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INSIGHTS

ISRAELI LAW CONFRONTS INTERNATIONAL TAX TREATIES AND PRINCIPLES VIA NEW TREATMENT OF MIXED-BENEFICIARY TRUSTS

B.E.P.S.

AND MORE B.E.P.S.

Insights Vol. 1 No. 9

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EDITORS' NOTE

This month's edition of *Insights* kicks off with an explanation of recent changes to the way personal trusts are taxed in Israel and then delves deeply into the world of B.E.P.S., following the first seven B.E.P.S. Action Reports, issued by the O.E.C.D. on September 16, 2014. Earlier editions of *Insights* addressed the O.E.C.D.'s ongoing initiative to combat base erosion and profit shifting. These are:

Vol. 1 No. 2: "The O.E.C.D. Announces Global Standard for Automatic Exchange of Information"

Vol. 1 No. 3: "O.E.C.D. Discussion Drafts Issued Regarding BEPS Action 2 – Neutralizing the Effects of Hybrid Mismatch Arrangements"

"The O.E.C.D.'S Approach to B.E.P.S. Concerns Raised by the Digital Economy"

Vol. 1 No. 7: "U.S.-Based Pushback on B.E.P.S."

This month's articles include:

- **Israeli Law Confronts International Tax Treaties and Principles Via New Treatment of Mixed-Beneficiary Trusts,** by Dr. Joshua Rosensweig and Revital Aviram, of Rosensweig Aviram & Co., Attorneys
- **Action Item 1: The O.E.C.D.'s Approach to the Tax Challenges of the Digital Economy.**
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We hope you enjoy this issue.

-The Editors

ISRAELI LAW CONFRONTS INTERNATIONAL TAX TREATIES AND PRINCIPLES VIA NEW TREATMENT OF MIXED-BENEFICIARY TRUSTS

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Tags
Estate Planning
Israel
Trusts

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HISTORY AND OVERVIEW OF ISRAELI TAXING MODELS IN RESPECT OF NON-ISRAELI TRUSTS[1]

Pre-2006 Situation – the Corporate Model

Israel has come a long way in its efforts to tax foreign-established trusts, which historically were assumed to have been used to shelter Israeli-source funds of high net worth Israeli residents and their families. Prior to the adoption of any relevant comprehensive Israeli tax legislation in 2006, the practice consisted mostly of viewing trusts and beneficiaries similarly to corporations and shareholders.

Thus, under customary Israeli international tax rules, if the "management and control" of the non-Israeli trust was effected outside of Israel, the trust was considered to be nonresident because the trust's assets were situated outside of Israel and the trustees had full discretion over their control. No formal powers were exercised directly or indirectly by Israeli beneficiaries. Hence, the trust was simply not subject to Israeli taxation. Moreover, discretionary distributions were viewed as tax-free gifts. In this way, wealthy Israelis could cause foreign trusts to be funded by Israeli-source wealth and invested outside Israel without subjecting the resulting income to Israeli tax.

Israel has neither an estate/inheritance tax[2] nor a gift tax, which means that *bona fide* gifts and inheritances are free of tax for both the donor or the decedent and the recipient. Thus, a foreign trust ostensibly became the perfect Israeli tax planning tool. Assets could be donated by an Israeli settlor to a foreign irrevocable discretionary trust for the benefit of family members. Legally, the assets were no longer owned by the Israeli donor but rather by a foreign body managed and

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1 Trust taxation in Israel is still a relatively new phenomenon, particularly in respect of the recent amendments to the legislation, which have entered into force only this year (2014). Consequently, this article reflects our views and opinions of the proper interpretation of Israeli legislation, practice, and case law as of October 15, 2014. We emphasize that most of the issues and topics discussed herein have not yet been exhaustively reviewed by the Israeli courts, tax authorities, or practitioners.

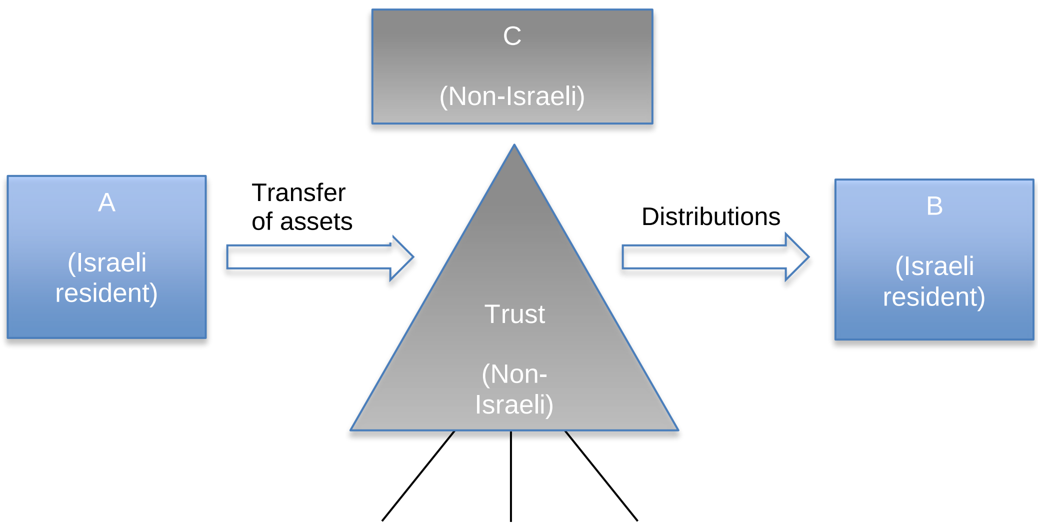
2 A rudimentary inheritance tax was repealed in 1980.

controlled by a foreign trustee. Therefore, the trust's non-Israeli assets and income were outside the scope of Israeli taxation. Distributions by these trusts to Israeli resident beneficiaries that were *bona fide* discretionary gifts were exempt in the hands of an Israeli recipient.

This perfect tax haven or shelter could, theoretically, be assailed only where the Israeli settlor or beneficiaries invaded the sanctity of the discretionary trust and exercised some form of management and control over the trust and its assets. In such cases, the Israeli Tax Authorities ("I.T.A.") could either (i) attempt to view the trust arrangement as a sham to be disregarded under appropriate doctrines or (ii) view the trust and any subsidiaries as Israeli tax residents by virtue of management and control emanating from Israel.

"The main thrust of the 2006 Legislation was to view the economic settlor – and not the trustee – as the person from whom the tax residence of the trust could be determined for Israeli tax purposes."

To summarize, the original trust taxation rules in Israel, based on the corporate model, emphasized the location of the effective place of management and control of the trust as the key to determining Israeli residence and taxation. In the customary Anglo-Saxon irrevocable discretionary trust scenario, the trustee is legally and formally possessed of ownership and control of the trust assets, and, if this structure was honored in practice, the scenario was effective. The following diagram may help to illustrate the situation:



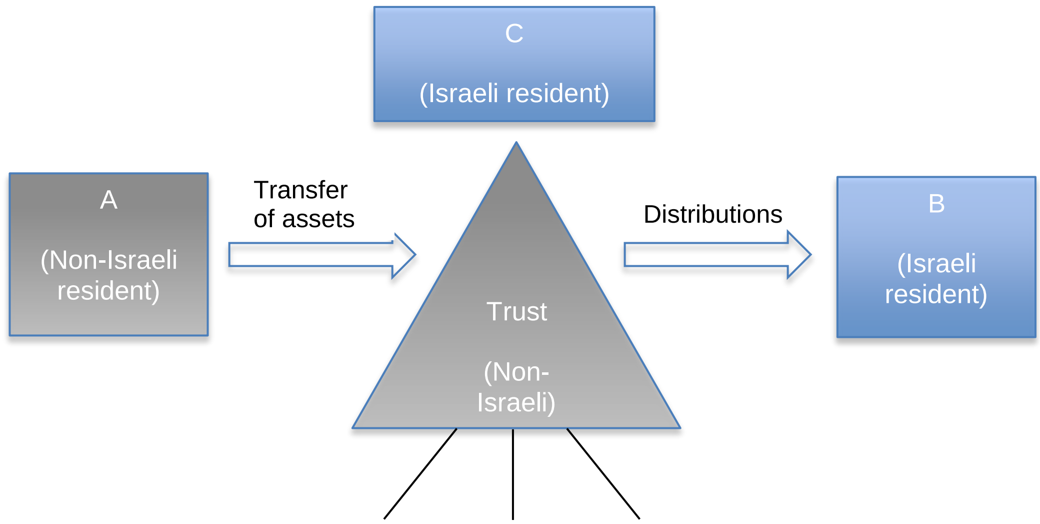
In the above diagram, the identity, status, operation, and actions of the trustee ("C") were the linchpin of non-Israeli residency and non-taxation. Neither the settlor's ("A's") transfer of funds to the trust nor the subsequent distributions of trust income or assets to the beneficiary ("B") were taxable.

<u>2006 Legislation – the Settlor Model</u>

In order to close this loophole, a new chapter was added to Israel's Income Tax Ordinance ("I.T.O.") which was devoted to the taxation of non-Israeli-established trusts. The legislation was effective as of January 1, 2006 (the "2006 Legislation"). The main thrust of the 2006 Legislation was to view the economic settlor – and not the trustee – as the person from whom the tax residence of the trust could be determined for Israeli tax purposes. An Israeli resident could be considered an economic settlor of a trust where he or she directly or indirectly transferred, controlled, or influenced the transfer or management of assets to or in the trust.

