

# International Tax Issues involving Hybrid Entities

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# Concept of Hybrid



# What is an Hybrid?

- Entities may have “hybrid” features which may make their classification difficult
  - Examples US LLC, UK LLP, Dutch CV, German KG&Co
- In most countries classification is based on civil or commercial law
- Divergence in approach among countries in classifying entities
- Can result in conflict in classification in cross-border scenario
  - Entity may be classified as “transparent” in one country but “non-transparent” in another

# Use of Hybrids

- Use of Hybrid entities common in international structures
- Commonly used by Venture Capital Funds and Collective Investment Vehicles
- Business reasons for using hybrids
  - Flexibility in operations
  - Better control over management
  - Limited liability
- Flexibility in international tax planning
- Potential risks and pitfalls if not structured properly

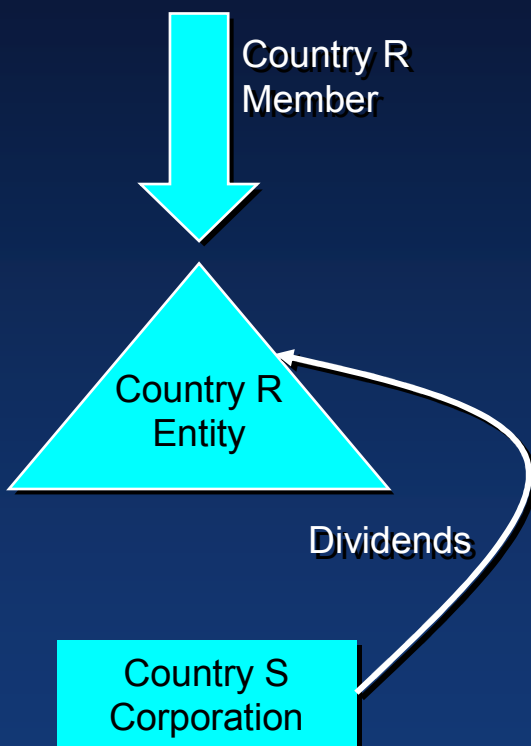
# Issues arising from Hybrid Entities



# Issues arising from Hybrid Entities

- Entity classification can have bearing on the following:
  - Determining the taxpayer – whether entity or its members
  - Determination of residency of the entity
  - Eligibility of the entity or its members for treaty benefits
  - Nature of income derived by entity/ members and taxation thereof
- Double taxation issues on account of mismatch in classification
- Tax-arbitrage opportunities and other unintended consequences

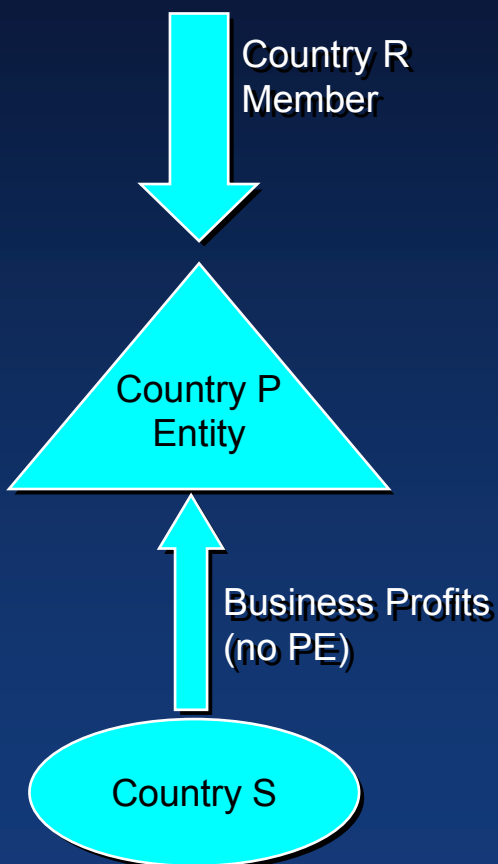
# Issues arising from Hybrid – Residence Issues



- Entity is treated as transparent by Country R
  - Country R member taxed on dividends received from Country S
- Entity is treated as non-transparent by Country S
- Can Entity avail benefits of treaty between R & S?
  - Entity not liable for tax in Country R
  - Entity may not qualify as “resident” even though dividend is fully taxed in Country R
- Can Country R restrict tax credit to the amount taxable in Country S under R-S tax treaty

