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Corso di Laurea Magistrale in International Economic and Commerce

**THE ROLE OF THE INTANGIBLE ASSETS IN THE
DOUBLE TAXATION: THE HYBRID LOAN IN
THE WALMART’ S CASE**

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Anno Accademico 2018– 2019

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ABSTRACT

Oggi la maggior parte delle grandi aziende è alla ricerca di nuovi modi per evitare la doppia imposizione per sostenere la propria strategia fiscale senza essere tassati sul profitto che generano. Le attività immateriali sono state una delle migliori soluzioni come strumento per minimizzare le tasse e massimizzare i profitti. Lo scopo di questa tesi è analizzare come lo strumento finanziario ibrido sia diventato rilevante e qual'è sia il suo ruolo nella doppia imposizione e in che modo le autorità fiscali hanno reagito a questa nuova tecnica del prezzo di trasferimento. Prima di tutto, l'idea è di analizzare le norme internazionali che affrontiamo e che sono inerenti all'uso abusivo di questi strumenti distorti. In particolare l'idea è prendere come esempio il caso di Walmart in cui il prestito ibrido di un'operazione infragruppo ha creato un nuovo ruolo delle attività immateriali che ha permesso di rafforzare la loro strategia fiscale e rivelare la mancanza di regolamentazione da parte delle autorità in merito a questo strumento finanziario . I suggerimenti che verranno formulati saranno riferiti al caso di Walmart e anche all'adattamento dell'OCSE rispetto al suo modello e alle sue regole in merito alle questioni relative alle attività immateriali.

ABSTRACT

Nowadays the majority of big companies are searching for new ways to avoid double taxation to support their fiscal strategy without being taxed on the profit they generate. The intangible assets have been one of the best solutions as an instrument to minimize taxes and maximize profits. The aim of this thesis is to analyze how the hybrid financial instrument have become relevant and so which is their role in the double taxation and in which way the tax authorities have reacted to this new technique of transfer price. First of all, the idea is to analyze the international norms that we face and that are inherent to the abusive use of these distorted instruments. In particular the idea is take as a sample the Walmart's case in which the hybrid loan of an intra-group operation has created a new role of intangible assets that enabled to strengthen their fiscal strategy and reveal the lack of regulation from authorities regarding this financial instrument. The suggestions that are going to be made will be referred to the Walmart's case and also to the adaptation of the OECD with respect to its model and rules regarding the issues of the intangible assets.

1. THE ROLE OF THE INTANGIBLE ASSETS IN THE DOUBLE TAXATION

1.1 The lack of regulation of the new hybrid financial instruments from the authorities

The traditional formula used by modern tax management systems is based, more or less, on ex-post (retroactive) audits of the self-assessed tax returns submitted by taxpayers. For the purposes of evaluating their compliance with tax obligations, it has two basic drawbacks that reveal the need to establish new formulas or mechanisms to prevent and combat aggressive tax planning. First, the complex and cross-border nature of many of the operations performed by large companies means that tax inspections are often unsuccessful. Second, even when practices that could be classed as aggressive tax planning have been detected, the time taken for this to be accomplished seriously hinders the relevant monitoring and control administrative actions. Precisely because of this, efforts were made to reconcile the possibilities of legitimate tax planning so that the system allows the taxpayer (in the framework of the new model of cooperative tax compliance) and the function (and duty) of the tax administration to control correct tax compliance and prevent abusive tax practices and those that take advantage of the 'loopholes' present in the national and international tax system. The creation ex-novo of the concept of 'aggressive tax planning' is included in this context and

responds, to a certain extent, to the need to define what type of tax planning falls within or outside the model of an enhanced relationship.

According to the WTO data, multinational enterprises (MNEs) control about 70% of the worldwide trade. A multinational enterprise could be defined as a group of associated companies, which are established in different countries. For example, Apple, Coca-Cola, IBM, Samsung, Toyota, Nike are multinational enterprises. MNEs are planning their profitability and tax arrangements taking into account different aspects of business, features of economics, and the national and international tax rules. MNEs explore the markets and choose the most benefiting places for businesses, the most beneficial place to make research and development, the best place to manufacture products and to assemble them and so on. The choice of the allocation of these associated companies could be determined by different factors, which could be the low cost of production, low cost labor, economies on taxes, possibilities to use double tax treaties and so on. The MNEs shift profits from one associated company to another trying to allocate expenses in the countries with high corporate income tax and to allocate profits in the countries with the low corporate income tax. This abusive practice got name

among the OECD countries “tax base erosion and profit shifting¹”. As a result of this practice a state’s budget of any state might get decreased tax revenue, and part of the profit move from one country to another. The role of transfer pricing rules and the arm’s length principle is to provide the fair profit allocation, allowing a state to benefit from the productivity and manufacturing carried out in its territory. The arm’s length principle could be explained as the obligation of the MNE to pay taxes as if there was the impartial, unprejudiced or unbiased approach in the choice of the business partner, when the only natural market forces and perspective profits may influence the choice. If the price of the transaction within a MNE is similar to the price, which independent companies, are neither associated nor influenced by common management then price is considered to be arm’s length.

At the beginning of the industrial age, the leading role of a company’s success was indicated by the possession of tangible assets such as industrial equipment. Currently the focus has shifted to intangibles. Nowadays, intangible assets like trademarks, patents, know-how, trade secrets play a significant role in the world’s economy: industrial R&D is a driving force for the economics development, trademarks are the driving forces for the products on the market. Transfer of rights on intangible assets constitutes a very

¹v. CARRERO J. M. C., SEARA A.Q., The Concept of ‘Aggressive Tax Planning’ Launched by the OECD and the EU Commission in the BEPS Era: Redefining the Border between Legitimate and Illegitimate Tax Planning, in *Intertax*, n. 44, 2016, Issue 3, pag. 208

important field of business interests. In many industries intangible assets constitute the majority of the business's value. For example the Apple brand is estimated to be worth \$98 billions, the Coca Cola's brand worth \$79 billions, the IBM's brand worth \$78 billions.

The GATT Trade-Related Aspects of Intellectual Property Rights (TRIPS), being part of the GATT, was signed in 1994. The TRIPS agreement contains minimum standards for different forms of intellectual property rights and its protection. The TRIPS agreement is the significant international tool, which allows setting up and developing the ways of national and international IP rights protection. In the modern world the companies and especially international corporations endeavoring to succeed in a competitive environment, have to deploy soundly the intangible assets they possess. Intangible assets started to play the very significant role. It is acknowledged that one of the most difficult issues for a MNE is the establishment of appropriate transfer prices for tax purposes. Things become even more complicated when it is necessary to establish transfer price for intangible assets. Most intangibles are unique assets, and their transfers rarely take place on external markets. As a result, reliable, comprehensive, and internationally comparable data at company and country level are scarce. Such data, however, would be necessary to assure that the application of arm's length transfer pricing methods follow objective rules.

There are two kinds of the transfer pricing: internal transfer pricing (transfer of intangibles within one country) and external transfer pricing when intangible assets are transferred cross-border between affiliated companies which are located in different countries. The following arm's length principle might be complicated if the countries do not have harmonized transfer pricing rules and approaches. Different countries might have different rules concerning taxation of multinational corporations, they might have different approaches for solving transfer pricing problems and countries might have different accounting rules. Multiple currencies involved in international trade and therefore in transfer pricing assessment and necessity to convert the price in foreign currency into the local currency make the practitioners think about calculation of different exchange rates in different days in different countries. The OECD in its report indicated that transfer pricing issues pertaining to intangibles were identified as a key area of concern to governments and taxpayers, due to insufficient international guidance in particular on the definition, identification and valuation of intangibles for transfer pricing purposes. To apply the arm's length principle, it is necessary to answer several questions: How should comparable transactions be identified? How should comparable transactions be adjusted, when they are not the same but reasonably similar? What should be done when comparables do not even exist,

which is likely to be the case when it comes to intangible assets? Which of the provided methods is best to apply?

The valuation of intangible assets for transfer pricing purposes has a lot of problems, and compliance to the law is quite a challenging task for MNEs. In the present thesis it will be considered how some intangibles (not trademarks and patents but hybrid loan) are defined and what are their characteristics, and the main approaches for valuation of intangible assets for international transfer pricing purposes will be considered. These approaches and analysis will be implemented in the Walmart's case in order to give a practical example of an intangible asset like the Cpec, the hybrid loan instrument exploited as a tax exemption strategy.

When there is no legal certainty in the particular field it might entail problems of the tax law implementation and therefore the risks of penalties.

The vague nature of the intangible assets concept creates problems in identifying intangibles in practice. There is no definition of intangible assets given on the EU binding law level. Also there is no definition of intangible assets in the OECD documents, which are already in force. The improving draft to the OECD Guidelines contains definition of the intangible assets, but improvements are not approved and officially published yet. The binding law and definitions could be found on the EU level law for each kind of

intangibles separately: for trademarks, patents, know how, trade secrets, industrial designs and so on.

The concept of intangible asset is specified by the accounting standard as an identifiable non-monetary asset without physical substance. The standard stipulates clearly those ascertainable resources without physical substance which shall not be treated as intangible assets (financial assets and expenditures spent on the development and extraction of minerals, oil, natural gas, and similar non-regenerative resources).

The IAS² 38 stipulates in details the recognition, acquisition and measurement of the intangible assets. In compliance with the provisions of the standard given intangible asset is recognized as being such in the event when: it complies with the definition of intangible asset (non-monetary asset without physical substance) and the criteria for recognition.

It is probable that the expected future economic benefits that are attributable to the asset will flow into the entity; and the cost of the asset can be measured reliably. Given intangible asset is recognized for tax purposes in the event when it complies with the criteria for tax intangible asset subject to the provisions of the Corporate Income Tax Act (CITA). The tax fixed intangible assets are acquired non-financial resources which:

² IAS 38 Intangible Assets outlines the accounting requirements for intangible assets, which are non-monetary assets which are without physical substance and identifiable

- have no physical substance;
- are used for a period longer than 12 months;
- have a limited period of useful life;
- have a value that either equals or exceeds the lower value of the following ones. The value threshold of significance of the fixed intangible asset specified in the accounting policy of the taxable person.

Before introducing the concept of the hybrid loan in the context of double taxation we have to understand the different meanings of this instrument in the financial market. A hybrid loan is a loan that starts out as a fixed-rate mortgage and eventually converts into a variable-rate mortgage. The timing of the conversion is set when the mortgage terms are being negotiated. There are situations in which taking out a hybrid loan makes sense for homeowners, as well as a few different hybrid options that allow homeowners to retain flexibility in their monthly mortgage payments. With a hybrid loan, buyers have a fixed low rate on the loan for the first five to seven years of the mortgage term, which allows them to save money on their payments. After the first five to seven years of the mortgage has been paid off, the loan then moves to an adjustable rate.

This may cause some trouble for the buyers in the sense that the payment will change from month to month depending on the interest rate. An option for those

who want to stay in the home without worrying about how high the interest rate will jump is to get a hybrid loan with an interest rate cap. This will set a maximum interest rate that can be charged in a monthly payment, therefore allowing buyers to budget the maximum amount their mortgage payment could be.