Where any of these acts occurred, the trust became a full Israeli tax resident.[3] The trust became taxable in Israel on a current basis in respect of its worldwide income, as is the case for any other Israeli tax resident.[4]

On the other hand, where the sole economic settlor or all of the economic settlors were nonresidents of Israel, the trust would be treated as a nonresident for Israeli tax purposes. Consequently, if the trust had no Israeli-source income, it was free of all Israeli tax and reporting obligations. Note that the identity and status of the trust's potential beneficiaries were irrelevant – the focus moved from the trustee to the economic settlor. The diagram below illustrates the change:



In the above diagram, the Trust is treated as a nonresident, since it takes the status of the economic settlor, A, rather than that of the discretionary trustee – who may now even be an Israeli tax resident. However, where the economic settlor is an Israeli tax resident, the entire Trust is an Israeli tax resident, even if the trust has several other economic settlors that are nonresidents with regard to Israel. Once the trust is treated as an Israeli resident, A's transfer of assets to the Trust is disregarded. Fundamentally, the Trust continues to be an extension of A, an Israeli resident.

Where A is Israeli, the trust is taxable on world-wide income. Either A or C is subject to tax reporting and payment obligations. Distributions to B by the Israeli resident trust remain nontaxable gifts (assuming a *bona fide* relationship between the Settlor/donor and recipient).

At the outset, the I.T.A. viewed the tax treatment of Israeli beneficiaries as fair and consistent with the overall Israeli tax treatment of gifts. On one hand, a non-Israeli trust that is set up economically by a non-Israeli person using non-Israeli assets

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3 This determination applied even in instances where the Israeli resident was only one of many such settlors.

4 In terms of the actual formal imposition of tax and accompanying reporting requirements, this was, in most cases, directed to either the settlor, or to the trustee.

and making distributions to Israeli beneficiaries should be subject to the same tax treatment as gifts made by a kindly non-Israeli uncle to his Israeli nephews and nieces. On the other hand, an Israeli resident settlor should not be able to escape Israeli tax on current income in respect of assets or activities simply by contributing the assets to a Jersey or BVI irrevocable discretionary trust. It was hoped that the broad definition given to the term "economic settlor" would be able to afford proper substance-over-form tax treatment, where the wealth of an Israeli resident found its way into a foreign trust, especially foreign trusts that were established for the benefit of Israeli beneficiaries.[5]

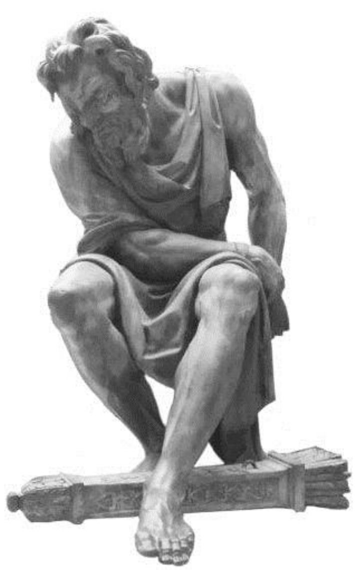
As mentioned above, the status and identity of the beneficiaries were basically overlooked or viewed as irrelevant within the context of the 2006 Legislation. Thus, a foreign trust settled by a non-Israeli person remained a non-Israeli resident forever, regardless of the residency status of the beneficiaries or the death of the non-Israeli settlor. Theoretically, the trustees could continue investing, accruing, receiving and distributing income to Israeli beneficiaries on a tax-free basis in Israel for as long as the relevant rule against perpetuities allowed.

I.T.A. Disillusionment with the 2006 Legislation and the Settlor Model

In the fiscal discussions leading up to 2014, it became clear that a radical change of perspective regarding the 2006 Legislation occurred within the I.T.A. The tax residence of the settlement itself and the settlor of the trust were viewed to be of less importance as a matter of policy. This shift in perspective was triggered by an overriding concern of the I.T.A. that the 2006 Legislation was being used to perpetrate massive tax fraud against the Israeli Treasury.

Tax Policy Considerations

The policy question was directed at the static status of the trust that remained unchanged even after the death of the settlor. If after the conclusion of the lifetime of the non-Israeli settlor, the Israeli beneficiaries are virtually assured of receiving the trust assets at some point in the future, the I.T.A. adopted a view that Israeli-resident beneficiaries are afforded the benefit of an endless tax shelter. Israeli beneficiaries would have a current income exemption at the trust level and unlimited deferral if the trust accumulated its income and gains. Under the new view, upon the demise of the original non-Israeli settlors, the Israeli resident beneficiaries are treated as the new persons-of-record for purposes of determining the Israeli tax status and residency of the trust.



Tax Evasion Considerations

The I.T.A. became convinced that wealthy Israelis were surreptitiously funding foreign settled trusts, treated in perpetuity as nonresident, while Israeli beneficiaries benefitted from unlimited deferral. Moreover, perceived widespread use of this tax evasion opportunity was viewed to be too difficult for the I.T.A. to effectively control through tax examinations. The I.T.A. concluded that the existence of even one

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5 Special provisions were made for trusts exclusively directed to benefit foreign beneficiaries and for "testamentary trusts." A full discussion of these provisions is outside the scope of this article.

Israeli beneficiary – however marginal – in a foreign trust is a *prima facie* reason to view the entire trust as an Israeli tax resident, with full taxpaying and reporting responsibilities. This gave birth to I.T.O. Amendment No. 197 earlier this year (the "2014 Legislation") which introduced the beneficiary model for purposes of determining residence.

2014 Legislation – the Beneficiary Model

The 2014 Legislation passed the Israeli Knesset on August 2, 2013, and most of its provisions became applicable as of January 1, 2014. The basic motif of the 2014 Legislation is as follows:

1. The legislation applies to all trusts, even those set up prior to its enactment.

2. Trusts that extended beyond the lifetime of a nonresident settlor would be treated as Israeli tax resident trusts subject to full Israeli tax on worldwide income if one or more of the beneficiaries are tax resident in Israel.

3. In order to be a foreign resident trust ("F.R.T.") during the lifetime of a non-Israeli settlor, all settlors and all beneficiaries from inception must be non-Israeli persons. If one Israeli resident beneficiary exists, the trust becomes either a conventional Israeli resident trust, or an Israeli Beneficiary Trust ("I.B.T.") as discussed below.

4. The 2014 Legislation introduces the newly-created mezzanine category of trust, the I.B.T., with a subcategory referred to as the Relatives Trust ("R.T."). An I.B.T. is a trust in which all settlors are non-Israeli but at least one beneficiary is an Israeli resident. An R.T. is an I.B.T. where there is an "adequate" first-degree family connection between all non-Israeli settlors and *all* of the Israeli resident beneficiaries. A connection is adequate, *inter alia*, if the relationship is that of:

    a. Parent-child;

    b. Grandparent-grandchild;

    c. Siblings and spouses of the foregoing persons, if approved as *bona fide* by the Assessing Officer;

    d. Nephew-Uncle, if approved as *bona fide* by the Assessing Officer.[6]

5. There are two alternatives set out in the 2014 Legislation regarding R.T. taxation.

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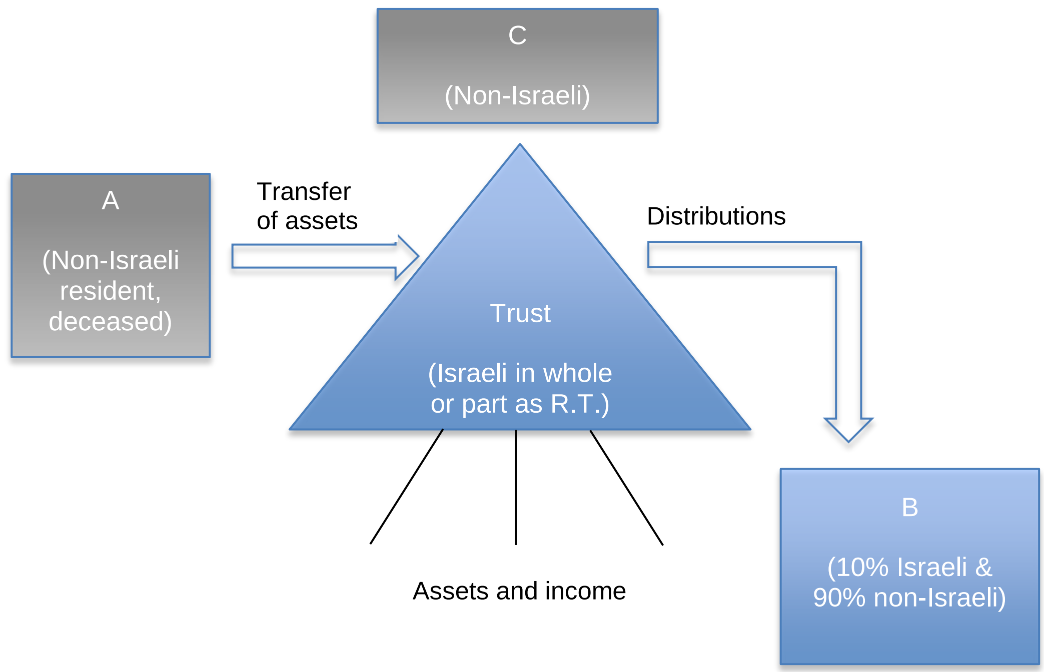
[6] Both "sibling" and "nephew-uncle" connections were drafted in the 2014 Legislation with language preventing these connections from being considered if the Assessing Officer determines that the arrangement was purchased with consideration, created for inappropriate purposes, and/or is deemed artificial. The fact that this provision is applicable to first-degree siblings may be evidence of the extreme anti-avoidance concern of the I.T.A.

a. The default option provides that, in the absence of a distribution to an Israeli resident, the R.T. is not a taxpayer in Israel in respect of its assets and activities, to the extent these are not carried on, situated, or sourced in Israel. When a distribution is made by the R.T. to an Israeli resident, this distribution is taxable in Israel at a flat tax rate of 30%, except to the extent it is attributable to the Israeli resident beneficiary's portion of the original capital contribution.[7]

As an alternative, the trustee may elect current income taxation, in which case Israeli tax is imposed at the trust level on the Israeli beneficiary's theoretical portion of undistributed trust income. The rate of tax under this option is 25%. A subsequent distribution of previously taxed income to the Israeli beneficiary can be made on a tax-free basis to the Israeli resident.

