

Tax memo

Canadian tax updates



OECD paper on aggressive tax planning based on after-tax hedging

An OECD report describes aggressive tax planning that is based on after-tax hedging, as well as strategies of tax authorities and the challenges they face.

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The Organisation for Economic Co-operation and Development (OECD) has just released a paper entitled “Aggressive Tax Planning based on After-Tax Hedging.” It describes the features of that type of planning, as well as the strategies tax authorities use to detect and respond to these arrangements. The OECD paper also highlights a number of challenges from a compliance and policy perspective.

What is after-tax hedging?

After-tax hedging is a difficult area and inevitably the explanations in the OECD paper are fairly complex.

The discussion in the paper notes that a hedge is effective in pre- and post-tax terms when the tax treatment is neutral – e.g., when losses on one position (e.g., an asset) are deductible and gains on the opposite position (e.g., the hedge) are taxable. When tax rules do not operate in such a symmetric way, the hedge will be imperfect on an after-tax basis (e.g., if gains on a hedge are taxable but losses on a corresponding asset are not deductible). The report recognizes that this may create situations in which taxpayers need to factor the effects of taxation into their hedging transactions in order to be fully hedged on an after-tax basis.

The main complaint, however, is when after-tax hedging is deployed as a feature of plans that are designed to allow taxpayers to achieve higher returns, without actually bearing the associated risk, which is in effect passed onto the government through the tax charge.

The report states that some aggressive tax planning involves the tax treatment of the hedge being symmetrical in relation to gains and losses and others feature the situation where the tax treatment of the hedge is not symmetrical (i.e., gains on the hedging instrument are not taxed while losses are deductible). An example of the latter is given in the paper involving gains and losses on the hedged transaction being non-taxable and non-deductible, with gains on the hedging instrument being non-taxable, yet losses being tax deductible. Accordingly, on an after-tax basis, tax benefits are obtained in the case of gains on the hedged item, which are not taxed, and losses on the hedging instrument, which are deductible. On the other hand, there are no tax consequences in the case of losses on the hedged item, which are non-deductible, and gains on the hedging instrument, which are not taxed.

Strategies to detect and respond

The paper notes that detection strategies can be divided into five main categories:

1. Strategies, whether designed as detection tools or not, that cause taxpayers or third parties to provide relevant information to the tax administrations (disclosure and reporting).
2. Strategies in which the tax administration is not in the role of a “passive” recipient of information but is in an active role seeking to detect relevant information by using its investigative powers (investigations and audits).
3. Strategies that seek to build on information held either by other government departments or that involve co-operation with the tax administration of another country (domestic and international co-operation).
4. Strategies that seek to make the best use of internal tax administration information or external public data (data analysis).
5. Strategies not covered otherwise (other detection strategies).

In relation to response strategies, it is stated that these are essentially focused on denying or limiting the tax benefits sought by the arrangements, sometimes in combination with strategies focusing on influencing taxpayer and promoter behaviour. The paper refers specifically to the use of general and specific anti-avoidance rules and transfer pricing to counter these arrangements.

Policy and compliance issues

It is recognized that after-tax hedging raises a number of challenges from a compliance and a policy perspective. These challenges relate chiefly to:

1. the difficulty in drawing the line between arrangements that should be accepted and those that should be countered;
2. the challenges in detecting these arrangements; and
3. the existence of appropriate domestic law measures to counter arrangements that are considered to be aggressive.

The paper notes that to meet these challenges it is necessary for tax administrations to have a good understanding of the financial world and hedging

generally as well as large corporates’ hedging policies. This leads to the conclusion that it is therefore important for tax administrations to ensure they have staff with the relevant background and expertise to understand planning of this nature, which are often very complex.

Overall conclusions and recommendations of the OECD

After noting that it is up to each country how to approach the issues addressed in the report, the overall conclusions of the paper are set out.