This financial explanation of this instrument is important to understand that have nothing to do with its concept in the international tax law. In the double taxation what makes tax arbitrage different from tax avoidance is the definition of the former as a set of transactions designed to take advantage of the different tax system in order to achieve no taxation or very low such . The hybrid financial instruments come under this definition and as such are seen as a manifestation of it. It is important to make a few illustrations on how tax arbitrage functions before drawing any conclusions. As already mentioned the main objective is to combine the most opportune tax treatment between two jurisdictions so to secure an interest deduction for the foreign entity and an unburdened payment at the level of the recipient entity. The rules differ from one jurisdiction to another. In France, the classification of a financial instrument is based mostly on whether voting rights are conferred on the holder or not. Another example of an inconsistent treatment of a financial instrument is the dutch perpetual loan that can be regarded as equity, because of the fact that the principal will never be reimbursed, but as debt-like due to the lack of voting rights, risk assumed in the business of the entity, because of a pre-established coupon rate, priority in the liquidation and

others. The inherent complexity around the hybrid financial instruments, as inferred from the examples above, is due to the country-specific tax environment. This point is of particular relevance upon the introduction of an effective solution that can identify all the specificities of the hybrid instruments. Each country adopts certain provisions that reflect existing economic circumstances at a given time frame. The jurisdictional reach of these provisions in many occasions proves to be limited in its material scope and at the same time not in pace with the incessantly innovative financial world. The recognition of all these developments and changes can be a challenging task for not only relatively developed countries. The contemporary financial products frequently do not provide for comparable transactions to serve as a benchmark. A financial product allows for a risk diversification and segregation of the composing elements with the objective to match the specific needs of the parties involved. This makes the characterization of an instrument unclear and gives way to legitimate manipulations. All this taken into account in combination with the attempts on part of many countries to restore the missing legal certainty when dealing with hybrid financial instruments provides for numerous opportunities for tax arbitrage. The diversity among tax jurisdictions do not create possibilities for tax arbitrage on in its own merits. The disparities originate where tax and economic distinctions do not match, or when the tax law provides a distinction but the economics of the transaction do not warrant one, thus allowing the taxpayer to elect the tax results without varying his

underlying economic position. If such asymmetries of the two or more international tax systems are inconsistent, the arbitrage opportunities arise. When solving these policy issues countries are very meticulous about preserving the delicate balance between protecting the tax base from being eroded and the same not to discourage the use of new financial instruments. Even though the last statement is contradictory in itself it certainly holds some merits on why the current rules of the game cannot be changed that easily. It has been stated that there is existing uncoordinated policy equilibrium in the treatment of hybrid financial instruments. From the perspective of the host state, stringent anti hybrid rules, the introduction of an effective taxation of the distributing entity or the disallowance of the deductibility of the interest payments would impair the established equilibrium. The same applies from the perspective of the home country. This is premised on the high mobility of capital being shifted to another jurisdiction where no such strict rules apply. As a result, the incidence of the tax would fall on the less mobile labor force and produce suboptimal effects. Apart from the latter, the ban on hybrid instruments will also have another consequence. It will certainly increase the tax base of the countries involved, but at the same time it will impact the ability of multinational companies to remain globally competitive, unless countries lower the tax rate in order to attract business back. In the last two years the outcome of the exploitation of hybrid financial instruments has become a serious concern for law makers. What are the causes for

the late response to this type of transactions, used for over two decades, is of no importance. The relevant question is whether a partial modification of the tax treatment would bring into practice a balanced outcome that would address the idiosyncrasies of these financial products, which in the end pursue a legitimate financing aim. The anti-abusive rules are not always applicable to situations of tax arbitrage, which requires compliance with the tax rules in each jurisdiction where the effects of the transaction take place. At an EU level the risks involved in the use of hybrid financial instruments, as part of the broad concept of tax arbitrage have been identified indirectly by the Commission stating that the lack of coordination may also lead to unintended non-taxation and provide scope for abuse. Non-taxation and abuse are equally detrimental to the interests of the internal market because they undermine the fairness and the balance of Member States tax systems. This problem can also be addressed by better coordination of Member States rules and improved cooperation with respect to enforcement. This will be an essential element of the Commission's initiatives. In fact later on 2007 the Commission referred directly to the unwanted results caused by hybrids: 'Lack of concerted interaction between MSs tax systems may result in unintended non-taxation and provide scope for abuse, thus undermining their fairness and balance. Mismatches may arise, for example, in relation to the qualification of debt and equity. One Member state may consider a transaction to be an equity injection and thereby exempt the income derived from it as profit distribution,

whereas another Member state may consider the same transaction to be a loan and allow tax deductibility for the consequent payments as interest. In order to provide an answer on what are the conditions for a certain transaction to be found as abusive and fraudulent ECJ's³ findings can be integrated into the analysis. So in order to have an abusive situation in the field of direct taxation the necessary elements to look at are the factors related to the artificiality of the establishment art.13 (objective test that examines the substance of the entity); artificiality of the transaction (subjective test that examines the lack of any genuine business purpose) and third, if the terms of the transaction are at arm's length. When analyzing the elements of the subjective test the tax saving purpose of the arrangement carried out is no longer deemed essential and it doesn't constitute abuse on its own basis if the transaction reflects economic reality. In the context of hybrid financial instruments this means that for these types of arrangements it would be rather difficult to substantiate the presence of an abusive practice based solely on the underlying savings motive. As already mentioned, the dual nature of the instrument derives from the divergent classification given by the Member State involved in the transaction. However in most cases they pursue a legitimate financing aim that cannot be automatically discarded or qualified as abusive. As a

³Communication of 19 December 2006 from the Commission to the Council, the European Parliament and the European Economic and Social Committee - Coordinating Member States' direct tax systems in the Internal Market COM(2006) 823 final, p.2.3

result the use of hybrid financial instruments remains outside the scope of the anti-abuse provision in the parent-subsidiary directive. In support of the latter statement is the fact that within the EU Member State are free to organize national tax systems at their own sovereign discretion and none of the members has the legal obligation under EU law to adapt and comply with the others jurisdiction as long as they do not act against the main principles and freedoms of EU law. As stated briefly, hybrid mismatch makes sense and occurs only in a cross-border situation, when at least two jurisdictions are engaged. It is a twocountry problem in having uncoordinated and unharmonized tax rules within the framework of differing independent legal systems.If we imagine a situation where two jurisdictions have the same legal system, in such a case the tax saving caused by the exploitation of a hybrid will disappear.The ECJ had the chance in various instances to state that disparities are not within the scope of the prohibitions of the treaty freedoms and since there is no harmonization in the field of direct taxation no remedy can be provided: Member State is notrequired to draw up its tax rules on the basis of those in another Member State in order to ensure, in all circumstances, taxation which removes any disparities arising from national tax rules. Further, it has been recognized by ECJ that sometimes juridical double taxation cannot be avoided and it is a matter of exercise in parallel of the fiscal sovereignty of a country and thus acceptable.On the contrary, double non-taxation caused by deduction at source and non-inclusion at residence, the normal

implications of a hybrid instrument, should be tackled by all means even if eventually double taxation might occur. The attempt to deal with an inconsistent situation through lack of consistency in the conceptual approach can result in adverse consequences. As already described the use of hybrid financial instruments in most cases shall not constitute an abusive practice. The fact that the paying company is established in a low tax jurisdiction cannot be opposed as long as it is not a purely artificial arrangement. And as long as it reflects a real economic activity. This is based on numerous examples from the jurisprudence of the ECJ. The case law states that any advantage derived from the low level of taxation at source cannot be given as a justification by the residence state in providing a less favourable treatment. The same is valid for any other existing advantage that has been granted and to which the other state attaches less beneficial tax treatment. In order to prevent this type of tax arbitrage and because of the fact that ECJ is unwilling to apply a teleological interpretation to limit the scope of the PSD (political subdivision) it has been acknowledged that a specific rule has to be incorporated into the text of the directive. The introduction of a single new rule, which can effectively tackle the use of hybrids and that can encompass all the specificities of those financial products, within the current legal framework of the directive, will most probably produce counter effects that will be not less unwanted. Under these circumstances, the potential inefficiencies

caused by the use of hybrid financial instruments have been addressed by the European Commission as an area that calls for immediate action.

The Commission issued an Action plan in order to improve the fight against tax fraud and tax evasion. Recognizing the weaknesses of the current regime, the various loopholes created and the numerous possibilities for tax planning. As previously stated, the only feasible way to deal with hybrid mismatches under the PSD is through a legislative amendment. The objective of this action is to ensure that the application of the directive does not inadvertently prevent effective action against double non-taxation in the area of hybrid loan structures. In order to prevent the double non-taxation resulting from deduction and non-inclusion schemes using hybrid instruments treated differently in the countries involved there are two generally accepted approaches: to condition the deductibility of interest payments to foreign entities on taxation in the home country and condition exemption of dividends from foreign entities on non-deductibility in the host country. The Commission decided to choose the second option- according to the proposed Article⁴ 4(1)(a), a tax exemption shall only be provided ‘to the extent

⁴Whereas the earliest conventions in general were applicable to “citizens” of the Contracting States, more recent conventions usually apply to “residents” of one or both of the Contracting States irrespective of nationality. It has been deemed preferable for practical reasons to provide that the Convention is to apply to persons who are residents of one or both of the Contracting States. The term “resident” is defined in Article 4. Reproduced in Volume II of the full-length version of the OECD Model Tax Convention at page R(15)-1.

that such profits are not deductible by the subsidiary of the parent company', if deductible

then the state of the receiving company shall tax the portion of the profit distribution payments which is deductible in the Member State of the paying subsidiary. The proposed amendment raises some doubts as to its clarity and precision of the wording, the objective pursued and the international tax developments in the field of double non-taxation resulting from hybrid mismatches. It is unclear whether the proposal by limiting the obligation of the parent company under the new Article 4(1)(a) 'shall refrain to the extent' also prevents the latter from providing an exemption upon distribution of profits that have been deducted by the distributing company ('the benefits of the tax exemption should be denied to distribution of profits that are deductible).

Before start analyzing the hybrid loan it is important to have a clear point of view how the double taxation works out in order to understand the principles under this situation.

Double taxation treaties generally follow the OECD Model Convention. Other relevant models are the UN Model Convention, in the case of treaties with developing countries and the US Model Convention, in the case of treaties negotiated by the United States. The OECD Model Convention and the UN Model Convention are identical. They first provide for a definition of "resident of a Contracting State":

1) For the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

2.) Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:

a) he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (center of vital interests);

b) if the State in which he has his center of vital interests cannot be determined, or if he has not a permanent home available to him in either State, or shall be deemed to be a resident only of the State in which he has an habitual abode;

c) If he has a habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;

d) If he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3.) Where by reason of the provisions, a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.

The US Model Convention is similar to the OECD and UN Model Convention with respect to residency of individuals. However, if non-individuals are considered to be residents of two countries, the default result is that they shall be considered resident of none for the purposes of claiming the benefits of the tax treaty. The countries will engage in mutual agreement procedures to reach a decision. Therefore, domestic taxation will continue as normal until an agreement is reached.

After the explanation of the model adopted by each Member State we should understand the new concept of tax haven in terms of jurisdictions.

1.2 The concept of the hybrid loan in the international tax law and its criticism

Groups of companies (holding companies) are becoming increasingly common in a globalized economic reality. Holding companies are typically comprised of companies that are located in different countries; as a result, these subsidiary companies are subject to different tax regimes. This situation creates significant implications for the international tax policy planning of these holding firms. The effective management of a holding firm can produce tax benefits by establishing various forms of capital flows among the firm's holding entities, planning proper fiscal policy for the firm and implementing tax planning tools that are appropriate for the various tax regulations applicable to its subsidiaries. In contrast, if a holding company does not use tax planning tools, it may lose the possibility of obtaining tax benefits. It is important to remember that hybrid tools (broadly defined and including both hybrid instruments and entities) are among the available instruments for tax planning. The concept of hybrid instruments does not include any previously unknown financial instruments but rather incorporates widely known debt instruments, typically loans and bonds. The idea underlying a hybrid instrument is the exploitation of a duality in the tax classification of various regimes. In particular, these instruments are designed such that in one regime, they are treated as regular loans for which interest is an expense that is deductible from taxable income, whereas in another regime, based on local

internal tax law, these instruments are considered to be the capital contribution for a company, and the interest received from these instruments is treated by a lender (or a bondholder, in the case of bonds) as a dividend, which in certain countries is exempted from taxation or taxed more favourably than income from interest.

By definition, a hybrid entity is associated with an existing entity category, such as a partnership or company, that may also have dual characteristics for tax purposes in two different legislations. The essence of the hybrid entity is the duality of the income tax qualifications that the entity has received. For example, in one legislation, a business will be formally run and taxed as a separate legal entity, whereas under the internal tax law of another country, it will be fiscally recognized as a partnership for which income will pass through to individual partners for taxation purposes; thus, a tax levied in one jurisdiction may be proportionally applied towards the future tax liabilities of each partner in another jurisdiction. A classic example of a hybrid entity under Polish tax law is a limited liability company. In Poland, this type of firm is a legal entity which is subject to the Legal Persons Income Tax Act. By contrast, according to U.S. tax law, American taxpayers may opt to treat the income received by a limited liability company in which they hold shares as income or loss from a partnership. Thus, one entity, for tax purposes, can be treated differently in two different countries, providing additional opportunities for legal tax planning designed to minimize the overall tax burden on the taxpayer. To understand the essential aspects of hybrid

instrument functionality for holding firms, it is necessary to distinguish between the two forms of company financing, namely, debt and equity financing. The tax laws of most EU countries clearly distinguish between equity and debt funding methods. Debt financing consists of the use of foreign assets for an agreed-upon remuneration. When a company pays remuneration for the use of foreign assets (e.g., real estate owned by others or cash loans), it receives tax benefits applicable to its business. In fact, the vast majority of existing tax regulations assume that such remunerations directly affect the size of the paying firm's income tax base, and therefore, tax laws often specify that these payments are tax-deductible expenses. It is worth noting that tax laws also provide for restrictions on the recognition of interest expense as a tax-deductible expense. The main applicable principle for the majority of tax regimes is that the remuneration paid by a taxpaying company to its shareholders (dividends) does not result in a decrease in the size of the firm's income tax base. Income that is obtained by an entity as compensation for providing funds to another, either in the form of capital or using a debt instrument (or derivative), is taxed under the tax law of the country where the beneficiary of the interest or dividend income conducts its business. If a company is based in an European Union country, its income from dividends may be untaxed due to participatory exemptions from taxation. Participation exemptions are subject to domestic tax laws that implement UE Directive 90/435/WE. Most EU countries treat debt and equity differently for the purposes

of determining a withholding tax basis. Certain countries (e.the United Kingdom), in accordance with their internal law, do not provide for a withholding tax upon dividends paid to shareholders that are considered to be foreign residents for tax purposes, whereas withholding taxes are mandatory on all interest income. However, it is important to recall the fundamental principle that, when considering the payment of remuneration on debt financing (interest) and capital received (dividends), the recipients of these payments must consider the potential tax consequences of a withholding tax in the source state. The existing agreements addressing the avoidance of double taxation favour corporate tax minimization of these consequences. Moreover, companies that are based in the European Union are able to avoid or minimize their exposure to the withholding tax thanks to national regulations that implemented community law (EU Directive 90/435/WE⁵for dividends and EU Directive 2003/49/EC for interest and royalties). Alternatively, agreements between the countries where the company paying interest or dividends and the entity receiving those payments are located can allow for the avoidance of double taxation by either excluding certain firms from withholding taxation or providing for the implementation of a preferential withholding tax rate for firms that satisfy the conditions of these agreements. In