6. The new regime of beneficiary-based taxation can be illustrated as follows:



In the example, a trust is settled by nonresidents with non-Israeli assets. The trustee is a nonresident trustee. The trust is liable to Israeli tax on worldwide income as an Israeli tax resident if there is at least one Israeli beneficiary and either

[7] The Israeli resident beneficiary's portion of the original capital contribution consists of assets contributed to the trust that would have been exempt from tax transferred or gifted directly from the settlor to the beneficiary by virtue of the classification of the transfer as a *bona fide* gift. Note that the law "orders" the distributions so that available noncapital value is always treated as distributed prior that attributable to capital contributions.

(i) the settlor[8] is deceased or (ii) the degree of family connection between the settlor and the Israeli beneficiary is less than an approved first-degree connection, even if the foreign settlor is still living. In such case, the 90% non-Israeli beneficiaries in our example become bear 90% of the economic burden arising from the imposition of full Israeli tax on all income of the trust.

In the one narrow case where (i) the settlor is alive and (ii) the family relationship between the foreign settlor or all foreign settlors and all Israeli beneficiaries is “first-degree” the Trust may still face Israeli taxation imposed at the rate of 25% on each Israeli beneficiary’s theoretical portion of its income. Alternatively, the Israeli beneficiary may pay 30% Israeli tax on distributions actually received. In this case – and only in this case – are the nonresident beneficiaries not subject to Israeli taxation (although the tax reporting costs to the trust may be onerous as well).

CRITIQUE OF ISRAEL’S TRUST TAXATION SYSTEM AFTER THE 2014 LEGISLATION

Putting aside the I.T.A.’s concerns regarding tax avoidance and abuse issues, it is fairly easy to criticize the result of the 2014 Legislation as it applies to existing foreign settled trusts with marginal Israeli beneficiaries or any mixed-beneficiary group.

Lack of Grandfathering

These existing foreign trusts were foreign residents with no reporting or taxpaying obligations in Israel until December 31, 2013. In one fell swoop they became full Israeli tax residents subject to full taxation and reporting. This appears blatantly unfair.

Such trusts, set up or modified to fit the criteria of the 2006 Legislation, were given no advanced warning that having mixed beneficiaries would disqualify purely foreign entities and turn them into 100% Israeli taxpayers. It seems clear that had the Settlors known this, they would never have agreed to include Israeli-resident beneficiaries along with foreign residents in the same discretionary trust; unfortunately, it may be ineffective or impossible to amend or change the class of beneficiaries at this time, especially after the demise of the settlors.

Faulty Logic – Lack of Sufficient Nexus for Full Residency Taxation

It seems doubtful that currently accepted international tax logic could support the proposition that a trust should be treated as an Israeli resident, where the *only connection* to Israel is the residency of, say, *one out of ten* beneficiaries and *all* of the settlors, trust assets, trust income, and trustees are non-Israelis. In our view, this connection, which exposes the trust and its non-Israeli beneficiaries are exposed to full rates of Israeli taxation on worldwide income, is tenuous at best, in many cases accidental, and certainly trivial.

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[8] An exception is made where the settlor’s spouse remains alive, for as long as he/she are still living.

The international tax world operates within a certain logical framework, whereby tax liability should only be claimed where sufficient nexus exists. By comparison, larger and more substantive connections to Israel are not subjected to comparable adverse tax treatment. For example, investments by foreign persons in Israeli businesses which pay dividends or interest are subject only to limited Israeli withholding taxes, and certainly do not cause the investors to become Israeli residents. Yet, under the 2014 Legislation, foreign persons who never invested in Israeli assets may wake up one fine morning and discover that a significant portion of their non-Israeli wealth, held in a non-Israeli trust, is now essentially treated as subject to full Israeli taxation, as if the assets were held by an Israeli resident!

TAX TREATY RAMIFICATIONS

The faulty logic we referred to in the previous section appears to surface immediately when the new Israeli rules confront tax treaty provisions.

Assume that a U.S. family sets up a U.S. discretionary trust to benefit various relatives. Further, the U.S. trust is categorized as a complex trust that can accumulate income. Assume all the income of the trust is U.S. domestic source income. Finally, assume that all substantial trust decisions are controlled by U.S. persons and that a court in the U.S. has primary jurisdiction in reviewing trust administration. The trust reports to the I.R.S. under its own tax identification number and pays U.S. tax on its undistributed income, all of which is earned on its exclusively U.S. assets. Then suppose that one fine morning, following the demise of the two original U.S. resident settlors, one of the ten beneficiaries takes up residence in Israel.[9] Until that event, Israeli taxation of the Trust was unthinkable. Now, with the commencement of residency of one impulsive beneficiary, the entire trust may become an Israeli tax resident in respect of its worldwide income and assets.

When Israel's residency claim confronts the provisions of the U.S.-Israel Income Tax Treaty ("U.S.I.T.T."), it appears that the new 2014 Legislation must give way. Article 3(1)(b) of the U.S.I.T.T. defines a U.S. resident as including a "trust, only to the extent that the income derived by such…[a] trust is subject to U.S. tax as the income of a resident, either in the hands of the respective entity or of its partners or beneficiaries." Article 3(1)(a) contains the mirror image definition for an Israeli resident. However, Article 3(3) of the U.S.I.T.T., which deals with conflicts of residency for persons other than individuals, provides that if both Israel and the U.S. respectively determine the trust to be a resident, the competent authorities of the two countries will endeavor to settle the question by mutual agreement.[10]

"When Israel's residency claim confronts the provisions of the U.S.-Israel Income Tax Treaty ('U.S.I.T.T.'), it appears that the new 2014 Legislation must give way."

In our example, the trust is treated as a U.S. taxpayer in the U.S. because it meets the control and court tests required to a U.S. domestic trust. In addition, its assets

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9 The word "return" is inserted in this scenario for purposes of maintaining the purity of the example, in order to negate the extraneous effect of Israel's immigrant tax holiday provisions, which are irrelevant to our discussions here.

10 Note that in its original text, the U.S.I.T.T. simply excluded dual-resident companies from the treaty provisions, but clearly this is not a perfect or even preferred response to such conflicts.

are U.S.-situs, and its income is U.S.-source. At the same time, Israel claims that the entire trust is an Israeli tax resident because one out of ten beneficiaries moved to Israel.

In our view, there is no doubt what the result will be in the course of a mutual agreement procedure – the trust will be a U.S. resident. In principle, the I.T.A. should be comfortable with the result as the tax avoidance motivating the 2014 Legislation is missing. No offshore jurisdiction is involved and the trust or beneficiaries receiving distributions are fully taxed in the U.S.

Article 6(1) of the U.S.I.T.T. provides that the Trust, as a resident of the U.S., is exempt from any Israeli tax on its income, unless sourced in Israel. Thus, Article 6(1) precludes taxation imposed by Israel on the Trust's non-Israeli-source income. Of course, Israeli law provides that tax treaty provisions shall be applied notwithstanding local Israeli law and legislation.[11] Thus, in this example, the treaty effectively overrides the new Israeli legislative attempt to tax foreign trusts based on marginal or mixed Israeli beneficiary representation.

"In the offshore world where tax treaties are not customary, the trust may find that there is no escaping Israeli tax where one beneficiary is an Israeli resident."

Although it may appear anomalous, it is possible to argue that the U.S.I.T.T. leaves Israel the right to tax distributions made to Israeli residents by an R.T. This result may be rejected under the theory that 30% Israeli taxation on a distribution is clearly directed at the beneficiary's portion of the Trust's global, non-Israeli income. As such, in substance, Israeli taxation should also be precluded due to the treaty determination of the Trust's U.S. residency. Moreover, the beneficiary is viewed, from the U.S. point of view, as receiving distributions of previously-taxed U.S. income; thus, at minimum, it is arguable that Israel would have to afford the Israeli beneficiary a full U.S. tax credit in respect of U.S. taxes levied on the Trust income now being distributed, which may not leave much, if anything for Israel to assess.

Although the above is only one example based on the U.S.I.T.T., other cases may carry similar results under different facts and diverse tax treaties. As always, the specific factual background and relevant treaty would have to be examined and analyzed.

