U.S. Tax Court Treaty Shopping Case Could Test Limits of Anti-Conduit Regs
by Kristen A. Parillo

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A U.S. Tax Court treaty-shopping case involving intercompany debt incurred by industrial manufacturer Ingersoll-Rand Co. in connection with its 2001 reincorporation in Bermuda could test the limits of the anti-conduit financing regulations issued in 1995 under Treas. reg. section 1.881-3, according to practitioners.

In a petition (link to 2013-26995) filed with the Tax Court on November 1, 2013, Ingersoll-Rand Co. (a U.S.-based subsidiary of Ingersoll-Rand Plc) challenged an August 2013 notice of deficiency in which the IRS asserted that interest payments made to related entities in Barbados, Hungary, and Luxembourg were not entitled to reduced withholding tax rates under the U.S. income tax treaties with those three jurisdictions. The IRS determined a withholding tax deficiency of $84 million for the 2002 tax year and assessed penalties under sections 6656 and 6662 totaling $25 million.

In a Form 10-Q filed on October 23, 2013, Ingersoll-Rand disclosed that an IRS examination team that is auditing the company’s 2003-2006 tax years recently provided notices of proposed adjustment in which the IRS took the same position regarding interest payments made to the related entities in Barbados, Hungary, and Luxembourg for the 2003-2006 period. The IRS asserted in those notices that Ingersoll-Rand owes approximately $665 million in additional taxes (plus penalties and interest) for that time period. The company said in the Form 10-Q that the IRS has not yet proposed any similar adjustments for the post-2006 tax years, although the IRS’s audits for those years are either still in process or have not yet begun.

The IRS filed its answer (link to 2014-1127) to Ingersoll-Rand’s petition on January 10.

Neither the petition nor the answer sheds much light on why the payments were routed through intermediate companies located in treaty jurisdictions, or what type of local activity (if any) those intermediate companies were doing. The petition states that in 2002, the taxpayer was a member of a worldwide group of affiliated companies headed by Ingersoll-Rand Company Limited (IR Limited), a publicly-traded company formed under the laws of Bermuda. IR Limited indirectly owned 100 percent of the taxpayer’s shares. Ingersoll-Rand had completed a plan to move its place of incorporation from New Jersey to Bermuda on December 31, 2001 (the company subsequently reincorporated in Ireland in 2009).
According to the petition, the financing structure involved a $3.6 billion note made in May 2002 between the taxpayer and Global Holding Co., Ltd. (Global Holding), a Bermuda-based wholly-owned subsidiary of IR Limited. The note was then transferred to a Barbados-based subsidiary. The note bore interest at an annual rate of 11 percent and was due in December 2011. The taxpayer in June 2002 made an interest payment to the Barbados subsidiary, which then immediately invested that interest payment by making a loan to IR Limited.

Similar loans, notes, and assignments were made in 2002 between the taxpayer and subsidiaries located in Hungary and Luxembourg. Interest was paid to the Hungary and Luxembourg entities; the entities then immediately invested the interest payments by making loans to Global Holding or IR Limited.

When making the interest payments to the foreign entities, the taxpayer applied the reduced interest withholding tax rates available under the relevant treaty: 5 percent under the Barbados-U.S. treaty, and a zero rate under the Hungary-U.S. and Luxembourg-U.S. treaties.

Which Treaty-Shopping Weapon to Deploy?

Practitioners who spoke with Tax Analysts said that while it’s not entirely clear from the IRS’s answer exactly what weapon the government will choose from its treaty-shopping arsenal – Treasury regulations, IRS revenue rulings, judicial doctrines, or treaty limitation on benefit provisions – to challenge Ingersoll-Rand’s transactions, the IRS will essentially argue that the company’s financing structure amounted to a conduit arrangement. That is, the interest payments were routed through intermediate treaty countries to reduce the amount of U.S. withholding tax on those payments.