⁵Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (the council of the European communities)

conclusion, financing via debt or equity instruments is associated with the analysis of the following specific taxation aspects:

- tax obligations related to the payment of the withholding tax when a company remunerates a financing source for providing funding;

- tax consequences for the entity paying this remuneration to compensate its funding sources;

- tax consequences for the recipient of the remuneration payment in question. Given the above analysis of aspects of taxation, it is noteworthy that from the viewpoint of the entity which has paid the remuneration for its financing, the optimal solution would involve the use of a debt instrument that creates the possibility of tax base reduction (because interest is classified as a tax-deductible expense). By contrast, from the viewpoint of the entity which receives the remuneration, the most attractive tax treatment would be achieved through capital financing instruments, as the dividends received from these instruments would be subject to participation exemptions. It is obvious that the best solution would be to use an instrument that would both permit the entity making remuneration payments to deduct these payments for tax purposes and avoid creating taxable income for the recipient of these payments. A hybrid instrument is a tool that can produce these desired tax effects. A hybrid instrument is distinguished by the presence of features that either produce contradictory tax classifications or prevent the application of any tax classification at all. For company financing purposes, the

use of a hybrid instrument with characteristics that do not clearly indicate whether it is a debt or capital instrument may lead to scenarios in which one country considers the instrument in question to be a debt, whereas another nation treats the same financing method as a capital instrument. In this type of situation, for companies operating in the EU, the payment of remuneration from the issue of hybrid instruments can become a tax-deductible interest expense, whereas remuneration received from the same instrument may be treated as dividends received from capital funding, which are subject to the participation exemption for the beneficiary of the dividend in question. Moreover, when an additional consequence of using a particular hybrid financing instrument is that it produces no withholding tax, the instrument in question can be employed to optimize the tax burden of the companies that belong to one capital group (holding). Thus, the following main tax benefits result from the application of an appropriate hybrid instrument:

- 1) the recipient of remuneration from the hybrid financing instrument in question is exempt from dividend taxation if that recipient is located in the same European Union country as the entity that pays the remuneration;
- 2) the entity that pays this remuneration may be able to treat that payment as a tax-deductible expense if that entity is located in a different country of the European Union from the recipient;

3) hybrid instrument remuneration paid to a beneficiary is not subject to a withholding tax.

The following characteristic features of certain financing tools allow these tools to be treated as debt instruments:

- the funds must be repaid within the agreed period; the amount of remuneration for the use of the provided funds is strictly defined;
- an inability to control the firm that obtains the funds from the instrument (the capital beneficiary);
- a legal claim for repayment of the provided funds.

The following characteristic features of certain financing tools allow these tools to be treated as capital instruments:

- the provided funds must be repaid as a part of the basic capital reduction or liquidation of the capital beneficiary;
- the return on provided funds is dependent upon the financial results of the capital beneficiary;
- the entities providing funds have the ability to control the recipient company (the capital beneficiary); the inability of entities providing funds to strictly enforce the return of the provided capital (if considering repayment priority, these entities have inferior status relative to creditors of the capital beneficiary).

Both hybrid instruments and hybrid entities may be aspects of the hybrid structures companies use to meet their financing needs. By definition, a hybrid

entity is one that is considered to be a tax resident by the applicable tax legislation of one country, whereas another country considers the entity in question to be transparent from a tax perspective, not subject to tax liability in that country. Thus, a hybrid entity may be described as creating a classification discrepancy between two countries regarding their recognition of this hybrid entity as a taxable business. This discrepancy is directly related to the specific legal form of a hybrid entity, which, in certain countries, allows the entity to bypass legal recognition as a transaction entity from the tax perspective. There may also be cases in which a hybrid entity creates a different classification conflict because one country treats the entity as a company, whereas another country regards the same entity as an establishment of a foreign company. This situation is caused by the fact that countries recognizing the entity as a tax resident do not account for the jurisdiction in which the entity in question was established. There are many examples of the functioning of both hybrid instruments and hybrid entities. A typical example of a hybrid instrument is a loan granted for a period of 80 years that allows capital providers to participate in the capital beneficiary's profits. This tool has characteristics of typical debt instruments because it must be returned within strictly specified time restrictions. This tool can also demonstrate features of capital instruments, such as remuneration that is dependent on the financial results of the capital beneficiary and the inferiority of capital providers relative to other creditors of the capital beneficiary. This example of a hybrid instrument

belongs to a category known as perpetual loans. Perpetual loans consist of loans that either lack a definite maturity date or specify that maturity will not occur for a prolonged time (typically longer than 50 years). An important observation is that perpetual loans are regarded as capital in certain countries (for example, the Netherlands and Luxembourg), whereas in other countries, these instruments are treated as loans (for example, the United Kingdom, France, Spain, Portugal and Italy). A hybrid instrument with diverse and opposing features may be used for structuring transactions that are optimal from a tax perspective. For the purpose of taxation optimization, other hybrid instruments are also used, loans converted into capital, preferential shares and loans that explicitly account for profit shares. These hybrid instruments are all characterized by traits of both equity and debt. In addition to hybrid instruments, hybrid entities can be used in the creation of a firm's taxation policy as well. These hybrid tools allow the companies included in the parent firm's holdings to achieve optimal transaction structures from a tax perspective. Each hybrid entity in either the European Union or the U.S. is characterized by being subject to tax in the country where it was established while remaining transparent for tax purposes in other countries. From a state point of view, the risks associated with the use of these kind of international tax arbitrage transactions is the fact that a taxpayer attempts to benefit from the different treatment of the instrument in two or more jurisdiction. The hybrids make sense only in a cross-border situation and none of the jurisdictions involved can blame

the other for the loss of tax revenue as a result of their application. Achievement of free capital flows inside the EU is long-run goal and is one of the most important conditions for existence of a single EU market. Harmonization of taxation inside the EU is very important for free capital flows and could also be treated as very important condition for single market development. The basic logic and taxation mechanisms involved in PSD were presented above and include elimination of double taxation, removal of withholding tax and participation exemption for EU cross-border groups. On the other hand, within the period of a few years after adaptation PSD was highly criticized because of negative side effects. There are still big differences in taxation inside EU countries and competition for capital inflows between EU member states is existing. In general these differences were in line with PSD, otherwise will be resulted in development of legal case on EU level for particular country, but these existing differences are material enough to create some distortions for single market. One of the main negative side effects of PSD is considered to be development of artificial holding structures where country resident for parent company is based not on business logic but on some taxation benefits existing between countries inside EU. Regardless of recognition of IAS/IFRS on EU level, such situation creates potential niche for different recognition of hybrid instruments, which represent traditionally one of the most complicated areas of accounting. Simple application of a classic fraud triangle to hybrid instruments, indicated that as always there was constant pressure for

minimization of taxes in cross-border groups even inside the EU, there were opportunities because of a well developed taxation system on one side and the taxation and accounting differences between member states on the other side and rationalization because the most such schemes were almost legal. Following a previous approximately two year discussion two amendments to PSD were done in the year 2014 (Council of the European Union, 2014A, 2014B). Member states will have until 31 December 2015 to transpose the new amendments of the PSD by introducing an anti-abuse rule and the amendments to tackle hybrid loan mismatches into national law. General principle, which is applied in the amended PSD (Council of the European Union, 2014A), is described as follows: “refrain from taxing such profits to the extent that such profits are not deductible by the subsidiary. This principle is shortly presented, but its implementation will be quite complicated as it will be necessary to change national tax systems and in some cases even accounting standards.

As far as the Article 4 is concerned, it is important to understand how the parts benefit from this financial hybrid tool.

The main source of difficulties is the fact that some countries treat partnerships as taxable units (sometimes even as companies) whereas other countries adopt what may be referred to as the fiscally transparent approach, under which the partnership is ignored for tax purposes and the individual partners are taxed on their respective share of the partnership’s income.

A first difficulty is the extent to which a partnership is entitled as such to the benefits of the provisions of the exemption. Under Article 1, only persons who are residents of the Contracting States are entitled to the benefits of the tax exemption entered into by these States. While paragraph on Article 3 explains why a partnership constitutes a person, a partnership does not necessarily qualify as a resident of a Contracting State under Article 4⁶.

Where a partnership is treated as a company or taxed in the same way, it is a resident of the Contracting State that taxes the partnership on the grounds mentioned in paragraph 1 of Article 4 and, therefore, it is entitled to the benefits of the Convention.

Where, however, a partnership is treated as fiscally transparent in a State, the partnership is not “liable to tax” in that State within the meaning of paragraph 1 of Article 4, and so cannot be a resident thereof for purposes of the Convention. In such a case, the application of the Convention to the partnership as such would be refused, unless a special rule covering partnerships were provided for in the Convention. Where the application of the Convention is so refused, the partners should be entitled, with respect to their share of the income of the partnership, to

⁶Reproduced in Volume II of the full-length version of the OECD Model Tax Convention at page R(15)-1. The *OECD Model Tax Convention*, a model for countries concluding bilateral tax conventions, plays a crucial role in removing tax related barriers to cross border trade and investment. It is the basis for negotiation and application of bilateral tax treaties between countries, designed to assist business while helping to prevent tax evasion and avoidance. The OECD Model also provides a means for settling on a uniform basis the most common problems that arise in the field of international double taxation.

the benefits provided by the Conventions entered into by the States of which they are residents to the extent that the partnership's income is allocated to them for the purposes of taxation in their State of residence.

The concept of "resident of a Contracting State" has various functions and is of importance in three cases:

- a) in determining a convention's personal scope of application;
- b) in solving cases where double taxation arises in consequence of double residence;
- c) in solving cases where double taxation arises as a consequence of taxation in the State of residence and in the State of source or situs.

The Article is intended to define the meaning of the term "resident of a Contracting State" and to solve cases of double residence. To clarify the scope of the Article some general comments are made below referring to the two typical cases of conflict, between two residences and between residence and source or situs. In both cases the conflict arises because, under their domestic laws, one or both Contracting States claim that the person concerned is resident in their territory. Generally the domestic laws of the various states impose a comprehensive liability to tax "full tax liability" based on the taxpayers' personal attachment to the State concerned (the "State of residence"). This liability to tax is not imposed only on persons who are "domiciled" in a State in the sense in which "domicile" is usually taken in the legislations (private law). The cases of full

liability to tax are extended to comprise also, for instance, persons who stay continually, or maybe only for a certain period, in the territory of the State.

The Paragraph 1 of this article provides a definition of the expression “resident of a Contracting State” for the purposes of the Convention. The definition refers to the concept of residence adopted in the domestic laws. As criteria for the taxation as a resident the definition mentions: domicile, residence, place of management or any other criteria of a similar nature. As far as individuals are concerned, the definition aims at covering the various forms of personal attachment to a State which, in the domestic taxation laws, form the basis of a comprehensive taxation (full liability to tax). It also covers cases where a person is deemed, according to the taxation laws of a State, to be a resident of that State and on account thereof is fully liable to tax therein (e.g. diplomats or other persons in government service).

In accordance with the provisions of the second sentence of paragraph 1, however, a person is not to be considered a “resident of a Contracting State” in the sense of the Convention if, although not domiciled in that State, he is considered to be a resident according to the domestic laws but is subject only to a taxation limited to the income from sources in that State or to capital situated in that State. That situation exists in some States in relation to individuals, e.g. in the case of foreign diplomatic and consular staff serving in their territory.

According to its wording and spirit the second sentence also excludes from the definition of a resident of a Contracting State foreign held companies exempted

from tax on their foreign income by privileges tailored to attract conduit companies. It also excludes companies and other persons who are not subject to comprehensive liability to tax in a Contracting State because these persons, whilst being residents of that State under that State's tax law, are considered to be residents of another State pursuant to a treaty between these two States. The exclusion of certain companies or other persons from the definition would not of course prevent Contracting States from exchanging information about their activities. Indeed States may feel it appropriate to develop spontaneous exchanges of information about persons who seek to obtain unintended treaty benefits.

The application of the second sentence, however, has inherent difficulties and limitations. It has to be interpreted in the light of its object and purpose, which is to exclude persons who are not subjected to comprehensive taxation (full liability to tax) in a State, because it might otherwise exclude from the scope of the Convention all residents of countries adopting a territorial principle in their taxation, a result which is clearly not intended.