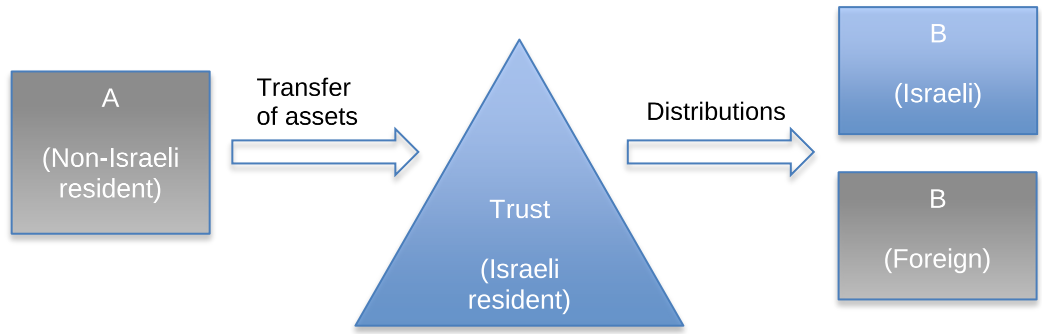
TAX PLANNING IN THE ABSENCE OF TREATIES

The previous example illustrates how the new Israeli legislation regarding foreign-settled mixed-beneficiary trusts may constitute legislative overreach when compared to customary international tax treaty principles. In such cases, it is reasonable to expect the legislation to give way before treaty provisions. Where, however, trusts operate in the offshore world where tax treaties are not customary, the trust may find that there is no escaping Israeli tax where one beneficiary is an Israeli resident. In these circumstances, certain planning alternatives may be worthy of consideration. However, the 2014 Legislation is too recent for tested plans to exist. A brief overview of several alternatives being discussed among tax lawyers are discussed below.

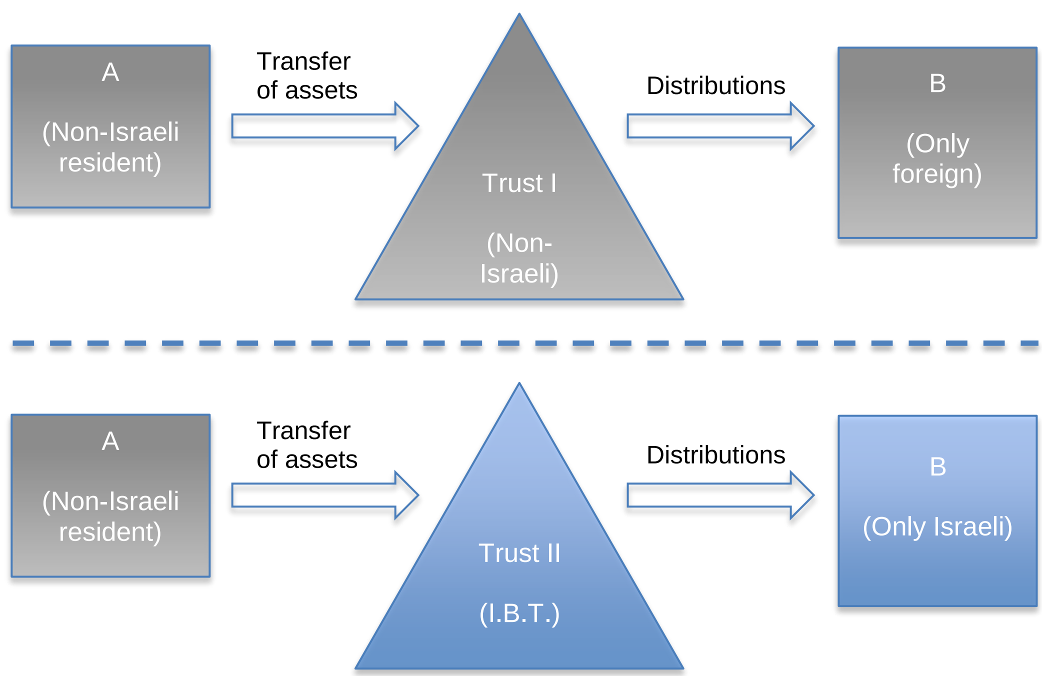
[11] I.T.O. §196.

1. *Bifurcation of Trusts* – It is often possible to avoid mixed classes of beneficiaries within existing trust deed provisions, without revoking the Trust.

Original Position



Post-Bifurcation Position[12]



The intended effect of the bifurcation is to ring fence Israeli tax to assets and income that are intended to benefit Israeli resident beneficiaries.

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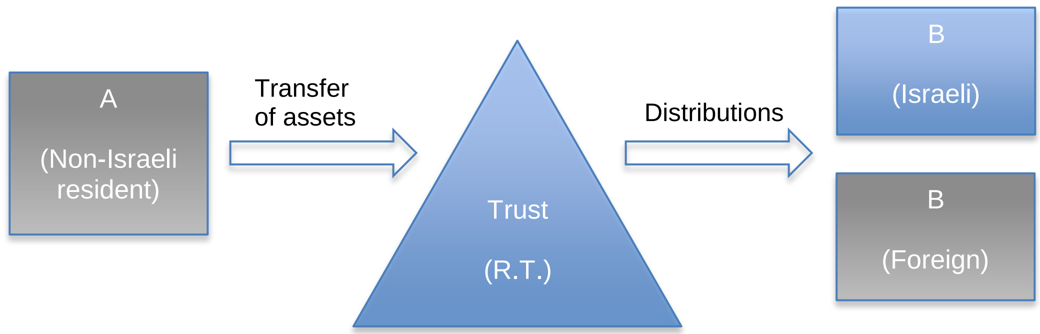
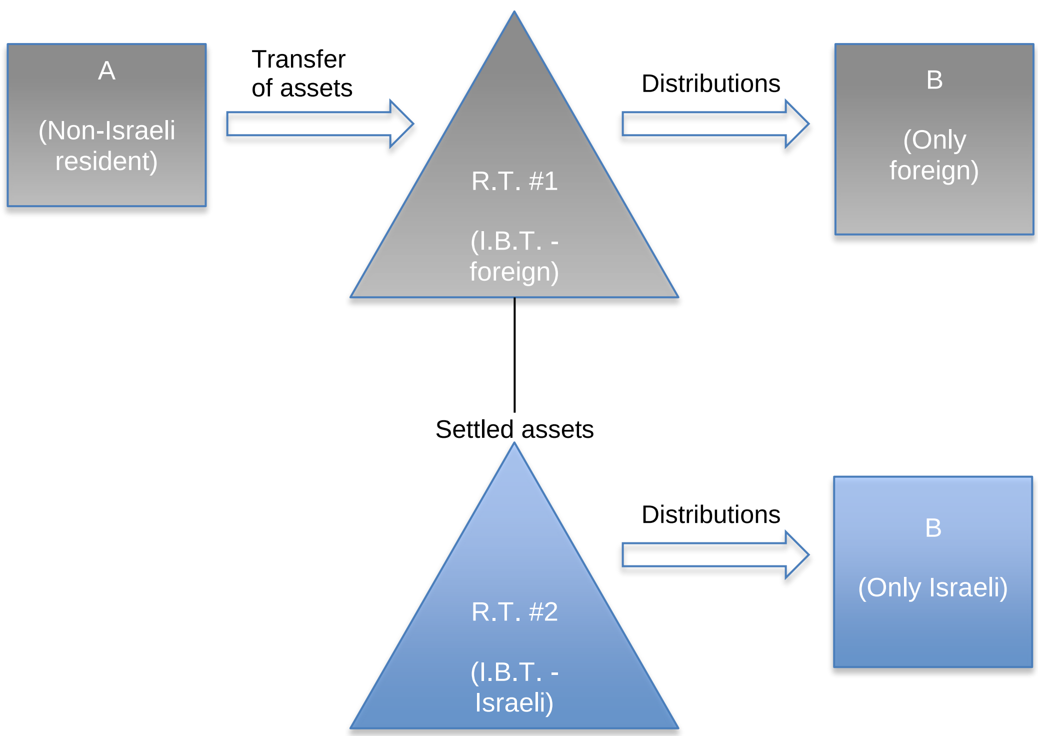
12 Trust II may also be a "R.T.," which is a subcategory of an I.B.T. See earlier discussion in 2014 Legislation – the Beneficiary Model.

2. *Creation of Separate Sub-Trusts* – Assets intended for individual Israeli beneficiaries of an R.T. are placed in a subsidiary trust, while such beneficiaries are excluded from the parent-trust, thus avoiding onerous Israeli tax consequences for foreign beneficiaries of the parent trust.

Original Position



Post Sub-Trust Position



In this manner, the I.T.A. will have cause to deal only with R.T. #2 in regard to reporting and taxpaying obligations. Only R.T. #2 has Israeli beneficiaries that may receive taxable distributions.

3. *Discretionary Ordered Distributions in an R.T.* – With proper timing and payments to beneficiaries, ordered distributions may prevent the spill-over from what should be foreign non-taxable income to local Israeli-taxable income. Details are intricate.

> “The zig-zag of reference points that control tax residence from a focus on the trustee to a focus on the settlor to a focus on Israeli beneficiaries – has created an unsettling and unsatisfactory regime.”

CONCLUSION

Legislative overreach in the tax area simply doesn’t work. In Israel, it usually creates a disorganized situation which encourages the I.T.A. to grant private extra-legal concessions in order to avoid the collection of tax in unjustified situations. However, this undermines the rule of law and creates confusion by virtue of the simultaneous existence of two tracks.

The history of Israel’s search for an answer to trust taxation – the zig-zag of reference points that control tax residence from a focus on the trustee to a focus on the settlor to a focus on Israeli beneficiaries – has created an unsettling and unsatisfactory regime, which we believe will not hold up against customary, international double-tax avoidance arrangements and principles.