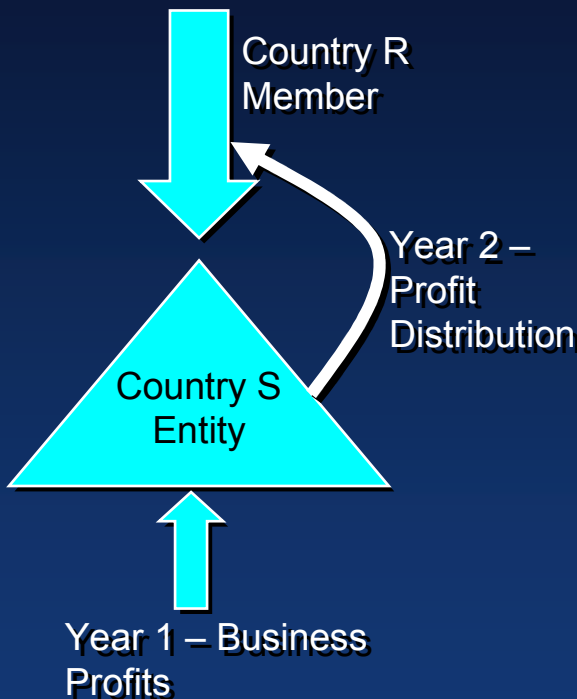


# Issues arising from Hybrid – Double Non-taxation



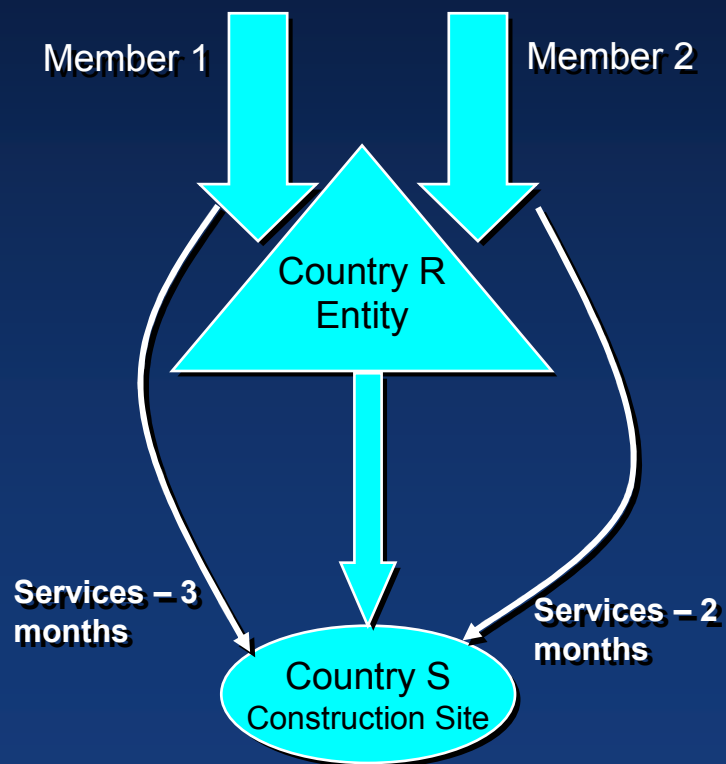
- Entity is treated as transparent by Country P & S
- Entity is treated as non-transparent by Country R
- Country S & P do not tax profits as income is attributed to Country R member
- Country R does not tax profits as it is attributable to Country P Entity
- Case of double non-taxation on account of classification conflict

# Issues arising from Hybrid – Double Taxation



- Entity is treated as non-transparent by Country S
- Entity is treated as transparent by Country R
- Country S taxes Entity in Year 1 on business profits as well as in Year 2 on distribution (as dividends)
- Country R regards Entity as a PE of Member and taxes profits in Year 1
- Double taxation arises from conflict in income allocation

# Issues arising from Hybrid – Application of treaty provisions



- Country R Entity has an installation contract in Country S
- Member 1 & 2 provide the installation services for 3 & 2 months respectively
- Country R & S treat Entity as transparent and tax Member 1 & 2
- Should the time spent by the members be aggregated for determining the time threshold for Construction PE?