It has been the general understanding of most member countries that the government of each State, as well as any political subdivision or local authority thereof, is a resident of that State for purposes of the Convention. Before 1995, the Model did not explicitly state this; in 1995, Article 4 was amended to conform the text of the Model to this understanding.

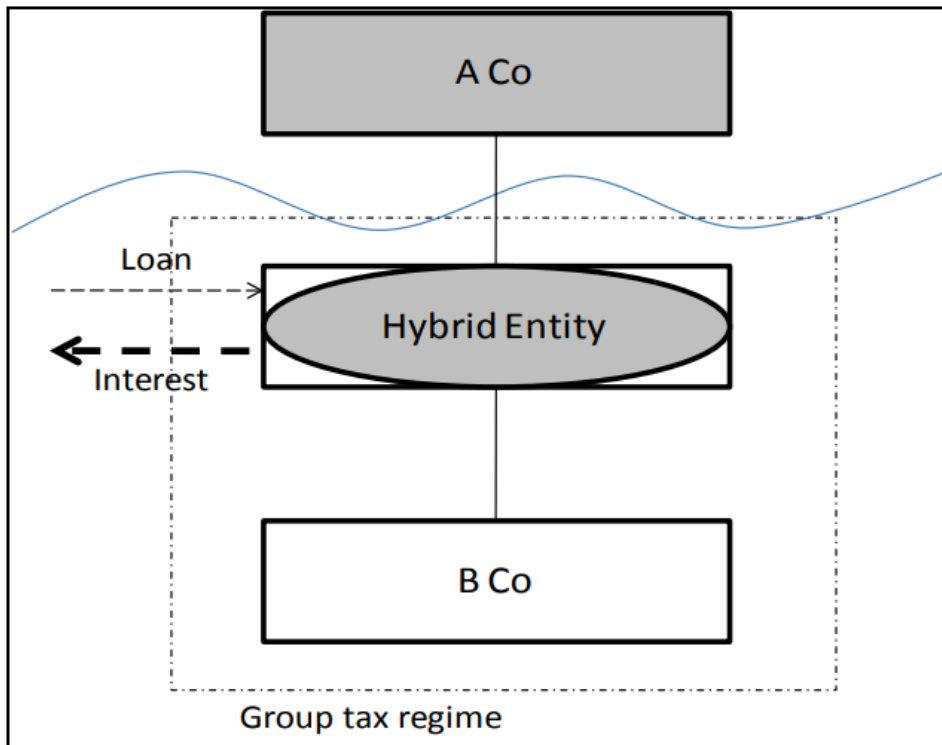
This raises the issue of the application of paragraph 1 to sovereign wealth funds, which are special purpose investment funds or arrangements created by a State or a political subdivision for macroeconomic purposes. These funds hold, manage or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets. They are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatisations, fiscal surpluses or receipts resulting from commodity exports. Whether a sovereign wealth fund qualifies as a “resident of a Contracting State” depends on the facts and circumstances of each case. For example, when a sovereign wealth fund is an integral part of the State, it will likely fall within the scope of the expression “the State and any political subdivision or local authority thereof” in Article 4. States may want to address the issue in the course of bilateral negotiations, particularly in relation to whether a sovereign wealth fund qualifies as a “person” and is “liable to tax” for purposes of the relevant tax treaty. So this article refers to persons who are “liable to tax” in a Contracting State under its laws by reason of various criteria. In many States, a person is considered liable to comprehensive taxation even if the Contracting State does not in fact impose tax. For example, pension funds, charities and other organizations may be exempted from tax, but they are exempt only if they meet all of the requirements for exemption specified in the tax laws. They are, thus,

subject to the tax laws of a Contracting State. Furthermore, if they do not meet the standards specified, they are also required to pay tax.

In some States, however, these entities are not considered liable to tax if they are exempt from tax under domestic tax laws. These States may not regard such entities as residents for purposes of a convention unless these entities are expressly covered by the convention. Contracting States taking this view are free to address the issue in their bilateral negotiations.

Where a State disregards a partnership for tax purposes (as it will be seen in Walmart's case) and treats it as fiscally transparent, taxing the partners on their share of the partnership income, the partnership itself is not liable to tax and may not, therefore, be considered to be a resident of that State. In such a case, since the income of the partnership "flows through" to the partners under the domestic law of that State, the partners are the persons who are liable to tax on that income and are thus the appropriate persons to claim the benefits of the conventions concluded by the States of which they are residents. This latter result will be achieved even if, under the domestic law of the State of source, the income is attributed to a partnership which is treated as a separate taxable entity. For States which could not agree with this interpretation of the Article, it would be possible to provide for this result in a special provision which would avoid the resulting potential double taxation where the income of the partnership is differently allocated by the two States.

Figure 1. “Double deduction” with hybrid entity



In a typical case a parent company in country A (“A Co”) indirectly holds an operating company in country B (“B Co”). Inserted between A Co and B Co is an entity (“Hybrid Entity”) that is treated as transparent or disregarded for country A tax purposes and as non-transparent for country B tax purposes. A Co holds all or almost all equity interest in Hybrid Entity which in turn holds all or almost all equity interests in B Co. Hybrid Entity borrows from a third party and uses the loan amount to inject it as equity into B Co (or to buy the shares in B Co from either another company of the same group or from an unrelated third party).

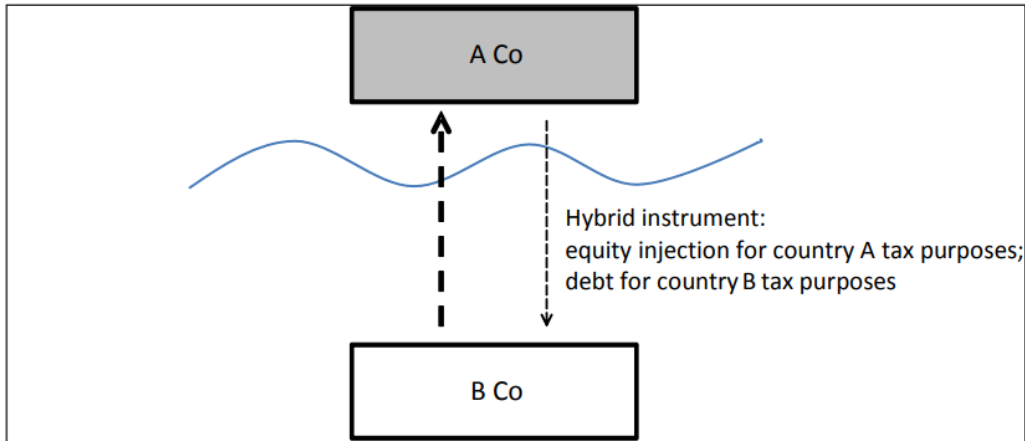
Hybrid entity pays interest on the loan. Apart from the interest, hybrid entity does not claim any other significant deductions and does not have any significant income.

For country B tax purposes, hybrid entity is subject to corporate income tax. Its interest expenses can be used to offset other country B group companies' income under the country B group relief regime. In contrast, country A treats hybrid entity as transparent or disregarded, with the consequence that its interest expenses are allocated to A Co, where they can be deducted and offset unrelated income.

The effect of the scheme is thus two deductions for the same contractual obligation in two different countries. Similar effects can also be achieved through different schemes, for instance through the use of a dual resident company instead of a hybrid entity where such a dual resident company has a loss and it can benefit from group relief and tax consolidation systems in both countries.

A company resident in country B ("B Co") is funded by a company resident in country A ("A Co") with an instrument that qualifies as equity in country A but as debt in country B. If current payments are made under the instrument, they are deductible interest expenses for B Co under country B tax law. The corresponding receipts are treated as exempt dividends for country A tax purposes.

Figure 2. "Deduction / no inclusion" with hybrid instrument



As a result, a net deduction arises in country B without a corresponding income inclusion in country A. Similar results can also be achieved through the use of hybrid entities (e.g. if an entity treated as non-transparent in the country in which it is organized makes a deductible payment to its shareholders, whose country of residence treats the foreign entity as transparent thus disregarding the payment for tax purposes) and of hybrid transfers (e.g. if two companies enter into a sale and repurchase agreement over the shares of a special purpose vehicle (SPV) and one country treats the transaction as a sale and repurchase of the SPV shares while the other country treats the transaction as a loan secured through the SPV shares).

As seen in the previous picture, hybrid mismatch arrangements may be used to exploit differences in countries' tax rules and achieve results such as the multiple deduction of the same expense in different countries, the deduction of a payment in the country of the payer without a corresponding inclusion in the country of the

payee and multiple tax credits for a single amount of foreign tax paid. Hybrid mismatch arrangements therefore raise a number of tax policy issues, affecting for example tax revenue, competition, economic efficiency, transparency and fairness.

Tax revenue: international hybrid mismatch arrangements typically lead to a reduction of the overall tax paid by all parties involved as a whole. Although it is often difficult to determine which of the countries involved has lost tax revenue, it is clear that collectively the countries concerned lose tax revenue. Further, the taxpayer will incur certain costs for devising and implementing these arrangements, such as costs for advice or for the formation of special purpose entities, which will generally be deductible in one of the countries involved and further reduce tax revenue.

Some businesses, such as those which operate cross-border and have access to sophisticated tax expertise, may profit from hybrid mismatch opportunities and have unintended competitive advantages compared with other businesses, such as small and medium-sized enterprises, that cannot or cannot easily use mismatch opportunities.

Economic efficiency: where a hybrid mismatch is available, a real cross-border investment will often be more attractive than an equivalent domestic investment in the investor's country, as well as more attractive than a competing local investor's investment in the target country (thus affecting Capital Import

Neutrality). In addition, hybrid mismatch arrangements may potentially contribute to financial instability through increases in leverage from tax-favoured borrowing, through increases in risktaking (as investments which are uneconomic before tax become marginally viable after tax) and through a relative lack of transparency caused by the adoption of tax-driven structures.

Transparency: it means that the public will be generally unaware that the effective tax regime is quite different for those taxpayers that can profit from mismatch opportunities. Even when the public may note a low effective tax rate, they may not fully understand the underlying reasons for that.

Fairness: it relates to the fact that mismatch opportunities are more readily available for taxpayers with income from capital, rather than labour. The ability of a select group of taxpayers to reduce their taxes could be perceived as unfair, thus affecting public confidence in the fairness of the tax system. This is to some extent linked with the competitive advantages hybrid mismatch opportunities may give to some businesses but not to all, as discussed above.

One preliminary conclusion is that hybrid mismatch arrangements that apparently comply with the letter of the laws of two countries but that achieve nontaxation in both countries, which result may not be intended by either country, generate significant policy issues. The same concern that exists in relation to distortions caused by double taxation exists in relation to unintended double nontaxation.

1.3 The hybrid loan as an instrument of transfer price

Transfer price is the price at which divisions of a company transact with each other, such as the trade of supplies or labor between departments. Transfer prices are used when individual entities of a larger multi-entity firm are treated and measured as separately run entities. A transfer price can also be known as a transfer cost. This part of the chapter describes several transfer pricing methods that can be used to determine an arm's length price and it describes how to apply these methods in practice. Before analyzing the hybrid loan it should be explained its meaning as a transfer price and so its value as an intangible asset. In general, the OECD Transfer Pricing Guidelines are followed, with emphasis on practicality solutions when using and applying transfer pricing methods. In response to practical difficulties that may exist in applying the OECD Guidelines, for example when no access to databases with relevant information on comparables are readily available, some requirements for applying the arm's length standard are softened or more flexibly applied. In order to calculate or test the arm's length nature of prices or profits, use is made of transfer pricing methods or methodologies. Transfer pricing methods are ways of calculating the profit margin of transactions or an entire enterprise or of calculating a transfer price that qualifies as being at arm's length. The application of transfer pricing methods is required to assure that transactions between associated enterprises

conform to the arm's length standard. Furthermore, transfer pricing methods are not determinative in and of themselves. If an associated enterprise reports an arm's length amount of income, without the explicit use of one of the transfer pricing methods recognized in the OECD Transfer Pricing Guidelines, this does not mean that its pricing is automatically not at arm's length and there may be no reason to impose adjustments. Some methods are more appropriate and indicative to provide for an arm's length result for certain transactions than others. For example, a cost-based method is usually deemed more useful for determining an arm's length price for services and manufacturing, and a resale price-based method is usually deemed more useful for determining an arm's length price for distribution, or selling functions.

The starting point to select a method is the functional analysis which is necessary regardless of what transfer pricing method is selected. Each method may require a⁷ deeper analysis focusing on aspects in relation with the method. The functional analysis helps:

1. to identify and understand the intra-group transactions,
2. to have a basis for comparability

⁷ Currently, the international tax principles for attributing profits to a PE are provided in Article 7 of the OECD Model Tax Convention on Income and on Capital (OECD Model Tax Convention), which forms the basis of the extensive network of bilateral income tax treaties between OECD Member countries and between many OECD Member and non-member countries. These principles are also incorporated in the Model United Nations Double Taxation Convention between Developed and Developing Nations

3. to determine any necessary adjustments to the comparables,
4. to check the accuracy of the method selected and
5. over time, to consider adaptation of the policy if the functions, risks or assets have been modified.