“This case is another iteration in a long line of ‘substance over form’ cases involving intercompany foreign transactions that appear to involve entities where there’s some question whether those entities are active companies engaged in any kind of substantive activity and whether they should be regarded as the true owners of the income,” said Ramon Camacho of McGladrey LLP.

He noted that there’s a significant body of “substance over form” case law, starting with the landmark treaty-shopping decision in Aiken Industries, Inc. v. Commissioner, 56 T.C. 925 (1971). Another important case is Northern Indiana Public Service Co. v. Commissioner, 115 F.3d 506 (7th Cir. 1997). Camacho said the IRS has also fought treaty-shopping cases through revenue rulings: Rev. Rul. 80-362, Rev. Rul. 84-152, Rev. Rul. 84-153, Rev. Rul. 87-89, and Rev. Rul. 89-110.

Congress sought to strengthen the IRS’s treaty-shopping arsenal by enacting section 7701(l) in 1993, which authorizes regulations "recharacterizing
any multiple-party financing transaction ... as appropriate to prevent avoidance of any tax law." Treasury used that regulatory authority to issue final conduit financing regulations under Treas. reg. section 1.881-3 in 1995. Those regulations (T.D. 8611) permit the IRS to disregard the participation of one or more intermediate entities acting as "conduit entities" in "financing arrangements" that are designed to avoid taxes. The rule allows the IRS to recharacterize a multiple-party "financing transaction" as a transaction directly between the parties on either side of the conduit entity for purposes of imposing tax under section 871, 881, 1441 and 1442.

Camacho, who helped draft the anti-conduit regulations when he worked as an attorney-adviser at the IRS Office of Chief Counsel (International), said the Ingersoll-Rand case could potentially be the first case to address the scope of those regulations. He noted that the regulations were designed to set some clear parameters around when a payment coming out of the United States should be viewed as not being received by the ostensible recipient but rather someone else. "The idea was to try to figure out who was the true owner," he said. "There were some tests put in the regs; you principally had to have a back-to-back transaction and have a tax avoidance purpose."

"The regs have been out there a long time, but there have been some questions," Camacho continued, "Such as, if you have a set of facts that fall within the regs and are protected by the regs, does that mean that all the other common law authorities and cases and so on no longer apply? Has the government limited itself to just the conduit regs, or will it apply traditional substance over form doctrines even where a taxpayer is safe under the conduit regs? I think this case will probably address that, if it proceeds."

Camacho said the petition and answer don't provide enough factual information to be able to predict how a court might rule. "The facts we have here involve payments going through Bermuda and Barbados, these things that generate the interest are notes that just seem to be shuffled around going into Luxembourg and Hungary," he said. "There aren't a whole lot of facts around why those transactions occurred and whether there is any substance to those transfers. There isn't much information about the entities that are the characters here; we don't know whether those entities are doing any real business in those jurisdictions, or are they just simply shell companies that are designed to take advantage of tax treaties?"

Camacho said Ingersoll-Rand might argue that its financing structure falls within the four corners of the anti-conduit regulations and therefore the transactions should be respected. "They could argue that there's no need to go into the sham transaction doctrine or pursue shamming the entity itself as the ostensible owner, and that there's no need to think about any other common law doctrine relating to treaties," he said, adding that the taxpayer may argue that if
the conduit regulations don’t catch a transaction then the transaction shouldn’t be attacked.

The IRS would likely respond that the anti-conduit regulations are just one tool in its arsenal and that they are not the exclusive set of rules for deciding beneficial ownership and conduit arrangement issues, Camacho said. “My guess is that the court, if this case proceeds and that argument were made, would probably agree with the government and say they still rely on common law doctrines to analyze these types of transactions,” he said.

