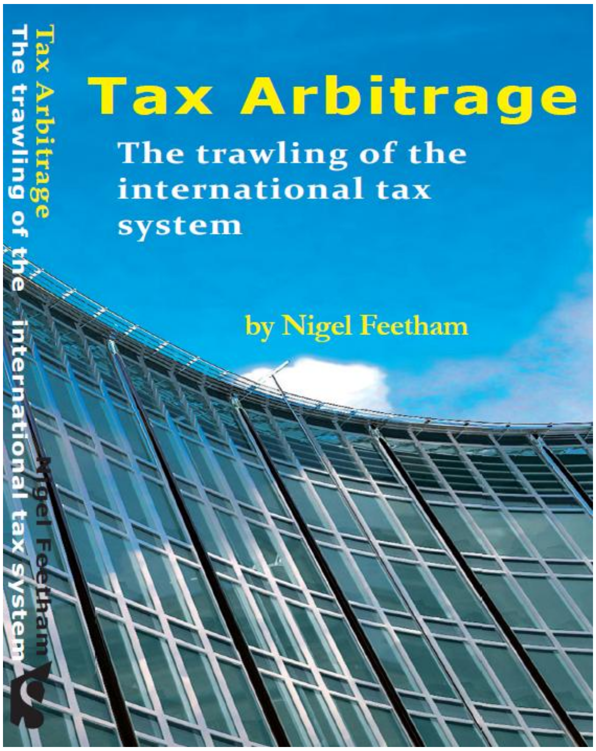
TAX ARBITRAGE - by Nigel Feetham

Book review by Mr Robin Amos

The trawling of the international tax system



Even before the global financial crisis there has been controversy about the extent to which multi-national companies (and particularly global banks) are able to minimise their tax bill - allowing for a low effective rate of tax (in some cases, substantially below the headline rate). Anyone interested in this issue can find commentary everywhere (via Google try searching “Vodaphone tax avoidance” for example), but unsurprisingly mostly critical. In the UK especially, the subject is very topical, making front page news on a regular basis, particularly so since the activities of the pressure group calling itself “UK Uncut” commenced. Household name companies have been criticized for lowering their taxes through supposedly clever but legal tax avoidance schemes. This debate is also political in the fullest sense.

Aside from the politics, if one is interested in the details, such as i) how and why tax is minimised legally, ii) whether it is done with the knowledge or even tacit approval of tax authorities, and iii) the fiscal policy choices facing countries, it is necessary to find a reference point. It is therefore so important and welcome when a dispassionate and objective analysis becomes available. Nigel Feetham, partner at Hassans International Law firm, and Visiting Professor at Nottingham Trent University, has created such an analysis with his new and latest book, “Tax arbitrage – the trawling of the international tax system”. The book title immediately tells you something about what the book is about, and follows Feetham’s earlier book on protected cell companies (currently in its second edition and a first in that field). Until recently, there was scarcity of material on tax arbitrage. Less so in recent years (and months) especially with a number of Court cases having been decided in several countries, with the most detailed description according to Feetham contained in a couple of New Zealand law reports.

Tax arbitrage is a specific form of legal (and often fully disclosed) tax avoidance, where typically a multi-national company achieves a tax benefit from a commercial transaction that is treated differently by two (or more) jurisdictions, including what is sometimes known as a “double-dip”. In many cases the respective jurisdictions will have a double taxation treaty in place, but a carefully structured transaction can create a situation where there is actually double non-taxation, and on the face of it achieving far more than the intended outcome of the tax code. The objection is that tax relief is claimed twice for the same income in two jurisdictions. One way this can happen is if one country treats a transaction on the basis of pure 'form' (say formal title/ownership) and another treats it on the basis of 'substance' of commercial activity (such as who is the ultimate beneficiary). As Feetham's book shows, tax arbitrage has always existed but it seems to have been brought to the forefront of public scrutiny and debate with the global financial crisis on 2008.

There are numerous examples in the book taken from public sources (e.g. OECD reports) and all are clearly explained sometimes with no technical jargon at all. A fascinating scenario involves local authorities (in Europe and the USA) selling public assets and then leasing them back. Feetham explains that the deals were intended to work (as the tax laws then stood) on the basis that a private sector buyer with "tax capacity" (i.e. profits) obtained a tax benefit (i.e. deduction) from the underlying transaction including depreciation and interest payments. These benefits (as is typical of such transactions) are shared between the parties as reflected in the pricing of the deal. In some cases the tax benefit was a driver for these transactions which may not otherwise have been economical. This gave rise to an interesting situation where tax arbitrage was initiated by one part of the public sector to create local public benefits, whilst creating wider tax revenue losses. These types of leasing deals, when they are cross-border, can have enhanced tax benefits for both sides (i.e "double-dip") when structured carefully, but have also led to objections that the public assets are being sold to foreign companies or that public revenues are taking a double hit.

Unsurprisingly, the most complex transactions involve global banks since banks have the huge funds necessary to structure some of these deals. In some structured deals, a cross-border loan or investment is made on terms that is profitable after tax, but can be neutral or negative before tax, adjusting for risk. Again, the tax benefits are carefully factored into the pricing so that each party is benefiting from the deal, post tax. In such deals, the lender will have "tax capacity" or taxable profits and it seeks out a deal where it obtains a tax relief (in the form of a credit, deduction or even a deduction and exemption) from another country which it can use to offset its domestic tax bill.