The major components of a functional analysis are functions performed. It describes the activities performed such as design, purchasing, inbound logistics, manufacturing, R&D, assembling, inventory management, outbound logistics, marketing and sales activities, after-sale services, supporting activities, services, advertising, financing and management, etc. It must be specified which party performs each activity and in case both parties are involved in performing an activity it should provide for the relevant differences; for example both have inventories but Company A holds inventories for a period of up to 2 years whereas company B only holds inventories for a period of 1 month. The activities that add most value must be identified and be discussed more in detail.

The functional analysis should identify risk undertaken. Examples are: financial risk (currency, commodity, interest rate, funding risks etc...), credit and collection risk (trading credit risk, commercial credit risk), operational risk (systems failure risk, reliability of customers, inventory risk and carrying costs, R&D risk, environmental and other regulatory risks), market risk .A risk-bearing party should have a chance of higher earnings than a

non-risk bearing party, and will incur the expenses and perhaps related loss if and when risk materializes. The central issue in risk analysis from the standpoint of transfer pricing is to determine which party bears the risk. In general, the party who bears the risk is entitled to the rewards (i.e., profits or losses associated with the risks). Contractual terms determine the party that bears the particular risk if the terms are consistent with “economic substance.” In this case the economic substance refers to Wall mart international’ s holding which bears the financial capacity to bear the loss that is expected to occur in light of the assumption of the risk. If the market risks would have been beared from the tax haven Pinnacle the Walmart’ strategy to avoid taxes would not have been successful.

Moreover the functional analysis must identify and distinguish tangible assets and intangible assets. Tangible assets such as a property, plant and equipment have to be financed and capital assets would usually be expected to earn a long term rate commensurate with the business risk assumed. Some assets could be specific and must be identified and quantified whenever possible. Intangible assets are very important as sustainable competitive advantage is often achieved by the use of intangible assets. Some intangibles have legal protection (patents, trademarks, trade names) but others without legal protection may be equally important and valuable (know-how, trade secrets, corporate goodwill, exclusive import or export

rights, etc). A party that developed the intangibles should be able to obtain benefit from the intangibles either through a sale or licensing of the intangibles or through an increase in prices of products or services with imbedded intangibles. It is important to determine which party has developed the intangibles and in what capacity, which has the legal ownership and which receives the benefit of the intangibles. Today in a multinational group, operations tend to be more integrated and functions, risks and assets are often shared. In some cases one company may perform one function but the cost thereof is incurred paid by the other party to the transaction. The functional analysis includes reference to the industry specifics, the contractual terms of the transaction, the economics circumstances and the business strategies. The functional analysis helps to identify if the operations are complex justifying a higher level of profit or more limited and consequently generating a lower profit. Once the functional analysis is performed and the functionality of the entity as regards the transactions subject to review (or the entity as a whole) has been completed, it can be determined what transfer pricing method is most suitable to determine the arm's length price for the transactions under the review (or the operating margin for the entity under review). For all transfer pricing methods access to information on comparables is necessary and it may be that due to difficulty in getting access to reliable data on comparables, in certain instances, other methods may need to be resorted to than those that would

seem initially preferred and most reliable. Without any preference, solutions may include the following:

1. Search for comparables in other geographical regions that share certain key similarities with the country in which a company conducts its business (e.g., depending on the industry, for manufacturers established in, for example, Africa, a search for comparables could be carried out in Asia or Eastern- Europe).
2. Use of industry analysis (publicly-available or internally conducted by the company) to identify profit levels that can reasonably be expected for various routine functions (e.g., production, services, distribution, etc.).
3. Undertake an analysis that demonstrates the general applicability of a company's transfer pricing policy given the specific economic environment in which the company conducts its business.

When applying the CUP method, an uncontrolled transaction is considered comparable to a controlled transaction if:

- There are no differences in the transactions being compared that materially affect the price.
- Reasonable adjustments can be performed to account for product and other differences that are material.

The so-called traditional transaction methods (Comparable Uncontrolled Price, Cost Plus and Resale Price Method) are preferred in certain countries, although no hierarchy of methods is being advocated in the Transfer Pricing Manual, other than applying a method that reliably calculates or tests the company's transfer pricing and application of the arm's length standard. Considering the difficulty and cost of getting access to reliable data, taxpayers may want to make use of industry margins when applying the chosen and appropriate transfer pricing method. However, the use of industry margins may raise the risk that not only unrelated but also related party transactions are included in the comparability analysis. Therefore, it is preferred that when using industry margins, the majority of participants in the industry do not have significant related party dealings and that the industries can be considered comparable. The Comparable Uncontrolled Price ("CUP") method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. It should be observed that the CUP method is also used in practice with respect to royalties. The CUP method applies to controlled transactions of property and services. CUPs may be found as internal transactions or as external transactions. The application of the CUP method based on internal comparable involves a detailed transactional comparison, whereby the controlled and uncontrolled transactions are compared based on the five comparability factors mentioned in

chapter. The details of these factors are necessary to perform such a comparison. Usually all of such details are not available when other methods (Cost Plus, Resale Price Method etc.) are being applied. The latter are usually applied using a benchmarking analysis (a search for comparable companies in publicly available databases). A price may be materially influenced by differences between the goods transferred in the controlled and uncontrolled transactions, although the functions performed and risks assumed (e.g. marketing and selling function) are similar so as to result in similar profit margins. The CUP method is appropriate especially in cases where an independent enterprise sells products similar to those sold in the controlled transaction. Although product comparability is important in applying the CUP method, the other comparability factors should not be disregarded. Contractual terms and economic conditions are also important comparability factors .

The strengths of the CUP method include:

- it is not a one-sided analysis as the price is arrived at between two parties to the transaction;
- avoiding the issue of which of the related parties involved in the controlled transaction should be the tested party for transfer pricing purposes. This issue arises if the other two traditional transaction methods are applied. These

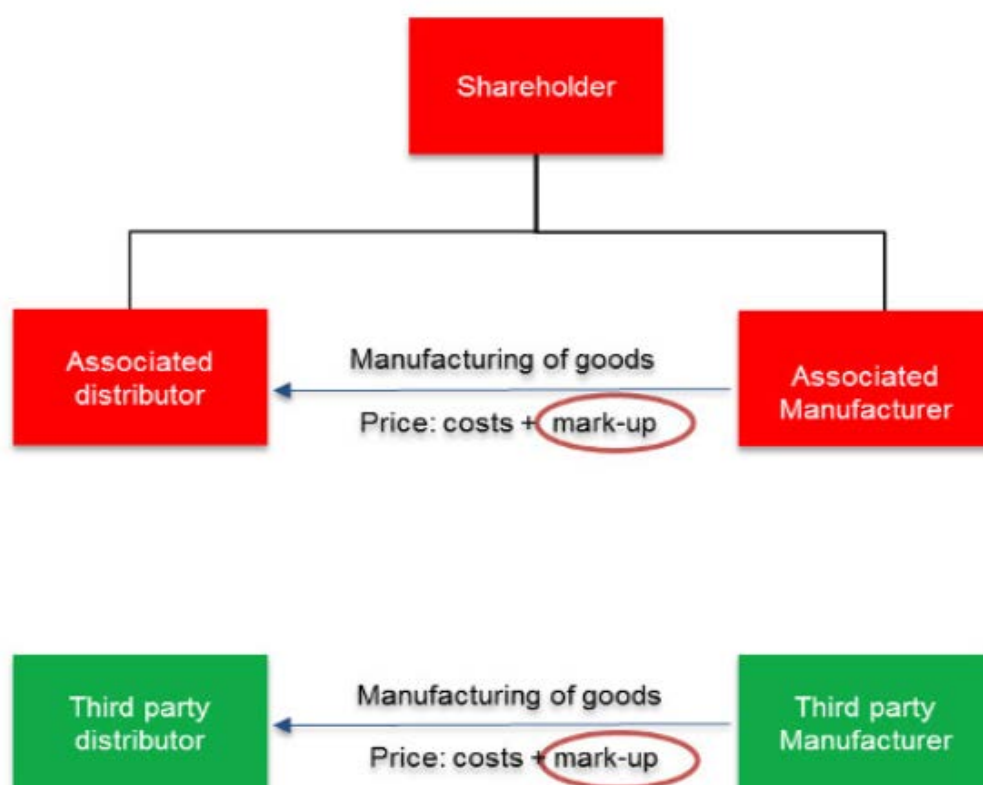
methods determine a transfer price based on the perspective of the tested party in the analysis.

The weaknesses of the CUP method include:

- it will very often be hard to find closely comparable uncontrolled transactions as a strict comparability standard is required particularly with respect to product comparability; and internal comparables frequently don't exist and external comparables are difficult to find in practice.
- The resale price method is one of the traditional transaction methods that can be used to apply the arm's length principle. The resale price method focuses on the related sales company which performs marketing and selling functions as the tested party in the transfer pricing analysis.

The Cost Plus Method compares gross profits to the cost of sales. The first step is to determine the costs incurred by the supplier in a controlled transaction for products transferred to an associated purchaser. Secondly, an appropriate mark-up has to be added to this cost, to make an appropriate profit in light of the functions performed. After adding this (market-based) mark-up to these costs, a price can be considered at arm's length. The application of the Cost Plus Method requires the

identification of a mark-up on costs applied for comparable transactions between independent enterprises. An arm's length mark-up can be determined based on the mark-up applied on comparable transactions among independent enterprises.



The cost plus method is used to analyse transfer pricing issues involving tangible property or services both under the OECD Transfer Pricing Guidelines and the US transfer pricing regulations. It is most useful where it is applied to manufacturing or assembling activities and relatively simple service providers. It focuses on the related party manufacturer or service as tested party in the

transfer pricing analysis. The method evaluates the arm's length nature of an intercompany charge by reference to the gross profit markup on costs incurred by suppliers of property (or services) for tangible property transferred (or services provided). It compares the gross profit markup earned by the tested party for manufacturing the product or for providing the service to the gross profit markups earned by comparable companies. Under the cost plus method, an arm's length price equals the controlled party's cost of producing the tangible property plus an appropriate gross profit markup, defined as the ratio of gross profit to cost of goods.

The arm's length (range of) gross profit markups can be established by the following two ways: transactional comparison: the gross profit markup earned by the related party manufacturer when selling goods to an independent enterprise in a comparable uncontrolled transaction, which previously has been rejected as an internal comparable; and functional comparison: the gross profit markups earned by independent companies performing functions and incurring risks comparable to the functions performed and risks incurred by the related party manufacturer.

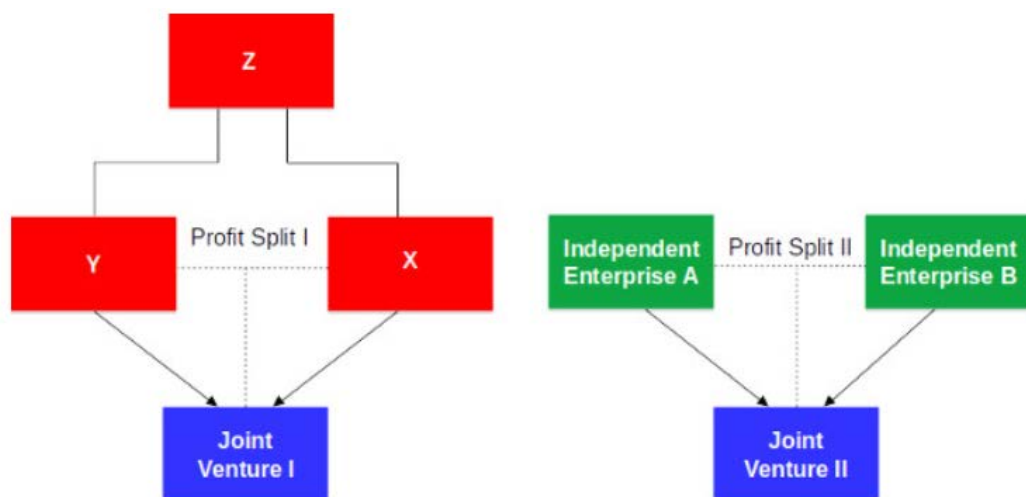
Functional comparison involves a search for comparable manufacturing companies. In practice, the comparability standard of transactional comparison

will be much higher than that of functional comparison. A taxpayer should select the most appropriate method. In general, the traditional transaction methods is preferred over the transactional profit methods and the CUP method over any other method.

Associated enterprises sometimes engage in transactions that are very interrelated. Therefore, they cannot be examined on a separate basis. For these types of transactions, associated enterprises normally agree to split the profits.

The Profit Split Method examines the terms and conditions of these types of controlled transactions by determining the division of profits that independent enterprises would have realized from engaging in those transactions.