On the other hand, legislation that is thought-through to reach a fair result for Israeli resident beneficiaries, nonresident beneficiaries and the Treasury is both easier for the taxpayer to accept and easier for the regulator and administrator to maintain. Our feeling is that Israel’s trust taxation rules are still in the process of formation. The 2014 Legislation is a midway point in the process and not the endpoint. Until legislation reaches a state of international tax equilibrium, taxpayers would be wise to proceed with caution – and with good advice.

ACTION ITEM 1:
THE O.E.C.D.'S APPROACH TO THE TAX CHALLENGES OF THE DIGITAL ECONOMY

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Tags
B.E.P.S.
Digital Economy

The O.E.C.D.'s Action Plan adopted in Saint Petersburg in 2013 aims at tracking where economic activities generating taxable profits are performed and where value is created. It aims at ensuring that taxation follows the economic activities and the creation of value and not the other way around. Action Item 1 of the Action Plan (the "Action 1 Deliverable") focuses on the tax challenges of the digital economy. Along with the 2014 Deliverable on Action 15 (Developing a Multilateral Instrument to Modify Bilateral Tax Treaties), the Action 1 Deliverable is a final report.

The Action 1 Deliverable published on September 16, 2014 mainly reiterates the March 2014 Public Discussion Draft on Action 1 (click here to access our article on the 2014 Public Discussion Draft). It restates that, while B.E.P.S. is exacerbated in the digital economy space, the digital economy cannot be ring-fenced from other sectors of the economy for B.E.P.S. purposes because the digital economy is an ever growing portion of the entire economy. The Action 1 Deliverable thus refers to other Actions to address common B.E.P.S. issues that are not specific to the digital economy. Action Item 1 also refers to the O.E.C.D.'s International V.A.T./G.S.T. Guidelines with regard to V.A.T. issues raised by the digital economy. Although the Action 1 Deliverable adds relatively little to the previously published Public Discussion Draft on Action Item 1, the benefit of a set of uniformly accepted rules should not be understated. With European countries struggling to raise tax revenue in order to close budget gaps, the risk of adverse unilateral action by one or more countries is real. During a symposium held in Rome at the beginning of the month, certain European countries, and especially Italy, pushed for unilateral action with regard to the taxation of the digital economy.[13] If that action proceeds to enactment, digital tax chaos could be encountered.

Like the Public Discussion Draft, the Action 1 Deliverable gives an extensive explanation of the evolution of the digital economy, its key features, and the ensuing B.E.P.S. opportunities arising from the conduct of a digital business. It restates the previously identified traditional B.E.P.S. concerns relating to direct and indirect taxation. These include the avoidance of a taxable presence in the market place, the avoidance of withholding taxes through treaty-shopping, the minimization

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13 "Profiles of Fiscal Policy and Markets for Digital Services and E-Commerce," Rome, October 6, 2014.

of tax in intermediate countries, the minimization of tax in the ultimate parent's home jurisdiction, and cross-border acquisitions by purchasers that are exempt from V.A.T.

"The Action 1 Deliverable . . . emphasizes restoring taxation at the level of the market jurisdiction and the jurisdiction of the parent company."

The Action 1 Deliverable lays out how B.E.P.S. issues arising in the digital economy can be addressed. It emphasizes restoring taxation at the level of the market jurisdiction and the jurisdiction of the parent company, which is referred to as the restoration of taxation on stateless income. In an attempt to illustrate that no ring-fenced approach should be chosen, Action Item 1 refers to Action Items 2 through 10 of the B.E.P.S. Action Plan for solutions. Action Item 1 also raises B.E.P.S. issues with regard to consumption taxes and refers to the Guidelines 2 and 4 of the O.E.C.D.'s "Guidelines on place of taxation for business-to-business (B2B) supplies of services and intangibles."

Chapter 7 of the Action 1 Deliverable delves deeper into the challenges raised by the digital economy and isolates the following broad categories that constitute the main B.E.P.S. challenges:

- Nexus (reduced physical presence and related nexus issues),
- Data (characterization and attribution of value),
- Characterization of payments made, and
- Administrative challenges (identification by the taxing authorities of economic activities, extent of activities, collecting and verifying information regarding the offshore entity, difficulty of identifying the location of customers).

The Action 1 Deliverable lists the following potential options to address these tax challenges and points out that some of the solutions will apply to several overlapping challenges:

- <u>Modifications to the exemptions from permanent establishment ("P.E.") status.</u> This would entail re-assessing the exemptions from P.E. status contained in paragraph 4 of Article 5 of the O.E.C.D. Model Tax Convention in light of the evolution of the digital economy. Certain preparatory and auxiliary activities in the article constitute the core functions for certain digital businesses. Among the options under consideration are the elimination of the entire paragraph, the elimination of only certain subparagraphs, or the addition of a condition that the exemptions are only available when the activity conducted is preparatory and auxiliary in nature.
- <u>New nexus based on significant digital presence.</u> Business ventures engaged in "Fully dematerialized digital activities" would have a taxable nexus in another country if a "significant digital presence" is maintained in that country. Action Item 1 provides a list of elements that would determine whether an activity is a fully dematerialized digital activity. These include the dedication of the core business to digital goods or services, the fact that contracts are generally concluded remotely via the internet or the telephone, the prevalence of online payments, etc.

  Once engaged in a fully dematerialized activity, nexus in a specific jurisdiction would exist should the enterprise have a significant digital presence in that jurisdiction. For this purpose, a "significant digital presence" could be deemed to exist, *inter alia,* in one of the following scenarios: significant number of contracts signed with tax residents of a particular jurisdiction; wide use or consumption of digital goods or services in a particular jurisdiction; substantial payments made to the enterprise by clients located in a particular jurisdiction; the fact that a branch located in the other jurisdiction offers secondary functions that are strongly related to the core business of the enterprise with regard to clients of that other jurisdiction.

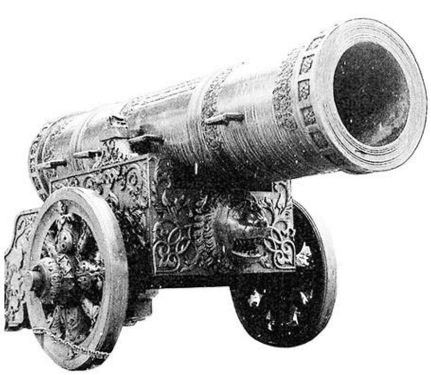
- <u>Replacement of the P.E. concept with a significant presence test.</u> This would include some level of physical presence and an ongoing relationship with a customer base in the country of physical presence.

- <u>Creation of a withholding tax on digital transactions.</u> The financial institutions involved with payments for goods or services would be required to withhold the tax, so as to avoid withholding of this tax by customers of the foreign digital goods and services provider.

- <u>Introduction of a "Bit" tax.</u> This tax would be based on bandwidth usage of a website. The number of bytes used by a website would be taken into consideration in calculating the tax, as would the turnover of the enterprise. The tax would be progressive and creditable against corporate income tax.

- <u>Several solutions with regard to consumption tax</u>.

In sum, the Action 1 Deliverable principally restates the previously published Public Discussion Draft on Action Item 1. The noticeable differences relate to length and the inclusion of examples of typical tax planning structures in the digital economy. It defers to other Deliverables when addressing the tax challenges of the digital economy.



ACTION ITEM 2: NEUTRALIZING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

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Tags
Double deductions
Dual Inclusion Income
Double Non-taxation
Hybrid Entities
Hybrid Instruments
Hybrid Mismatches
Imported Hybrid Mismatches

On the heels of the discussion drafts issued in March, the Organization for Economic Cooperation and Development ("O.E.C.D.") released the initial components of its plan to fight base erosion and profit shifting (the "B.E.P.S. Action Plan"). Action Item 2 addresses the effects of hybrid mismatch arrangements and proposes plans to neutralize the tax deficits caused.

These responses aim to tackle the following issues created by the hybrid mismatch arrangements:[14]

- Reduction in overall tax revenue,
- Unfair advantage given to multinational taxpayers with access to sophisticated tax-planning expertise, and
- Increased expense often incurred in setting up hybrid arrangements compared to domestic structures.

This article introduces the different hybrid arrangements, looks at the proposed changes in both domestic law and international tax treaties, and discusses the ripple effect this could have if implemented.

INTRODUCTION

A hybrid mismatch arrangement is one that exploits a difference in the way an entity or instrument is taxed under different jurisdictions to yield a mismatch in total tax liability incurred by the parties.[15] The two possible mismatches that could result are either a "double deduction" ("DD") or a deduction that is not offset in any jurisdiction by ordinary income ("D/NI"). These mismatches are brought about by the different interpretations afforded to the entities and transactions in relevant

[14] IFA, "Hybrid Mismatch Arrangements," February 21, 2013, http://www.ifausa.org/dman/Document.phx?cmd=download&documentId=se05413101027678.

[15] OECD (2014), Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing. *http://dx.doi.org/10.1787/9789264218819-en*, pg. 29, #41.

jurisdictions. The root cause of the hybrid mismatch is that an entity may be a "hybrid entity" and an instrument may be a "hybrid instrument." Understanding the different hybrid arrangements is instrumental to understanding the plan proposed by the O.E.C.D.