# International Approach to Hybrids



# The U.S. Approach

## ■ Entity Classification

- The 1996 “check-the-box (CTB)” regulations provides an elective classification system
- Broad discretion to determine classification of most foreign entities
- Predetermined list of *per se* corporations
  - Automatically treated as corporations for tax purposes
- Simple election for classifying all other entities
- Default rules if election is not made

# The U.S. Approach

## ■ Eligibility for Treaty Benefits

- Art 4(1)(d) of 1996 U.S. Model Treaty addresses issues presented by hybrid entities
- “Look through” approach recognized for determining treaty eligibility
  - Item of income derived through hybrid entities will be considered as derived by a resident if the resident is treated as deriving the item of income
- Rev. Reg. under IRC 894(c) & (d) provide rules for determining treaty eligibility for hybrid & reverse hybrid entities

# The OECD Approach

- 1999 OECD Report on application of Model Convention to Partnerships
- Issues addressed by the Report
  - To what extent a partnership and its partners may claim the benefits of a tax treaty with respect to the partnership's income
    - Whether a partnership qualifies as a "person" and as a "resident"
  - How the partnership's and the partners' entitlement to the benefits of tax conventions interact in bilateral and triangular cases
  - Difficulties raised by "conflicts in classification" when Source State and Residence State apply different articles of the treaty
  - Potential for double non-taxation arising from conflict in classification
  - Difficulties related to foreign tax credits that can arise from different treatment of partnerships

# German LLC Rules

- Rules issued by German Tax Authorities in March 2004
- Employs a six-factor test:
  - Centralization of management
  - Limited liability
  - Free transferability of interest
  - Discretion to access profits
  - Equity contribution
  - Continuity of life
- Case-by-case basis for classification as company or partnership
  - Overall assessment of whether the characteristics more closely resemble those of a typical corporation or those of a partnership



# Dutch Entity Classification Rules

- Guidance issued in Dec 2004 on classification of foreign entities
- Four factor-test:
  - Can the entity hold legal title to the assets and liabilities;
  - Is there at least one participant that has unlimited liability;
  - Does the entity have a capital divided into shares;
  - Is the admission or replacement of participants possible without the consent of all other participants
- Depending on the answers to these questions, the entity is either transparent or non-transparent

# Anti-abuse Rules

- Countries introducing anti-abuse rules to target tax arbitrage arising from hybrid entities
- UK arbitrage rules introduced in 2005
  - Apply to hybrid entities set-up with main purpose of tax avoidance
- Denmark anti-check the box rules

# Specific Issues relating to India



# Indian Issues

- Tax law recognizes various entities
  - Company (including foreign company), partnership/ firm, AOP
  - No specific rules on circumstances under which an foreign entity would be classified as company/ partnership/ AOP (or even disregarded)
  - Determination would have to be based on legal characteristics of the entity based on foreign law
    - Can create practical as well as technical difficulties in determination

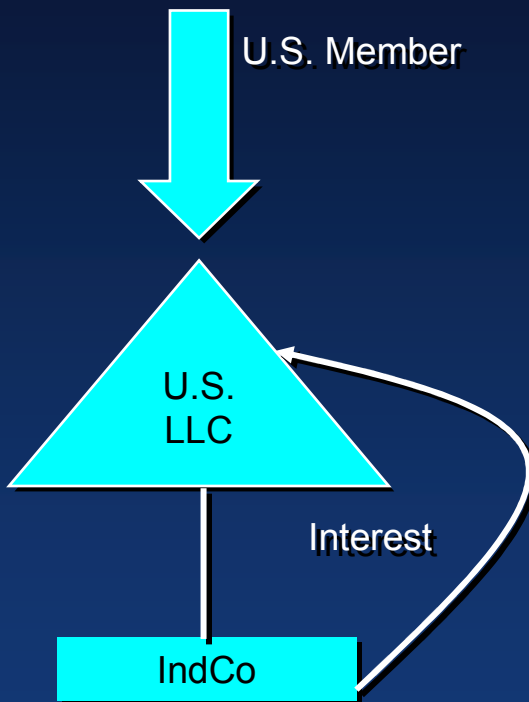
# Indian Issues

- Entity Classification can have bearing on the following:
  - Determination of residency
  - Eligibility for treaty benefits
  - Nature of income derived by entity/ members and tax treatment thereof
  - Application of provisions in the Act which are entity specific