An example of this method is shown in this image:

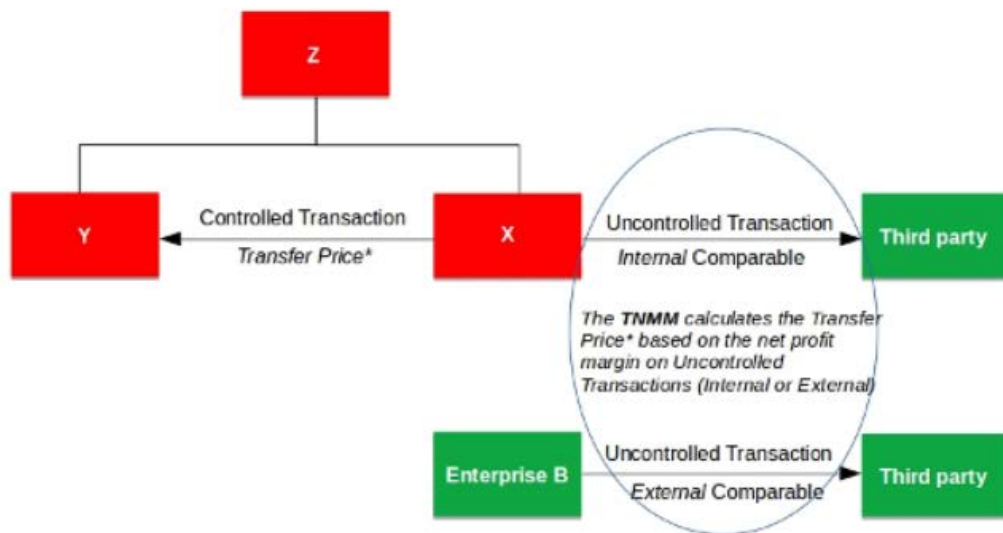


In the above example, we see two comparable joint ventures. Joint Venture I is owned by associated enterprises Y and X. Opposite to that, Joint Venture II is owned by independent enterprises A and B.

Let's say that we need to determine the transfer prices to be charged for the transactions related to Joint Venture I. For that, we can compare the terms and conditions of the controlled transactions by determining the division of profits of comparable uncontrolled transactions. In this example, this means that we can compare Profit Split I with Profit Split II. With the Transactional Net Margin Method (TNMM), you need to determine the net profit of a controlled transaction of an associated enterprise (tested party). This net profit is then compared to the net profit realized by comparable uncontrolled transactions of independent enterprises. As opposed to other transfer pricing methods, the TNMM requires transactions to be "broadly similar" to qualify as comparable. "Broadly similar" in this context means that the compared transactions don't have to be exactly like the controlled transaction. This increases the amount of situations where the TNMM can be used.

A comparable uncontrolled transaction can be between an associated enterprise and an independent enterprise (internal comparable) and between two independent enterprises (external comparables).

Let's see how this looks in this example:



In practice, the TNMM is the most used of all five transfer pricing methods, followed by the CUP method and Profit Split method. Cost Plus Method and Resale Margin Method are barely used.

2. WALMART' S CASE AND ITS STRATEGY TO AVOID DOUBLE TAXATION

2.1 Creation of subsidiaries in Luxembourg as a result of intra-group operation

First of all, to analyze the Walmart' s tax residence case we started by asking crucial questions that will lead us step by step to understand the strategy of tax heavens which are accomplished by a new financial technique that it is a typical instrument in the strategy of transfer pricing in order to maximize profits and minimize taxes. After explaining this two decisions we will point out why we are in a mixed strategy and the way how this complex company will be identified by Us Securities. In February 2008 the Organization for Economic Cooperation and Development (OECD) identified three key factors in considering whether a jurisdiction is a tax haven:

- No or only nominal taxes – Tax havens impose no or only nominal taxes (generally or in special circumstances) and offer themselves, or are perceived to offer themselves, as a place to be used by non-residents to escape high taxes in their country of residence.
- Protection of personal financial information – Tax havens typically have laws or administrative practices under which businesses and individuals can benefit from strict rules and other protections against scrutiny by foreign tax

authorities. This prevents the transmittance of information about taxpayers who are benefiting from the low tax jurisdiction.

- Lack of transparency ;a lack of transparency in the operation of the legislative, legal or administrative provisions is another factor used to identify tax havens. The OECD is concerned that laws should be applied openly and consistently, and that information needed by foreign tax authorities to determine a taxpayer's situation is available. Lack of transparency in one country can make it difficult, if not impossible, for other tax authorities to apply their laws effectively. 'Secret rulings', negotiated tax rates, or other practices that fail to apply the law openly and consistently are examples of a lack of transparency. Limited regulatory supervision or a government's lack of legal access to financial records are contributing factors.

However, the OECD found that its definition caught certain aspects of its members' tax systems (some countries have low or zero taxes and ring fencing or certain favored groups). Its later work has focused on the single aspect of information exchange. This is generally thought to be an inadequate definition of a tax haven, but is politically expedient, because it includes the small tax havens (with little power in the international political arena) but exempts the powerful countries with tax haven aspects such as the US and UK.

In deciding whether or not a jurisdiction is a tax haven, the first factor to look at is whether there are no or nominal taxes. If this is the case, the other two

factors whether or not there is an exchange of information and transparency must be analyzed. Having no or nominal taxes is not sufficient, by itself, to characterize a jurisdiction as a tax haven. The OECD recognizes that every jurisdiction has a right to determine whether to impose direct taxes and, if so, to determine the appropriate tax rate.

The central importance of tax havens to Walmart's International division is explained by the fact that the company has transferred ownership of most of its foreign operating companies to subsidiaries in tax havens. So the main two reasons to adopt this strategy are those of enlarging their international division which accounts for about one-third of the company's annual profits and to maximize profits by expanding the use of tax-haven subsidiaries that facilitates tax avoidance. Here the idea seems to be more a decision for economical purposes than a tax residence scope.

Walmart uses its subsidiaries in tax havens to pursue well-known international tax avoidance strategies that rely on hybrid financial instruments and complex inter-company debt arrangements to avoid taxes overseas.

- Walmart generates about \$1.5 billion worth of tax deductions in Luxembourg each year by using the technique of hybrid loan that makes this income disappear for tax purposes in both Luxembourg and the United States. The Wal-Mart Stores Inc. is registered in Delaware

(USA) where it has its legal seat. Whereas the place of effective management (“POEM”) is in Arkansas where the multinational has its headquarter and where the main decisions on the management of the company are taken. Regarding the first factor about the artificiality of the establishment (Art.13) was clearly identified as a transparent component.

- The subjective test that examines the lack of genuine business purpose was overpassed by using one of the instruments which allows companies to take full advantage of the taxation benefits available in Luxembourg, the Convertible Preference Equity Certificate.
- CPECs are often used in structuring transactions for internationally-based investors, as they are often treated as debt for Luxembourg tax purposes, hence the interest (yield) paid to holders of CPECs would not be subject to withholding tax in Luxembourg.

The terms of transaction are at arm’s length (Art.9) thanks to the key consideration with a thorough identification of the commercial and financial relations entered into by the associated enterprises and the economically relevant characteristics attached to those relations were identified.

2.2 The effective transaction made by the holding and its branch

On November 24, 2011, Walmart transferred ownership of Azure Holdings Sarl (Azure), a newly established Luxembourg subsidiary with \$45.2 billion in assets, to WMT Pinnacle Holdings Sarl (Pinnacle), a company that Walmart had formed in Luxembourg a few months earlier. Through its ownership of Azure Holdings, Pinnacle became the indirect parent of 20 limited partnerships and limited liability companies registered in Canada, Luxembourg, Switzerland, and the United States.

The assets under Pinnacle's ownership include a number of foreign operating companies that generate profits for Walmart. Having placed these operating companies and other undisclosed assets under Pinnacle's ownership, Walmart set out to minimize the taxes that Pinnacle (and ultimately, Walmart) has to pay on the income they generate. To do this, Pinnacle issued \$41.5 billion in Convertible Preferred Equity Certificates (CPECs) to the U.S.-domiciled Walmart International Holdings, Inc. in 2011. This transaction effectively converted Walmart's transfer of \$45.2 billion worth of assets to Pinnacle into a hybrid loan. These are reserved agreements, signed by multinational companies through their consultants, with the Luxembourg authorities. They

set privileged checks, which have the effect of reducing or eliminating the weight of actions.

The mother-daughter⁸ directive is a European directive issued to avoid double taxation cases: a daughter company is exempt from taxes if the parent-company makes the payment and it is based in a different State. But in Luxembourg the tax rulings can produce the distortive effect of a double non-taxation. The both companies don't pay taxes in either of the two European states. In this way tax-free profits can be used by Luxembourg holding companies to finance subsidiaries or buy assets abroad. Two main ways are opened to them like shareholder capital or debt. Although it is believed that the capital is the most obvious way to support the financial needs of a company, the debt can be seen as a much more efficient mean since it has a different tax impact than the capital. The income from the capital is considered as a dividend while the one inherited from a loan is considered as interests. In Luxembourg, any dividends paid out by a daughter or received from a sister company resident in a double tax treaty contracted country that is above the threshold of a participation percentage of 10 % (or alternatively at a purchase price of 1,2 billion €) with a minimum period of 12 months is tax

⁸The "Directive on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States" was first adopted by the European Union on 23 July 1990 (90/435/EC) and was later amended on 22 December 2003 (2003/123/EC) and on 20 November 2006 (2006/98/EC).

exempted. Meanwhile a debt interest's charge based on a loan agreement is fully integrated in the P&L Luxembourgish companies and sees the interests fully deductible without withholding taxes. An investment will be qualified as a capital or a debt based on terms and conditions related to the time period limit, the yield. As a result, Wal-Mart International Holdings, Inc. does not have to pay any U.S. tax on the interest "accruing" to it in Luxembourg until it actually redeems the CPECs (by essentially selling the certificates back to Pinnacle). Luxembourg has become a major player in the European Private Equity market. One of the instruments which allows companies to take full advantage of the taxation benefits available in Luxembourg is the Convertible Preference Equity Certificate. Typical features of the CPEC include a 49-year term; a fixed annual interest rate computed based on the "arm's-length" principle, taking into consideration their conversion feature; convertibility into shares of the issuer at a fixed ratio established upon the issuance of the instrument; an ability to be redeemed at fair market value under certain conditions; transferability by the holder only with the simultaneous transfer of an equivalent portion of the holder's shares of the issuer; subordination to other debt; and no voting power. Because CPECs are treated as debt for Luxembourg tax purposes, interest expense may be imputed on its resulting in Luxembourg tax deductions. In addition, interest paid on financial tool is generally exempt from Luxembourg withholding tax. From a U.S. perspective,

assuming the holder is treated as owning equity, interest imputed on a CPEC does not result in corresponding imputed interest income in the United States. Holders typically owe U.S. tax on dividend income only when declared and paid. In addition, CPECs are convertible into common shares and under certain circumstances are redeemable. Because conversion or redemption is typically carried out at the fair market value of the shares at the time of the conversion or redemption, holders are able to extract appreciation in the issuer in a tax efficient manner. From a Luxembourg perspective, a conversion is not a dividend subject to withholding, and from a United States holder's perspective, the exchange may qualify for a preferential rate of tax as qualified dividend income or the sale or exchange of a capital asset. Since CPECs are also treated as equity in certain foreign jurisdictions, CPECs may also be used to facilitate cross-border arbitrage between Luxembourg and other foreign jurisdictions. International businesses are often faced with issues of double taxation. Income may be taxed in the country where it is earned, and then taxed again when it is repatriated in the business' home country. In some cases, the total tax rate is so high, it makes international business too expensive to pursue. To avoid these issues, countries around the world have signed hundreds of treaties for the avoidance of double taxation, often based on models provided by the Organization for Economic Cooperation and Development (OECD). In these treaties, signatory nations agree to limit their

taxation of international business in an effort to augment trade between the two countries and avoid double taxation.

The OECD, whose 34 members include the United States, recently characterized hybrid financial instruments such as those used by Walmart as abusive and called on member states to prohibit their use.

This means that taking short-term loans from subsidiaries in tax havens could give international companies like Walmart an unfair competitive advantage with respect to smaller and more domestically-oriented competitors who cannot use low-taxed foreign earnings in this way.

It was possible thanks to the use of this complex hybrid loan scheme to achieve what is known in the tax planning business as “double non-taxation.”

As we can see the idea of Walmart was that of avoiding the tax residence with an instrument of transfer pricing that allows to get over the double-taxation (that should be respected to the limit of the agreement concluded by two states) in first place and then and to support their fiscal strategy without any explanation to Us Securities since it is an inter-company operation.

According to the Article 4(1)(a) of the Chapter II which a tax exemption shall only be provided ‘to the extent that such profits are not deductible by the subsidiary of the parent company’.

Here Walmart was able to take advantage of the non-transparency of the norm by gaining a tax exemption that was provided through a certificate which are hidden all the interests that were deducted in order to have a fiscal advantage. So for Walmart' holding this transaction is considered to be an equity injection and it was able to exempt the income derived from the loan as a profit distribution.