Hybrid Financial Instruments

A hybrid financial instrument is an instrument that can be construed as either a debt instrument or a class of equity such as preferred shares, depending on the rules in force in a country. The transaction using the instrument involves two or more countries having different rules in effect, and the terms of the instrument are sufficient to bring about such a mismatch in tax outcomes.[16]

The most common example of this is a debt/equity instrument: a loan from an entity ("A") in Country A to an entity ("B") in Country B where A treats the instrument as equity and B treats it as debt:

- B is granted a deduction on interest payments because the loan is treated as debt.

- A isn't taxed or offered tax relief such as an exemption or an indirect foreign credit – meaning that taxes paid by the borrower in Country B may offset tax owed by A on the receipt of income from countries outside A – in connection with the interest received from B. This presumes that A is a 10% or greater shareholder of B.

Determining whether an instrument is debt or equity can have a significant impact on tax consequences for the borrower and the lender. Well advised companies can negate home-country tax through the foreign taxes paid by subsidiaries when dividends from the subsidiaries are received. If the subsidiary can reduce its own tax with a deduction because the dividend is afforded interest treatment, a D/NI result is achieved. The U.S. has been dealing with tricky debt-equity cases for years; the three most exemplary cases being *PepsiCo* (2012),[17] *Dixie Dairies* (1980),[18] and *Monon Railroad* (1970):[19]

- The court in *Monon Railroad* held that an instrument constituted debt notwithstanding a long maturity term and contingent timing for interest payments.

- The *Dixie Dairies* case established a list of thirteen factors used to determine whether an instrument constitutes a debt or equity.[20]

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[16] Neutralising the Effects of Hybrid Mismatch Arrangements, p. 30.

[17] *Pepsico Puerto Rico, Inc. v. Commissioner*, T.C. Memo 2012-269.

[18] *Dixie Dairies Corp. v. Commr.*, 74 T.C. 476 (1980).

[19] *Monon Railroad v. Commr.*, 55 T.C. 345 (1970).

[20] See http://www.aicpa.org/Publications/TaxAdviser/2013/February/Pages/clinic-story-01.aspx?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed:+AICPA_TaxAdvisor+(AICPA+Tax+Adviser+Feed)?action=print.

- The *PepsiCo* case is the most recent case to deal with the issue. PepsiCo was a Dutch L.L.C. wholly owned by the PepsiCo Inc. in the U.S. PepsiCo Inc. wanted to treat the agreement between the two companies as debt in the Netherlands and equity in the U.S. for a double tax exemption. The court applied the *Dixie Dairies* factors to determine that the instrument should be treated as equity for U.S. federal income tax purposes.

Despite the fact that all thirteen *Dixie Dairies* factors were applied, two seemed to hold more weight than the others. The first was the degree of certainty regarding repayment of principal and payment of interest, as of the date of issue. As certainty wanes, the instrument begins to look more and more like equity. A second factor was whether the funds were used to acquire core capital assets of the business. If so, the advanced funds are characterized more as equity than debt. On the other hand, if the capital is used for day-to-day expenses, it would weigh towards debt.[21] Note that in all cases the U.S. acknowledges that no single factor is controlling and the importance of the two factors could be different if other circumstances were to exist.

This was also seen in *Hewlett-Packard* (2012),[22] a case involving a put option between a U.S. taxpayer and a foreign corporation. The put option was to all the shares of a Dutch entity in which the U.S. taxpayer was a minority shareholder and the foreign corporation held significantly more shares. The U.S. taxpayer was entitled to put the shares of the Dutch entity to the foreign corporation on specified dates in return for the fair market value on that date. The U.S. taxpayer held certain enforcement rights against the Dutch entity, presumably to force a redemption of its shares by the Dutch entity. The court held that the option instrument was, in substance, debt. According to the court, the key to this determination is primarily the taxpayer's actual intent, as revealed by the circumstances and conditions of the transaction.

Luxembourg offers two such hybrid planning options regarding instruments. One is the Convertible Preferred Equity Certificate ("C.P.E.C."), which is structured to be debt in Luxembourg but equity in the U.S. Another planning option is a profit participating loan which also has the same effect – it is treated as debt in Luxembourg and equity in the U.S.[23] Luxembourg's cooperation, or lack thereof, is what makes it difficult for the I.R.S. to fight the D/NI outcome. If Luxembourg were to decide that payments on these instruments are not deductible, the D/NI treatment would disappear. The lender would not enjoy the tax "kicker" that enhances interest income.

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21 Joe Dalton, "Has PepsiCo's US Tax Court win revealed 'super factor' in deciding debt vs equity cases?," *International Tax Review*, October 4, 2012, http://www.internationaltaxreview.com/Article/3098235/Has-PepsiCos-US-Tax-Court-win-revealed-super-factor-in-deciding-debt-vs-equity-cases.html.

22 Hewlett-Packard Company v. Commr., T.C. Memo 2012-135.

23 Jasper L. (Jack) Cummings, Jr. and Edward Tanenbaum, "Convertivble Preferre Equity Certificates," *Alston & Bird Tax Blog*, July 13, 2011, http://www.alstontax.com/convertible-preferred-equity-certificates/.

Action Item 2 aligns the treatment of cross-border payments so that they are treated as a financing expense by the issuer's jurisdiction and ordinary income in the jurisdiction of the holder.[24]

Hybrid Transfer

A hybrid transfer is a collateralized loan arrangement or a derivative transaction in which each of the counterparties are in different jurisdictions and each treats itself as the owner of the loan collateral.[25]

This is clearly seen in sale and repurchase arrangements: A sells its shares in B2 to B with an agreement to repurchase later down the line. A treats the transaction as a collateralized borrowing and any dividends paid to B are treated by A as an interest cost. B treats the transaction as the purchase of participation. Consequently, the dividends B receives from B2 are exempt. A D/NI result is achieved as A's deduction is not matched by the recognition of taxable income by B.

Action Item 2 proposes to neutralize the tax benefit through the following recommendation: Jurisdictions that relieve economic double taxation by offering a dividend exemption for amounts paid by a foreign payor should limit the benefit when the dividend is paid by a company resident in a foreign jurisdiction and is deductible for the payor in that other jurisdiction.

Hybrid Entity Payments

Hybrid entity payments create a D/NI situation where the entity is transparent in the payee jurisdiction but not under the laws of the payor jurisdiction.

An entity is transparent with regard to an income item or expense if the laws of a relevant country provide that the entity should be treated as an extension of its sole shareholder. To illustrate: A owns all the shares in B, an entity that is treated as a branch or an extension of A for purposes of Country A tax. In other words, it is a disregarded entity for tax purposes in Country A. In Country B, B is a taxpayer. A makes a loan to B and receives interest income.

For purposes of computing A's taxable income in Country A, the interest is disregarded – A cannot pay interest to itself.

For purposes of computing B's taxable income in Country B, the interest is recognized as an item of income and expense for tax purposes. The interest payment is deductible. Implicit in this example is the absence of an obligation imposed on B under the laws of Country B to collect withholding tax on the interest payment. Either Country B's domestic law does not provide for withholding tax on interest or an income tax treaty between Country A and Country B exempts the interest income of A from tax in Country B.

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[24] OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, p. 31.
[25] OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, p. 34.

Action Item 2 proposes to neutralize the tax benefit of the foregoing mismatches through the adoption of a linking rule that would seek to align the tax outcomes for the payor and the recipient under a financial instrument. The primary response would be to deny the payor a deduction for payments made under the hybrid financial instrument. If a deduction is allowed in the payor's residence jurisdiction, the recipient's jurisdiction would treat the recipient as fully taxable income. The rule does not apply to payments that are fully taxable in both jurisdictions or to mismatches in the recognition of income and expense in the payor's and payee's jurisdictions of residence.

Reverse Hybrids

Reverse hybrid entity payments occur where the entity is transparent in the payee jurisdiction but not under the laws of jurisdictions relevant to the payor.[26] In other words, when looking from the subsidiary up to the shareholder/payee, the subsidiary is transparent in its resident jurisdiction (*i.e.*, it is viewed as a part of the shareholder/payee). However, in the payee's jurisdiction, the foreign subsidiary is opaque, meaning it is recognized as an entity that qualifies for benefits because of the payee's status as an owner.[27]

To illustrate: A is the shareholder/payee and B is the subsidiary/payor. B is transparent under the tax laws of Country B but opaque in Country A. B makes a loan to an unrelated entity ("C") and pays interest on the money borrowed:

- The payment is deductible for C under the laws of Country C.
- Owing to the way the loan is structured or booked, in country A, the loan is viewed as income of B.
- Also due to the way the loan is structured or booked, in country B, the loan is viewed as income of A.

Thus, neither Country A nor Country B treats the interest as income of a resident. Each set of laws attributes the income to a resident of another country.

The response recommended in Action Item 2 is to neutralize the effect of hybrid mismatches that arise under payments made to reverse hybrids through the adoption of a linking rule that denies a deduction for such payments to the extent they give rise to a D/NI outcome. The proposed adoption of an offshore investment regime for C.F.C.'s would call for taxation on a current basis of income accrued through offshore investment structures to occur in the shareholder's jurisdiction.[28]

"Action Item 2 proposes to neutralize the tax benefit of the foregoing mismatches through the adoption of a linking rule that would seek to align the tax outcomes for the payor and the recipient under a financial instrument."

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26 OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, p. 45.

27 See http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2001/0111c894.authcheckdam.pdf, p. 3.

28 OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, p. 47.

Indirect Hybrid Mismatches
Hybrid mismatches can be imported into a jurisdiction of choice through the use of straightforward financial instruments such as loans.