Feetham is very strong on challenging inaccurate and misleading perceptions. An example is "tax havens". Clearly, there are legitimate issues in terms of tax competition, but in the technical matter of implementing tax arbitrage, it is almost always a case of applying a business transaction in two onshore jurisdictions to benefit from a different or contradictory tax treatment. The role of tax havens in classic tax arbitrage (eg "double-dipping") is shown to be incidental. A more long term form of arbitrage (if arbitrage is the correct term but the term certainly seems wide enough to include this and many other forms of transactions/structuring) is where companies can relocate to a country (say Switzerland) that has a "territorial" tax system, such that profits made outside of Switzerland are not taxed in Switzerland. An example is where a branch of a Swiss (say reinsurance) company is set up in a zero tax jurisdiction such as Bermuda, with all reinsurance business written by the branch. In this scenario, the effective rate of tax can be zero, and yet the company can avail itself of Swiss double tax treaty arrangements with the USA and other countries. Both countries take a different view of taxation and the profits are not taxed in either.

Feetham illuminates the difficulty in deciding what is objectionable or aggressive tax practice. The long-standing principle is that the legislature is free to legislate on tax matters, and companies/individuals are free to minimise their tax liability according to the law. If the law is inadequate, it can be changed, even to the extent of a general anti avoidance rule (known as GAAR) – as has actually been done in several countries, notably Australia and New Zealand. In these cases, it makes for a very effective weapon as discussed in Feetham's book.

There is a discernible trend across territories as more tax authorities challenge tax arbitrage transactions. It is fair to say that a contrived scheme of a company that has its sole purpose to create a profit out of its "tax capacity", with otherwise no commercial rationale and profitability, is going to be objectionable to tax authorities. Feetham's book opens up the case-law reports to analysis, and especially fascinating are the recent English tax cases, which seem to uphold the principle of form over substance, in support of the long-standing principle as mentioned.

This book is very clear on the perils of trying to apply overt moral judgments in the field of tax law, simply because a taxpayer is taxed according to law, not morality. It seems obvious (to this reviewer at least) that a company needs firstly to be understood in terms of its directors who have a legal responsibility to maximise profits for their shareholders. It also becomes very difficult to be (morally) judgmental on corporate tax as a single issue without looking at taxation of individuals and companies (and spending) as a combined political question.

Feetham makes the important point that individuals also engage in tax (price) arbitrage, almost on a daily basis. An example is internet VAT free purchases or even filling a motor vehicle with cheaper petrol across borders. This is not thought to be objectionable.

The politics get even more interesting when one considers the international dynamics of tax competition. Each country wants to maximise its own tax revenue, and very often it appears to be a zero-sum or negative-sum game as tax rates are competed downwards. For example, the UK has announced its intention to have the lowest headline corporation tax rate (24%) in 4 years time amongst the G20 countries (and in the March 2011 budget accelerated this process). Just as important, the UK is moving to a more territorial tax system to prevent the exodus of large companies.

Although there is more international coordination than ever before, specifically on tax arbitrage (for example the Joint International Tax Shelter Information Centre - JITSIC), there is clearly a tension and crucial difference between i) each nation state maximising its own tax revenue (in "beggar thy neighbor" fashion) and ii) tax revenue being maximised for all nation states combined. This tension will stay for the foreseeable future despite concerted attempts for nations to work together. These issues will be well known to the OPEC oil cartel - concerning the dynamics and incentives under international agreements.

Some would argue that since capital is economically more mobile than people or land, it makes sense for a tax system to concentrate on the immobile contributors to economic production. There is indeed an argument (although Feetham does not advance it) for having no corporation tax worldwide, leaving the tax system to focus on an equitable tax basis on individuals alone, since clearly all companies are ultimately owned by people of various incomes and wealth. This view is entirely consistent with even increasing the overall tax burden, should that be politically possible or desirable.

The tax arbitrage industry will remain in place for the foreseeable future, since with any kind of arbitrage (including regulatory arbitrage), arbitrage is effectively the turning of an economic activity to profit based in differences between countries or financial markets. So whilst differences exist, so will the opportunity for arbitrage in its various forms.

Feetham has produced yet another informative work – the book may well become an essential introduction and textbook to this (until now) relatively mysterious if not a murky world. Once the mystery and shadows are removed as Feetham has attempted to do in his latest work, what is visible is different levels of sophisticated but legal structuring of commercial transactions across borders with tax benefits.

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"Tax arbitrage – the trawling of the international tax system" is published by Spiramus Press, hardback, 196 pages.

The author

Nigel Feetham is a partner at a leading Gibraltar law firm (Hassans). He is also a Visiting Professor at Nottingham Law School, Nottingham Trent University, and a non-executive member of the Gibraltar Financial Services Commission. He graduated with a First Class Honours degree from Manchester Metropolitan University, and was awarded a Masters degree in law with Distinction at Manchester Victoria University. He is the co-author of the book *Protected Cell Companies: a guide to their implementation and use* (now in its Second Edition), the leading reference work on protected cell companies.