- Aggressive tax planning based on after-tax hedging poses a threat to tax revenue. Any country that taxes the results of a hedging instrument differently from the results of the hedged transaction/risk is potentially exposed to these arrangements.
- Aggressive tax planning based on after-tax hedging originated in the banking sector, but there is evidence that it is also used in other industries and, in some instances, also by medium-sized enterprises, thus generating an even bigger threat to tax revenue.
- It is important that governments are aware of arrangements that use hedging for aggressive tax planning purposes. Aggressive tax planning based on after-tax hedging poses a number of challenges, in particular regarding the difficulties in detecting these arrangements and in deciding whether and how to respond.
- Engaging in a dialogue with the taxpayer through co-operative compliance programs and having staff with the relevant background and expertise to understand the rationale and the key industry drivers (and therefore be able to detect these complex and engineered aggressive tax planning schemes) have proven extremely helpful. In addition to providing the necessary training to existing staff, it may be necessary for tax administrations to recruit staff with relevant industry experience externally.
- Not all after-tax hedging arrangements are aggressive, making it important for governments to exercise considerable care when

designing and applying deterrence, detection and response strategies.

- Exchanges of information, spontaneously and on request, and the sharing of intelligence on aggressive tax planning schemes based on after-tax hedging, their deterrence, detection and response strategies have proven extremely useful.

The report recommends:

- focusing on detecting these arrangements and ensuring that their tax administrations have access to sufficient resources (in particular expertise in financial instruments and hedge accounting) to detect and examine after-tax hedging in detail;
- introducing rules to avoid or mitigate the disparate tax treatment of hedged items and hedging instruments;
- verifying whether their existing general or specific anti-avoidance rules are suitable to counter aggressive tax planning based on after-tax hedging and, if not, considering amending those rules or introducing new rules;
- adopting a balanced approach in their response to after-tax hedging, recognizing that not all arrangements are aggressive, that hedging in and of itself is not an issue and that aggressive tax planning based on after-tax hedging may necessitate a combination of response strategies; and
- continuing to exchange information spontaneously and share relevant intelligence on aggressive tax planning based on after-tax hedging, including deterrence, detection and response strategies used, and monitoring their effectiveness.

Our views

Given the inherent difficulties in the topic of after-tax hedging (both in the tax policy issues involved and also in the basic explanation of what is meant by after-tax hedging), this seems a slightly odd topic for such a lengthy OECD paper. The paper is perhaps best considered in the context of the ongoing momentum for change arising out of the OECD's

Base Erosion and Profit Shifting (BEPS) project.¹

The paper is clearly seeking to bolster the case for continued and enhanced co-operation between tax authorities and to highlight an area where broad corrective action is required.

However, at the same time, the OECD paper is careful to note that it is up to each country to decide how to approach the issues addressed, including determining what responses would be appropriate in the context of its own tax rules and framework. There is perhaps a warning sign here in relation to BEPS and the extent to which proposed solutions will depend upon positive action from countries on a broad basis.

The paper focuses heavily on the aggressive tax planning aspects of the topic but says very little about the more fundamental tax policy problems that arise when the taxation of, say, an asset is subject to different rules than those that apply to a corresponding hedge. An opportunity to make a clearer policy recommendation to avoid asymmetries in the tax treatment of asset and hedge has therefore been missed.

The paper also struggles – perhaps inevitably given the nature of the topic – to identify criteria that distinguish perfectly acceptable after-tax hedging (which the paper acknowledges clearly exists) from what is to be regarded as aggressive after-tax hedging, which is to be countered. In that regard, the paper does little more than refer to tests based on the facts and circumstances of the case, the commercial reasons underlying the transactions and the intent of the applicable domestic law.

Overall, the real significance of the paper seems derived from the ongoing BEPS project and the paper seeks to further bolster the case for enhanced co-operation between tax authorities in the specific context of this (difficult) topic, which is set out as representing a material threat to tax revenues.

1. See our *Tax memo* “OECD report on “base erosion and profit shifting” looks to action plan” at www.pwc.com/ca/taxmemo.

We can help

For more information on the significance of the OECD report and the issues it discusses, contact your PwC adviser or any of the individuals listed below.

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1. Also a member of Canadian National Tax Services

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