To illustrate: An entity ("A") is a resident of Country A. It intends to make a loan to a related party ("C"), resident in Country C. Instead of making a direct loan to C, it lends money to its subsidiary ("B") pursuant to a hybrid instrument that is viewed to be debt under the tax laws of B's resident jurisdiction, but equity under the tax laws of Country A. B enters into a straightforward lending transaction with C. The ultimate result is a deduction for C and no offsetting of income to B – because of the back-to-back funding transaction with A, which is respected as debt – and no offsetting of income to A – because of the hybrid nature of the loan to B. In substance, the hybrid nature of a parent-subsidiary loan can be extended to a transaction with an unrelated party.

The response of Action Item 2 is to apply the hybrid mismatch rule discussed above in the jurisdiction of residence of C. Again, the effect of timing differences would be ignored. The rule would apply to situations in which all participants are related parties – A, B, and C are in the same group – and situations involving unrelated parties – A and B are related, but C is not – that are acting in concert pursuant to an overall arrangement.

PROPOSAL

To date, the provisions of U.S. tax law that deal with hybrid mismatch include Code §894, §909, and several income tax treaties that exclude income from hybrid transactions from treaty coverage. Code §894, when applicable, prevents taxpayers from taking advantage of withholding tax reductions through tax treaties when the claim for relief is made by the ultimate investor acting through the hybrid entity. It denies treaty benefits to the ultimate investor if the tax laws of its country of residence treat the hybrid entity as a recognized entity.[29] Section 909 'splitter' rules don't allow foreign credits without a corresponding income inclusion.[30] Paragraph 7 (a) of Article 4 (Residence) of the Canada-U.S. Income Tax Treaty extends the rule to business profits. Paragraph 3 of Article 4 Residence of the France-U.S. Income Tax Treaty ignores the hybrid nature of a third-country instrument used by a U.S. company if the third country has not concluded an agreement containing an exchange or information provision. However, none of these measures have been proven to be thorough enough, and therefore, the O.E.C.D. has put forward Action Item 2.

For a rule to effectively address the mismatches and tackle them head-on, it has to be comprehensive and automatic. However, it must also be coordinated enough to avoid a D/NI result, as well as double taxation on the same item of income. The

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[29] Jeffrey Rubinger, "Tax Planning for 'Inbound' Licensing of Intellectual Property," May 12, 2011, http://www.ttn-taxation.net/pdfs/Speeches_Miami_2011/01-JeffreyRubinger.pdf, slide 8.

[30] IFA, "Hybrid Mismatch Arrangements," February 21, 2013, http://www.ifausa.org/dman/Document.phx?cmd=download&documentId=se05413101027678, slide 32.

rule must be clear and workable in eliminating the mismatch. The planned response is two-pronged: changes to domestic law in member states and treaty applications.

"All cases of dual treaty residence would be solved on a case-by-case basis by the Competent Authorities, rather than on the basis of the current rule that is self-applied."

Domestic Law

Action Item 2 recommends adoption of a linking rule that aligns tax consequences for payors and payees under the hybrid arrangements. This rule has been discussed above and focuses on a two-step response:

- A more offensive, primary response that denies the deductions to the payors;

- And where the payor is in a jurisdiction that doesn't apply the primary rule, the payee jurisdiction should apply a defensive rule that would require the deductible payments to be included in ordinary income.

These mismatch rules would apply to related parties of structured arrangements.

O.E.C.D. Model Tax Convention

In addition to changes in domestic law, Action Item 2encourages countries to co-operate by sharing data and following the prescribed treatment for dealing with hybrids:

- Collaboratively determine the tax residency of the entity in question to properly determine the tax consequence.[31] This means that all cases of dual treaty residence would be solved on a case-by-case basis by the Competent Authorities, rather than on the basis of the current rule that is self-applied. In the absence of an agreement by the Competent Authorities, the entity would not be entitled to any relief or exemption from tax provided by treaty.

- The income of wholly- or partly-transparent entities would be considered to be income of a resident of a State only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.[32]

- Individuals and entities should be taxed appropriately.

Scope

The linking rule cannot be limitless and should not apply to transactions where the hybrid result is a coincidence. Therefore, the O.E.C.D. recommends applying the rule only to mismatches arising between related parties who may be acting in concert.

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31 OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, p. 81.
32 OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, p. 86.

A related party is a person who acts together with another person in respect of ownership, control, voting rights, or equity if he or she has an owning or controlling interest. In addition, family members, managing parties, and a person acting in accordance the wishes of another, are all treated as if they were acting together.

THE BALANCING ACT

By their very nature, hybrid mismatch arrangements are cross border transactions that manipulate facts in order to find ways to diminish the overall tax liability of the participants. The planned approach is an ambitious one; one that depends on the co-operation of other countries.

Action Item 2 basically requires one country to check another's decisions before imposing its own taxes. However, the procedures that are proposed under Action Item 13, related to intangible transfer pricing, may also be applicable to hybrid instruments. If all transactions are open to all tax authorities, the opportunity to "play" the system is reduced.

ACTION ITEM 5: COUNTERING HARMFUL TAX PRACTICES MORE EFFECTIVELY

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Tags
B.E.P.S.
Compulsory Spontaneous Exchange of Information
F.H.T.P.
Harmful Tax Competition
Harmful Tax Practices
Nexus Test
Qualified Expenditures
Transparency and Substance

The Organization for Economic Co-operation and Development ("O.E.C.D.") worked together with G20 countries[33] to develop a 15-point action plan to deal with Base Erosion and Profit Shifting ("B.E.P.S."). The goal of the B.E.P.S. Action Plan is to develop a single global standard for automatic exchange of information and stop corporations from shifting profits to jurisdictions with little or no tax in order to ensure taxation in the jurisdiction where profit-generating economic activities are performed and where value is created.

B.E.P.S. occurs in situations where different tax laws interact in a way that creates extremely low global tax rates or results in double non-taxation. This kind of planning gives a competitive advantage to multinational entities that have substantial budgets to engage high-powered tax advisers and to implement their plans.

The O.E.C.D. published deliverables that intend to eliminate double non-taxation resulting from B.E.P.S. The final measures will be completed in 2015 and will be implemented either through domestic law or the existing network of bilateral tax treaties.[34]

ACTION ITEM 5: HARMFUL TAX PRACTICE

Harmful Tax Competition: An Emerging Global Issue

In 1998, the O.E.C.D. published the report *Harmful Tax Competition: An Emerging Global Issue*[35] ("the 1998 Report") with the intention of developing methods to prevent harmful tax practices with respect to geographically mobile activities. These methods have been adopted in the Forum on Harmful Tax Practice ("F.H.T.P.") with some modifications. Significant attention is given to:

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33 The G20 countries are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States and the European Union.

34 O.E.C.D. Action 5: 2014 Deliverable.

35 O.E.C.D. (1998), Harmful Tax Competition: An Emerging Global Issue, O.E.C.D. Publishing. http://dx.doi.org/10.1787/9789264162945-en.

"In order for a regime to be considered preferential it must offer some form of tax preference in comparison with the general principles of taxation in the relevant country."

- Elaborating on a methodology to define a substantial activity requirement in the context of intangible regimes; and

- Improving transparency through compulsory spontaneous exchange on rulings related to preferential regimes.

<u>*Forum on Harmful Tax Practice*</u>

The 1998 Report describes three stages to determining whether a regime is harmful or provides preferential treatment:

- Consideration of whether a regime is within the scope of work of the F.H.T.P. and, if so, whether it is preferential;

- Consideration of the four "Key Factors" and eight "Other Factors" set out in the 1998 Report to determine whether a preferential regime is potentially harmful; and

- Consideration of the economic effects of a regime to determine whether a potentially harmful regime is actually harmful in practice.

In order for a regime to be considered preferential it must offer some form of tax preference in comparison with the general principles of taxation in the relevant country. The preferential regime may take a wide variety of forms, and even a small amount of preference is sufficient for the regime to be considered preferential.

To determine whether a preferential regime is potentially harmful, the F.H.T.P. uses four Key Factors and eight Other Factors set out by the 1998 Report.

Key Factors:

4. The regime imposes no or low effective tax rates on income from geographically mobile financial and service activities.

5. The regime is ring-fenced from the domestic economy.

6. The regime lacks transparency (*e.g.,* the details of the regime or its application are not apparent, or there is inadequate regulatory supervision or financial disclosure).

7. There is no effective exchange of information with respect to the regime.[36]

Other Factors:

8. An artificial definition of the tax base;

9. Failure to adhere to international transfer pricing principles;

10. Foreign source income exempt from taxation in the country of residence;

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[36] O.E.C.D. Action 5: 2014 Deliverable.

11. A negotiable tax rate or tax base;

12. The existence of secrecy provisions;

13. Access to a wide network of tax treaties;

14. The promotion of the regime as a tax minimization vehicle; and

15. The regime encourages operations or arrangements that are purely tax-driven and involve no substantial business activities.[37]

The presence of first factor is established once it is determined that the regime has a "no or low effective tax rate." This is a gateway criterion. It is evaluated based on the combined effective tax rate for both national and subnational taxes. Once this first criterion is met the regime will be considered *potentially harmful* based on an overall assessment of the other three Key Factors and, where relevant, the eight Other Factors. As the presence or absence of any one factor is not controlling, a tax regime may be characterized as potentially harmful if at least one of the Key Factors or Other Factors is met. By its nature, if a tax regime provides a preferential rate and is an attractive *entrepôt* in the context of a cross border transaction, it almost certainly will be viewed as potentially harmful.