Whereas for the subsidiary (the debtor) Pinnacle this transaction was considered to be a loan and so its action consisted on deducting the interests charges on the loan for the consequent payments. It is obvious that Walmart adopted the best solution that was an instrument that would both permit the entity making remuneration payments to deduct these payments for tax purposes and avoid creating taxable income for the recipient of these payments.

Walmart which is the holder of the CPEC obtained a tax exemption to the extent that , the payment of taxes on the interests accruing in the CPEC were never paid back to the Internal Revenue Services. The result of one transaction that has produced two hybrid loans meant to US securities a series of consequences: a loophole that cost 60 billion a year.


The main part of the Walmart colossus profit comes from its fiscal activity more than from the profits coming from its general retailing activity. In fact, this sector bases its operational activity on very low margins and strongly

competitive prices that allow the firms to achieve high sale volumes. Walmart takes advantage of different fiscal loopholes in the American legislation that allows him to elude the federal taxation through a huge network of subsidiaries in tax heavens and through intra-group loans. The exact amount of assets the company has moved to tax heavens is yet unknown. Walmart has established a vast and relatively new web of subsidiaries in tax havens, while avoiding public disclosure of these subsidiaries. Walmart's subsidiaries in tax havens have remained largely invisible to even the most knowledgeable experts on corporate tax avoidance. This is partly due to the fact that Walmart has never listed any of them on Exhibit 21 ("Subsidiaries") of the company's annual 10-K filing with the SEC.

A possible error made by the multinational is not declaring the presence of a subsidiary that accounts for greater than 10 percent of assets of income. There is a legal requirement to list it. Walmart appears to have some subsidiaries that meet the 10 percent disclosure threshold by virtue of their ownership of lower-tier Walmart operating companies or other assets. Nonetheless, Walmart only discloses six foreign subsidiaries, all of which are domiciled in countries where it has retail operations.

The fiscal practices adopted by Walmart do not technically go against the American taxation policy but on the contrary, it has took advantage of some legal loopholes in the American legislation. In fact, the United States taxes

U.S.-based multinational corporations on their worldwide earnings at a 35 percent rate after subtracting a dollar-for-dollar tax credit for taxes paid to foreign governments. However, foreign income is not taxed until it is paid to the U.S. parent company (repatriated) as a dividend, or equivalent. This is essentially a giant tax loophole known as “deferral”, which lets corporations delay paying taxes on foreign profits until they are repatriated to the United States. However, companies may exempt some or all of their foreign earnings from U.S. tax by declaring those earnings to be indefinitely or permanently reinvested overseas, which Walmart does.

<p>Corporate Taxation/Country</p>	 <p>A map of Luxembourg, colored orange, with the word "LUXEMBOURG" in white capital letters across the center and "LUXEMBOURG CITY" with a black dot below it.</p>	 <p>A map of the United States of America, titled "UNITED STATES OF AMERICA" in bold black letters at the top. The map shows all 50 states, each colored differently. A watermark "gettyimages" is visible in the lower right quadrant of the map.</p>
<p>Residence</p>	<p>Based on domestic law, a company is considered to be resident in Luxembourg if either its registered office or place of central administration is located in Luxembourg. The registered office is designated as such in the company's article of incorporation.</p>	<p>A corporation organized or created in the United States under the law of the United States or of any state is a domestic corporation. A domestic corporation is a resident corporation even though it does no business or owns no property in the United States.</p>
<p>Basis</p>	<p>Luxembourg tax resident companies are taxed on their worldwide income. Non-Luxembourg tax resident companies are taxed only on income generated in Luxembourg.</p>	<p>In the United States, resident corporations are taxed based on worldwide income. Generally, a foreign corporation engaged in a US trade or business is taxed at regular US corporate tax rates on income from US sources that is effectively connected with that business and at 30% on US-source</p>

		income not effectively connected with that business.
Taxable income	Taxable income is calculated based on the profits as stated in the commercial balance sheet, plus certain adjustments provided for under the tax law (e.g. non deductibility of taxes, an exemption for dividends). Taxable income of companies resident in Luxembourg includes business income from all sources. Therefore, foreign-source income, whether distributed or undistributed, is included in taxable income subject to any specific exemptions	Domestic corporations are taxed on nearly gross income (including, e.g. income from a business, compensation for services, dividends, interests, royalties, rents, fees and commissions, gains from dealings in property and income from a partnership), from whatever source derived, less allowable deductions for depreciation, amortization, expenses losses and certain other items.
Capital Gains	Capital gains generally are included in taxable income and taxed at the standard corporate tax rate. However, capital gains derived from the sale of shares may be exempt from corporate income tax in certain cases.	Gains recognized by domestic corporations on capital assets (e.g. assets held for investment) are taxed at the same rate as ordinary income. Capital losses may be deducted against capital gains, but not against ordinary income.

Capital Losses	Losses incurred up to fiscal year ended on 31 December 2016 may be carried forward indefinitely. Losses incurred as from 2017 are restricted to a period of 17 years. The carryback of losses is not permitted.	A corporation's net operating losses generally may be carried back two years and forward 20 years.																
Rate	Corporation tax is levied at the rate of 21% for companies with taxable income above €15,000 and at 20% for companies with taxable income less than €15,000.	<p>In the USA, the tax rates depend on the taxable income of the company as below :</p> <table data-bbox="986 981 1342 1794"> <tr> <td>\$0-\$50,000</td> <td>15%</td> </tr> <tr> <td>\$50,000-\$75,000</td> <td>25%</td> </tr> <tr> <td>\$75,000-\$100,000</td> <td>34%</td> </tr> <tr> <td>\$100,000-\$335,000</td> <td>39%</td> </tr> <tr> <td>\$335,000-\$10,000,000</td> <td>34%</td> </tr> <tr> <td>\$10,000,000-\$15,000,000</td> <td>35%</td> </tr> <tr> <td>\$15,000,000-\$18,333,333</td> <td>38%</td> </tr> <tr> <td>\$18,333,333-</td> <td>35%</td> </tr> </table>	\$0-\$50,000	15%	\$50,000-\$75,000	25%	\$75,000-\$100,000	34%	\$100,000-\$335,000	39%	\$335,000-\$10,000,000	34%	\$10,000,000-\$15,000,000	35%	\$15,000,000-\$18,333,333	38%	\$18,333,333-	35%
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\$10,000,000-\$15,000,000	35%																	
\$15,000,000-\$18,333,333	38%																	
\$18,333,333-	35%																	

Surtax	<p>A 7% solidarity surtax is imposed on the CIT amount.</p> <p>Taking into account the solidarity surtax, the aggregate CIT rate is 20.33% for companies with taxable income in excess of EUR 30,000.</p>	No
Taxation of Dividends	Dividends received by a resident company are included in taxable income, unless participation exemption regime applies.	A dividends received deduction is available for dividends received by a corporate shareholder from a domestic corporation, at a rate of 70% (for a less-than 20% shareholder), 80% (for a non controlling shareholder owning 20% or more) 100% (for distributions among members of the same affiliated group, provided other requirements are met.)
Participation Exemption	Dividends and capital gains derived by a qualifying entity from a qualifying shareholding may be exempt from Luxembourg corporate income tax and municipal business tax if the qualifying entity deriving the income holds or commits to hold	The deduction for dividends received, which serves a similar function in the case of participation in a subsidiary (but no a branch or a PE), generally is not available for dividends received from foreign corporations (except in certain

	the participation, directly or indirectly for an uninterrupted period of at least 12 months and the qualifying participation does not fall below 10% or below an acquisition price of EUR 1.2 million (EUR 6 million for capital gains) throughout that period.	cases where the foreign corporation has ECI)
Controlled Foreign Companies	No	Certain types of income of controlled foreign corporations (CFCs) are included currently in the taxable income of “US shareholders”
Withholding Tax : Dividends	Dividends paid to a non-resident company are generally subject to withholding tax at 15%, unless the rate is reduced under a tax treaty.	The gross amount of dividends paid by a domestic corporation generally is subject to a 30% withholding tax, unless the rate is reduced under a tax treaty or the income ECI.
WithholdingTax: Interest	Luxembourg does not levy withholding tax on interest. However, profit-sharing bonds and debt instrument with remuneration linked to the issuer’s profits are taxed as	The gross amount of interest received by a foreign corporation from US sources generally is subject to a 30% withholding tax, unless the rate is reduced under a tax treaty or a statutory exemption

	dividends at a 15% rate.	applies.
Withholding Tax: Royalties	Luxembourg does not levy withholding tax on royalties.	Royalties received by a foreign corporation for the use of property in the US are subject to a 30% withholding tax, unless the rate is reduced under tax treaty or the income is ECI.
Withholding Tax: Technical Service Fee	Luxembourg does not levy withholding tax on Technical service fees.	There is generally only a tax on fees for personal services, if the services are performed within the US. If the services are performed in the US, such fees typically would be ECI.
Withholding Tax: Branch Remittance Tax	No	The US imposes a branch profits tax, as discussed under the “Taxable income” section of “Corporate taxation”

2.3 The consideration of this parental operation by the USA authorities

The Internal Revenue code (Section 956) expressly provides that loans to U.S. multinationals from controlled foreign corporations or CFCs (such as Walmart’s Luxembourg subsidiaries) will be considered dividends that are subject to U.S. tax.

While Luxembourg authorities treat this arrangement as a loan, U.S. authorities view it as an investment of a \$41.5 billion in Pinnacle, a Luxembourg firm, by Wal-Mart International Holdings, Inc., a U.S. firm.

This hybrid loan has “magical” properties for Walmart because Luxembourg allows the “debtor” (Pinnacle) to deduct annual interest charges on the “loan” as they accrue, even if the interest is not actually paid out to the “lender” (Wal-Mart International Holdings). This is why the hybrid loan can “disappear” taxable income for an extended period of time in both Luxembourg and the United States. There is evidence that Walmart uses inter-company loans to shift profits from foreign operating companies based in higher-tax countries to shell companies in low-tax Luxembourg and other tax havens. This also allows Walmart to avoid taxes in countries where it earns profits by simply paying interest to itself in places where the interest will be taxed lightly or not at all. This is known as earnings stripping. International businesses are often faced with issues of double taxation. Income may be taxed in the country where it is earned, and then taxed again when it is repatriated in the business' home country. In some cases, the total tax rate is so high, it makes international business too expensive to pursue. To avoid these issues, countries around the world have signed hundreds of treaties for the avoidance of double taxation, often based on models provided by the Organization for Economic Cooperation and Development (OECD). In these

treaties, signatory nations agree to limit their taxation of international business in an effort to augment trade between the two countries and avoid double taxation.

The OECD, whose 34 members include the United States, recently characterized hybrid financial instruments such as those used by Walmart as abusive and called on member states to prohibit their use.

This means that taking short-term loans from subsidiaries in tax havens could give international companies like Walmart an unfair competitive advantage with respect to smaller and more domestically-oriented competitors who cannot use low-taxed foreign earnings in this way.

It was possible thanks to the use of this complex hybrid loan scheme to achieve what is known in the tax planning business as “double non-taxation.”

As we can see the idea of Walmart was that of avoiding the tax residence with an instrument of transfer pricing that allows to get over the double-taxation (that should be respected to the limit of the agreement concluded by two states) in first place and then and to support their fiscal strategy without any explanation to Us Securities since it is an inter-company operation.

Walmart has never openly reported their existence in the U.S. Securities and Exchange Commission (SEC) filings where subsidiaries are normally disclosed. Moreover, Walmart gives many of its tax-haven subsidiaries obscure names like “Azure Holdings” or “MCLM III,” which turns the simple

task of identifying them into a major investigative effort. In a first moment they were identified because of two characteristics of tax residence: foreign dressing and the fact that is not known the place of effective management.

Second reason that was identified by The Internal Revenue Service (IRS) is that of the transfer of Walmart of billions of dollars to its tax-haven subsidiaries and its use of various financial instruments to move taxable income out of the United States. In a second moment the shift of loans that were not paid became relevant to the financial institutions of U.S.

Third reason is that The European Commission should examine Luxembourg and Walmart's presence there to determine whether Luxembourg has been providing Walmart with sweetheart tax deals equivalent to illegal state aid, thereby engaging in unfair competition against Luxembourg's European neighbors.

3. THE LEGAL LOOPHOLE TO SOLVE THIS INTRA-GROUP OPERATION

3.1 Suggestion to make an agreement to limit the hybrid loan in Walmart's case

The main part of the Walmart colossus profit comes from its fiscal activity more than from the profits coming from its general retailing activity. In fact, this sector bases its operational activity on very low margins and strongly competitive prices that allow the firms to achieve high sale volumes. Walmart takes advantage of different fiscal loopholes in the American legislation that allows him to elude the federal taxation through a huge network of subsidiaries in tax heavens and through intra-group loans. The exact amount of assets the company has moved to tax heavens is yet unknown. Walmart has established a vast and relatively new web of subsidiaries in tax havens, while avoiding public disclosure of these subsidiaries. Walmart's subsidiaries in tax havens have remained largely invisible to even the most knowledgeable experts on corporate tax avoidance. This is partly due to the fact that Walmart has never listed any of them on Exhibit 21 ("subsidiaries") of the company's annual 10-K filing with the SEC.