# India-U.S. Tax Treaty

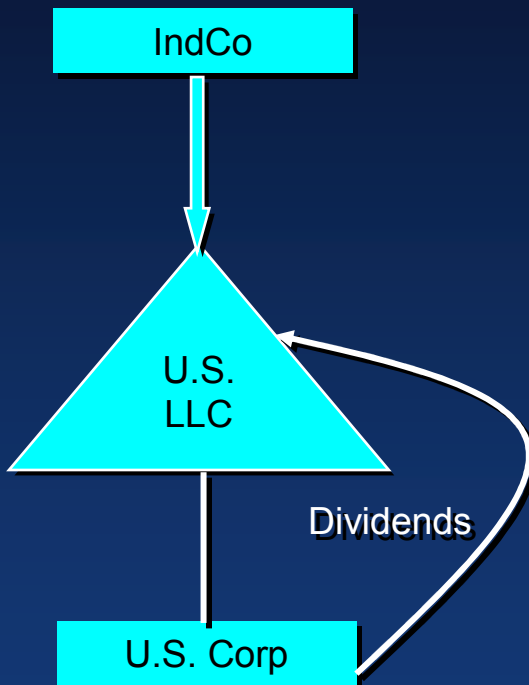
- Article 4(1)(b):
  - The term “resident” means any person who, under the laws of that [residence] state, is liable to tax therein ... provided, however, that in the case of income derived or paid by a partnership...this term applies only to the extent that the income derived by such partnership...is subject to tax in that state as the income of a resident, either in its hands or in the hands of its partners...
- Issues arising from the treaty:
  - Under which state's laws is it determined whether the entity is a partnership?
  - When is income derived by a partnership “subject to tax” in the residence country?
  - To what extent does the treaty apply when the entity is established in a third state?
  - Can a U.S. LLC which has elected to be taxed as a partnership be eligible for treaty benefits?

# Application of India-U.S. Tax Treaty to Hybrid Entities – Inbound Case



- US LLC “checks-the-box” and taxed as transparent entity in U.S.
  - U.S. Member taxed on interest from IndCo
- India likely to regard LLC as “foreign company”
  - LLC not liable for U.S. tax by virtue of election
  - LLC may be denied treaty benefit as it is not a “resident”
- 1996 U.S. Model Treaty could prevent this result

# Application of India-U.S. Tax Treaty to Hybrid Entities – Outbound Case



- IndCo is member in US LLC which owns US Corp
- US LLC earns dividends from US Corp
- US LLC “checks-the-box” and taxed as transparent entity in US but as a taxable entity for India
- IndCo not liable for residence country tax on LLCs income
- Treaty benefits may be denied
- Similar result likely under 1996 US Model Treaty



# India-U.K. Tax Treaty

- Article 3(1)(f):
  - Partnership not considered as a “person” for purpose of treaty, subject to exception in Art 3(2)
- Article 3(2):
  - A partnership treated as a taxable unit in India shall be treated as a person
- Issues arising from the treaty:
  - Applicability of treaty benefits to U.K. general partnerships?
  - Applicability of treaty benefits to U.K. LLPs?
  - Can a U.K. partnership be treated as a taxable unit in India and qualify for treaty benefits?

# Tribunal Rulings on Taxation of Law Firms

- DCIT v Chadbourne & Parke LLP (2005) 93 TTJ 734, Maharashtra State Electricity Board v DCIT (2003) 90 ITD 793 [Freshfields case], Clifford Chance UK v DCIT (2002) 76 TTJ 725
  - Taxability to be determined under Article 15 (Independent Personal Services) of the treaty
  - Law Firms taxable if they had a fixed base or if any of its personnel spent more than 90 days in India for providing services
  - Multiple counting of common days to be avoided for measuring 90 day test
  - Residency of partnership and applicability of treaty not discussed in the rulings

# Need for Entity Classification Rules

- Guidance on approach for classification of foreign entities
- Specific provisions in tax treaties to address application of treaties to hybrid entities
- Anti-abuse provisions to prevent cross-border tax arbitrage on account of mismatch in entity classification



# Thank You