Camacho said the outcome of the Ingersoll-Rand case could have a significant impact on taxpayers and the IRS. “It would be interesting if the government scores a win and is able to say that if a foreign company doesn’t have significant activity going on in that jurisdiction [the IRS] has the ability to disregard transactions that don’t appear to have any relationship to whatever little activity is going on there,” he said. “That would have an impact on planning structures and activities. It is conceivable, but unlikely, that a taxpayer-adverse decision might even be so significant that it could cause other companies to assess their own structures and book a reserve for financial accounting purposes.”

Bret Wells of the University of Houston Law Center agreed that the case could hinge on an interpretation of the anti-conduit regulations. “I think the fundamental question will be, what flexibility does a foreign investor have to use intermediate companies to access favorable treaties in those jurisdictions when they want to lend to their U.S. affiliate,” said Wells.

“In this particular case, it looks like the loans were contributed to each of the treaty companies, so they owned them without any borrowings from the Bermuda company,” Wells said, “so in effect they made a loan to the U.S. company with their own equity because they were fully equity capitalized. As soon as the funds left, the interest was paid from the U.S. company to the treaty companies, and it appears that all that cash was immediately reloaned to the Bermuda companies and interest was charged to them. But the funds were made available immediately by each of these tax haven companies.”

Because the funds originated with the Bermuda companies and equity was contributed by those companies into the treaty resident companies and then lent from those treaty jurisdictions to the U.S. affiliate, the fundamental question will be whether that intermediate lending from a treaty company is going to be respected, Wells said. “Were these intermediate companies merely a conduit for the avoidance of U.S. withholding taxes, and was there any substance in these jurisdictions?”

Policy Implications
Aside from testing the limits of the anti-conduit regulations, the Ingersoll-Rand case also raises significant policy issues regarding the U.S. inbound taxation rules, said Wells. “The petition shows us that after the inversion in Bermuda [in 2001], they were trying to re-lever their U.S. business just like many foreign multinationals do when they invest in the U.S.,” he explained. (Prior Tax Notes articles on inversions written by Wells link to 2012-14119 and 2010-11447.)

“The fact they did it hastily and they were trying to set it up with the intent of reducing U.S. withholding taxes may or may not create an issue in this litigation,” he said. “But the larger policy issue is that this case is showing us that foreign owned multinationals, including inverted companies, have significant opportunities to base erode and strip earnings out of the U.S. taxing jurisdiction under existing law. The court may find that because they were doing this as a major restructuring this all fails because of substance over form, or was all done for tax reasons or the like.”

“But the reality is that old and cold companies can achieve the same or similar benefits as to what Ingersoll-Rand is doing as foreign multinationals that aren’t available to U.S. multinationals,” Wells said. “That ought to concern us that there’s a significant tax arbitrage depending on whether something is a foreign-owned multinational because of their potential to strip U.S. profits out of the United States free of withholding tax.”

That arbitrage opportunity shows that the United States must start to think about reforming its inbound taxation rules, Wells said. “And inverted companies are telling us we need to rethink our ability to tax U.S. territorial profits. Because there’s a significant benefit to inverted companies, if they’re not a U.S. company, and they seem to be able to strip U.S. profits and use techniques that are widely employed by foreign-owned multinationals that are not recently inverted companies.”

Wells said that the section 163(j) rules remain weak at preventing interest earnings stripping. “There have been proposals to tighten 163(j),” he said. “The Obama administration has said it needs to be tightened, but Congress has done nothing about it.”

However, the ability to get around section 163(j) is just one technique to strip profits, Wells noted. “There are other ways to strip profits other than with interest,” he said. “But certainly the main point of giving an interest deduction in this situation represents a one-sided entry; it’s reducing U.S. tax when the income is not subject to foreign tax in the hands of the offshore entity.”

Relinquishing U.S. taxation when the income is not going to be taxed in the offshore location creates a significant tax savings and should test the U.S. government’s premise for why it relinquished U.S. withholding taxation in the first
place, Wells said. “The relinquishment of U.S. taxation in order to prevent double international taxation should not create double non taxation results, and the ability to create double non taxation results is a significant competitiveness issue,” he added.