A possible error made by the multinational is not declaring the presence of a subsidiary that accounts for greater than 10 percent of assets of income. There is a legal requirement to list it. Walmart appears to have some subsidiaries that

meet the 10 percent disclosure threshold by virtue of their ownership of lower-tier Walmart operating companies or other assets. Nonetheless, Walmart only discloses six foreign subsidiaries, all of which are domiciled in countries where it has retail operations.

The fiscal practices adopted by Walmart do not technically go against the American taxation policy but on the contrary, it has took advantage of some legal loopholes in the American legislation. In fact, the United States taxes U.S.-based multinational corporations on their worldwide earnings at a 35 percent rate after subtracting a dollar-for-dollar tax credit for taxes paid to foreign governments. However, foreign income is not taxed until it is paid to the U.S. parent company (repatriated) as a dividend, or equivalent. This is essentially a giant tax loophole known as “deferral”, which lets corporations delay paying taxes on foreign profits until they are repatriated to the United States. However, companies may exempt some or all of their foreign earnings from U.S. tax by declaring those earnings to be indefinitely or permanently reinvested overseas, which Walmart does.

Another important legal loophole regards the taxation of intra-group loans. In fact, the Internal Revenue code (Section 956) expressly provides that loans to U.S. multinationals from controlled foreign corporations or CFCs (such as Walmart’s Luxembourg subsidiaries) will be considered dividends that are subject to U.S. tax. However, the code also excludes loans that are repaid

within 30 days, if all of the loans made by the CFC throughout the year are outstanding for less than 60 days in total. In addition, only loans outstanding at the end of a company's financial quarter are subject to analysis under this deemed dividend rule. These loopholes provide U.S. multinationals with many opportunities when it comes to taking untaxed loans from their offshore profits.

The Walmart case opened a strong debate in the American government and in the institutions linked to fiscal policies regarding the possible repatriation of profits moved to subsidiaries in tax heavens at an advantageous tax rate. In July 2011, then Walmart CEO Mike Duke testified before the Senate Finance Committee in favour of a "territorial" tax system that would exempt the foreign earnings of U.S.-based multinationals from U.S. income tax. An immediate goal of multinationals and some members of Congress is to make it attractive for U.S. corporations to repatriate \$2.1 trillion in profits that are currently offshore and untaxed in the United States.

Two proposals have been put forward:

- A voluntary repatriation tax holiday similar to what was done in 2004, with a tax rate around 6 percent.
- Deemed repatriation at a 14 percent tax rate, proposed by President Obama.

This would require companies to pay taxes on their current offshore profits,

whether they repatriate them or not, less any foreign tax credits. This would raise approximately \$268 billion, which would be used in public expenditure.

Giving the possibility of repatriating assets back in the United States at an advantageous tax rate (which would be necessarily lower than the tax percentage in tax heavens) represents a big opportunity for the American coffer and for multinational companies that would avoid paying sanctions and high tax percentages on their expatriated profits.

U.S. domiciled multinational firms have become used to moving income earned in high-tax foreign countries to very low-taxed ones taking advantage from these huge tax loopholes as the deferral. Closing the deferral loophole would raise about \$60 billion a year in corporate taxes, according to the congressional Joint Committee on Taxation.

These fiscal policies and tax avoidance activities advantage only big multinational companies that already earn huge profits on their sales and that have the possibility to spread over the world their earnings and take advantage on the most interesting fiscal policies of tax heavens, protected by the secrecy typical of these countries. On the contrary, small companies that earn less and that are far more fragile than multinationals have to pay taxes at the national percentage, which means tens of times higher than in Luxembourg for example. This is unfair.

3.2 The new solution adopted by OECD to regulate the tax avoidance of the hybrid loan

Analysing the case of Walmart's fiscal strategy, you cannot avoid thinking that it is a winning strategy from the company's point of view. Since the report, regarding the systematic use of tax heavens and hybrid loans by the company, has been published in 2015 the American government had tried to find sanctions and illegal procedures but it seems that the multinational had never been accused of tax evasion.

This is the reason why to analyse some possible actions that the authorities could make in order to limit the tax elusion reached through the fiscal strategies we explained before.

First of all, we know about the practice of some governments, that don't receive tax payments from firms. They use to decrease periodically the amount of corporate rate in order to incentive those companies to defray their debts, so to obtain a money entrance even if it is lower than what they should have received. Knowing this, firms will wait the period of lower taxes to pay them. Hence, in order to avoid that multinational companies to take advantage of these "tax shields", our proposal for the American government is to eliminate this method fixing a constant corporate lower tax level that could represent an incentive to pay steadily. On the other hand, if this rule is not

followed by companies, the penalties should be harder in terms of sanctions in addition to the amount of taxes they have to pay back on their profits.

Another interesting method to avoid taxes by circumventing the law without breaking it, is to use the so called Tax loophole in the USA fiscal legislation. The tax deferral states that profits are taxed only when they are repatriated in the country as dividends. Avoiding tax payment by keeping earnings outside results to be very easy. A possible solution that authorities can follow is to tax every profit belonging to the same company even if it is not reentered in the country, without making any difference. In this sense, it is easier for the authorities to control the taxable income without distinguishing between repatriated and non-repatriated profits and it becomes more difficult for firms to elude taxation.

Closing the deferral loophole would raise about \$60 billion a year in corporate taxes, according to the congressional Joint Committee on Taxation. Since the deferral came up from the hybrid loan that in our case was used by creating a debt from the American holding to the subsidiary in Luxembourg that was realized by buying from the holder the Convertible Preference Equity Certificate. The interest paid to holders of CPECs would not be subject to withholding tax in Luxembourg. The Internal Revenue code (Section 956) expressly provides that loans to U.S. multinationals from controlled foreign corporations or CFCs (such as Walmart's Luxembourg subsidiaries) will be

considered dividends that are subject to U.S. tax. However, the code also excludes loans that are repaid within 30 days, if all of the loans made by the CFC throughout the year are outstanding for less than 60 days in total. In addition, only loans outstanding at the end of a company's financial quarter are subject to analysis under this deemed dividend rule.

The suggestion to the IRS is to make an agreement with Luxembourg to limit this instrument. The strategy is very simple: if Walmart will not pay the interest accruing to avoid taxes to the holder, Luxembourg will not be allowed to use the CPEC to attract American investors for others transactions even though this is an intra-group operation. In this way, it is realized the payment of taxes on the interests accruing in the CPEC in the future by giving to the holder again an extra-time where only the dividends that are not paid within 120 days will be taxed at a discounted rate of 20% instead of 35% so a more advantageous tax rate for this kind of income.

In 2014, in Berlin, during the Global Forum on Transparency and Exchange of Information for Tax Purposes, all OECD and G20 countries, as well as most major international financial centres, signed a "multilateral competent authority agreement" that will activate the automatic sharing of financial data for tax purposes. Under the Foreign Account Tax Compliance Act (FATCA⁹),

⁹The Foreign Account Tax Compliance Act ("FATCA") was passed by the U.S. Congress and signed into law by President Obama in March of 2010, as part of the "Hiring Incentives to Restore

the United States will automatically exchange information with other countries beginning in 2015. In 2017, 58 jurisdictions of the "early adopters", among those also Luxemburg, start to share information automatically. Based on this new agreement, the American government will have a much clearer and wider view of the extent of the tax avoidance Walmart has reached in its Luxemburg's subsidiaries and not only. The IRS (Internal Revenue Service) in this way should analyse the use of short-term offshore loans and the amount of taxable income moved to tax heavens in order to determine effectively if Walmart has been improperly avoiding USA tax. On the other side, the European Commission should examine Luxemburg and Walmart's presence there in order to analyse which agreements have been taken by both parties and if the country has engaged in unfair competition against its European neighbours.

Worldwide unitary taxation may be a solution to part of Walmart's tax elusion technique. In fact, considering Walmart's parent company and all its subsidiaries as a unique entity would make impossible short-term internal

The Foreign Account Tax Compliance Act ("FATCA") was passed by the U.S. Congress and signed into law by President Obama in March of 2010, as part of the "Hiring Incentives to Restore Employment (HIRE) Act" FATCA was added to the U.S. tax code (the "Internal Revenue Code of 1986" or "IRC") by the inclusion of sections 1471. FATCA was adopted as part of a coordinated effort by the U.S. Government to eradicate the evasion of taxes by U.S. citizens and U.S. tax residents. The primary requirement of FATCA is that all foreign financial institutions (an "FFI") or non-financial foreign entities (an "NFFE") must report to the IRS information about accounts or holdings belonging to U.S. taxpayers; and pay a tax of 30% on the gross amount of transfers received by an FFI or a NFFE from U.S. sources

loans between subsidiaries in high tax rate to low tax rate ones since they will be considered as part of the same company. In this way, the American government can avoid multinationals from earning on the interests of internal loans.

The hybrid mismatch rules have been designed to maximize the following outcomes:

1. Neutralise the mismatch rather than reverse the tax benefit that arises under the laws of the jurisdiction;
2. Be comprehensive;
3. Apply automatically;
4. Avoid double taxation through rule coordination;
5. Minimize the disruption to existing domestic law;
6. Be clear and transparent in their operation;
7. Provide sufficient flexibility for the rule to be incorporated into the laws of each jurisdiction;
8. Be workable for taxpayers and keep compliance costs to a minimum;

9. Minimize the administrative burden on tax authorities;

10. Cure all disease, end poverty, and eradicate world hunger.

If we decide to follow the OECD's path, we would have a three-step analysis: First, all countries should act to deny exemption or credit relief for a hybrid dividend. Second, if such a general rule is not adopted by a particular payee country or if it is not applicable to a particular instrument, the payer country of a hybrid mismatch payment should deny the deduction. Third, if there is no such denial by the payer country, the payee country of that hybrid mismatch should fully tax the payment, which would mean denying exemption or credit relief for the payment. Sounds like a bit of a circle, doesn't it?

The recommendations specify that the denial of deduction should be aligned with the extent of the non-taxation of the payee. So if, say, a 90% exemption, then a 90% disallowance. And in situations where the benefit is in the form of a foreign tax credit, there would be a need to compute the extent to which the credit led to a non-tax result. This latter situation seems particularly messy since a disallowance by the payer country would increase the underlying tax on the payer. This would potentially result in a circular calculation. Moreover, the deemed paid credits used to offset the hybrid payment would almost certainly result in there being fewer credits left to offset the payee country tax

on future dividends. Thus, a disallowance likely would result in current or eventual double taxation. Apparently, potential double tax doesn't merit the same in-depth thinking as does double non-tax.

Differences in timing of deductions versus inclusions are also covered. This could have an impact on discount notes or similar instruments. The recommendation excludes a timing difference from being considered a hybrid mismatch where the payment will be included as ordinary income "within a reasonable period of time." To the extent this approach is implemented by countries, there could be some practical issues for multinationals.

It is considered as a payment to a reverse hybrid to create a hybrid mismatch to the extent there is a deductible payment made to the reverse hybrid and the related income is not taxable to the owner of the reverse hybrid. The rule recommended by the report is that the payer country should disallow deductions for the payments to the extent the income is not taxed to the reverse hybrid owner. As with the proposed disregarded payment rule, this would not apply only to interest payments, but presumably could apply also to rents, royalties, service payments, etc. It's a clear example that, to the extent the income of a reverse hybrid is fully taxed under a CFC regime, the payer country should not treat the payment as a hybrid mismatch with the burden of proving full current taxation falling on the taxpayer. In this regard, however,

the inclusion of the reverse hybrid income in the investor country through a dividend payout rather than a CFC inclusion would not be satisfactory from the OECD's standpoint to trigger a turning off of the treatment of the arrangement as a hybrid mismatch.

This rule applies any time there is a deductible payment to a payee that benefits from a hybrid mismatch to reduce the payee's tax on the deductible payment. The rule can apply through unlimited tiers of related entities which would seem likely to cause incredible potential complexity and I could foresee enormous taxpayer burden in having to disprove the existence of any tainted imported mismatch anywhere in the chain of intercompany treasury transactions.

Don't forget a hybrid mismatch for this purpose could arise from a hybrid instrument, a disregarded payment, a reverse hybrid or a dual resident company payment. The level of transparency, knowledge of foreign country rules, burden of proof, and implications of currency differences and valuation differences that would be involved are just a few quick reasons why this proposal seems totally unworkable. Drafting legislation and regulatory guidance to enact such a rule would seem nigh on impossible, much less actually administering it in practice. But take heart"structuring opportunities will usually be available to avoid the risk of double taxation." That's starting

to seem like a common theme let's propose rules that are unmanageable that hybrids can no longer exist. However, that unreasonable starting point presumes that hybrids are all optional and since we live in a world of disparate national rules, hybridity good and bad, however you define what's good and what's bad is a reality that can be unavoidable.

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