Once the regime is considered *potentially harmful* it may still not be viewed as *actually harmful*. The following three questions are identified as helpful in assessing whether or not the regime is actually harmful:

- Does the tax regime shift activity from one country to the country providing the preferential tax regime, rather than generate significant new activity?

- Is the presence and level of activities in the host country commensurate with the amount of investment or income?

- Is the preferential regime the primary motivation for the location of an activity?

Once the preferential regime is found to be actually harmful, the relevant country is given an opportunity to abolish the regime or remove the features that create the harmful effect.

Action Item 5: Substantial Activity

Action Item 5 requires the F.H.T.P. to revamp the existing standard to concentrate on the existence or absence of substantial activity and improve transparency through mechanisms such as compulsory spontaneous exchanges on rulings related to preferential tax regimes. The framework for the substantial activity test was established by the 12 factors outlined in the 1998 Report. Its importance is now elevated.

The substantial activity test looks at whether a regime encourages purely tax-driven operations or arrangements. Action Item 5 observes that many harmful preferential

[37] O.E.C.D. Action 5: 2014 Deliverable.

tax regimes are designed to allow the taxpayers to derive benefits from those regimes while engaging in operations which are purely tax-driven and involve no substantial activities. The 1998 Report contains limited guidance on how to apply this factor.[38]

Substantial Activity Requirement

"The nexus approach focuses on the relationship between R&D activities actually carried out in a jurisdiction and preferential tax treatment …If the nexus test is met, both front-end and back-end tax regimes that incentivize innovative activities will not be categorized as actually harmful."

There is no clear definition of a "substantial activity requirement," but there is general agreement among the O.E.C.D. countries that it is an important factor in determining if a regime is potentially harmful. The substantial activity factor from the 1998 Report has been elevated under the Action Item 5 and is now considered with the four Key Factors in determining if a regime is potentially harmful.

The F.H.T.P., for the first time, focuses on regimes which provide preferential treatment for income arising from intellectual property ("I.P."). It is understood that I.P.-intensive industries are beneficial to a country, and therefore governments are free to grant incentives for research and development ("R&D") activities, but such incentives should be created within the scope of the principles agreed upon under the F.H.T.P. All intangible regimes in member countries are being reviewed simultaneously.

Application of Substantial Activity in the Context of Intangibles

Three different approaches were considered to define substantial activity in an I.P. regime. These approaches address value creation, transfer pricing, and nexus. Action Item 5 eliminates the first two approaches and concentrates solely on nexus. The nexus approach focuses on the relationship between R&D activities actually carried out in a jurisdiction and preferential tax treatment. This approach is designed to encourage R&D by only allowing tax benefit for taxpayers who are actually engaged in R&D activity. If a taxpayer outsources its R&D to an unrelated party, the taxpayer will continue to be entitled to the benefit of an I.P. regime. However, if R&D activity is assigned to a *related* party, the taxpayer will not be entitled to the benefit from an I.P. regime even if it funds the entire activity with its own capital.

If the nexus test is met, both front-end and back-end tax regimes that incentivize innovative activities will not be categorized as actually harmful. A front-end regime provides benefits when and as I.P. is created or developed. An example would be an allowance of more than 100% of development costs as funds are expended. A back-end regime would provide a preferential tax rate when and as developed I.P. is exploited. An example would be a preferential rate on royalty income.

Under the approach approved in Action Item 5, the portion of I.P. income that may benefit from an I.P. regime is based on the portion that qualified expenditures by the taxpayer bear to the overall expenditure for R&D activity. As a result, capital contributions or expenditures for substantial R&D activity by parties other than the taxpayer will disallow subsequent income from the benefits of an I.P. regime.

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[38] O.E.C.D. (1998), Harmful Tax Competition: An Emerging Global Issue, O.E.C.D. Publishing. http://dx.doi.org/10.1787/9789264162945-en.

This approach becomes complex when several entities bear a share of substantial R&D. Where that occurs, the ratio of qualifying expenditures of each entity to the total amount of expenditures is applied to the qualifying I.P. income generated from the R&D at the level of each entity. The formula is as follows:

$$\frac{\textbf{Qualifying expenditures incurred to develop I.P. asset}}{\textbf{Overall expenditures incurred to develop I.P. asset}} \times \textbf{Overall income from I.P. asset} = \textbf{Income receiving tax benefits}$$

Action Item 5 suggests that this calculation should be treated as a rebuttable presumption. The taxpayer can demonstrate that more income should receive a benefit than in the presumed calculation by showing a direct link between income that would benefit from the I.P. regime and qualifying expenditures. This may require a greater degree of recordkeeping on the part of the taxpayer. The circumstances under which the taxpayer can rebut the presumption are not yet defined, but further guidance is being developed.

Where the amount of income receiving benefits under an I.P. regime does not exceed the amount determined by the nexus approach, the regime has met the substantial activities requirement. Note that this analysis is conducted on a country-by-country basis and is applied to entities that are taxpayers in the jurisdiction providing the benefits. Consequently, a permanent establishment ("P.E.") maintained in a foreign jurisdiction cannot be taken into account by the head office of an entity unless the I.P. income of the P.E. is subject to tax in the jurisdiction of the head office. Also, expenditures of a P.E. that ceases to exist cannot be taken into account at the time I.P. revenue is generated.

Definitions

An exact definition of the term "qualified expenditures" is not provided under Action Item 5. Instead, each jurisdiction will provide its own definition, which must meet certain requirements to be deemed acceptable. The definition must be limited to actual R&D activity and would exclude interest payments, building costs, acquisition costs, and other assets that do not have a direct connection to the I.P. assets. Suggested qualified expenditures include salary and wages, direct costs, overhead costs, cost of supplies, and, in some circumstances, depreciation.[39]

The term "overall expenditures" will be defined in such a way that if the qualifying taxpayer incurs all relevant expenditures itself, the ratio will allow 100% of the income from the I.P. asset to benefit from the preferential regime. This means that the taxpayer's overall expenditures must equal the sum of all qualifying expenditures. Any expenditure that would not be included as a qualifying expenditure, if incurred by the taxpayer, cannot be included in overall expenditures. This general rule is subject to several exceptions. I.P. acquisition costs, for example, are included in the overall expenditures, even though they are not considered qualifying expenditures at the level of the entity. Additionally,

[39] O.E.C.D. Action 5: 2004 Deliverable.

comparable treatment is given to acquisition costs and outsourcing costs. In each of these cases, the rationale is that benefits under an I.P. regime should relate to all of the taxpayer's qualifying expenditures.

The term "overall income" will be defined by each jurisdiction according to its domestic laws. However, the definition must meet a standard under which income benefitting from a preferential regime is not disproportionately high in relation to the percentage of qualifying expenditures claimed by qualifying taxpayers. Under this standard, overall income means overall net income.

The goal is to exclude capital contributions or expenditures for substantial R&D activity by parties other than the taxpayer from the definition of a "qualified expenditure."

Outsourcing

Action Item 5 presumes that outsourcing to unrelated parties is not a significant problem. Thus, the nexus approach allows all qualifying expenditures for activities undertaken by unrelated parties to qualify even if the activities of the unrelated party were not carried out within the jurisdiction. Individual countries may further limit the definition of an unrelated party to universities, hospitals, R&D centers, and nonprofit entities.

Tracking Income and Expenditures

The nexus approach mandates that an I.P. regime must require taxpayers to track expenditures, I.P. assets, and income to ensure that only income related to R&D expenditures benefit from the preferential regime. While tracking may be relatively simple for a taxpayer that has only one I.P. asset, the task becomes more complex when more than one I.P. asset is owned. Action Item 5 cautions against manipulation of revenue streams to artificially provide benefits to income that is not overall income, in substance.

Grandfathering

Grandfathering of a harmful preferential regime will be permitted so long as the regime in question meets the following conditions:

- No new entrants are permitted;
- A definite date for complete abolition of the regime has been announced; and
- The regime is transparent and has effective procedures for exchange of information.

Presumably, the grandfathering provision found in Action Item 5 will apply to the winding down of so-called "double Irish" arrangements. Residency rules terminating these arrangements will take effect on January 1, 2015 with regard to new Irish companies. Existing companies will enjoy a grandfathering period until the end of 2020.

"Action Item 5 presumes that outsourcing to unrelated parties is not a significant problem. Thus, the nexus approach allows all qualifying expenditures for activities undertaken by unrelated parties."

Transparency through Compulsory Spontaneous Exchange

Lack of transparency is one of the key issues addressed under Action Item 5. Lack of transparency may arise as a consequence of the way in which a regime is deigned and administered. It may also arise from the existence of secrecy laws or other impediments regarding the effective exchange of information. To combat the lack of transparency, the F.H.T.P. is authorized to focus on developing a framework for the compulsory spontaneous exchange of information regarding rulings related to preferential regimes. This will introduce an obligation for an individual country to spontaneously exchange information that could be relevant to another country, even when the information has not been requested by the second country. In addition, the F.H.T.P. is authorized to prepare a report on preferential regimes for public dissemination – *viz.*, name and shame.

Application of Filters

The framework developed for compulsory spontaneous exchanges addresses four key design questions:

16. When does the obligation to spontaneously exchange information arise?

17. With whom must information be exchanged?

18. What information must be exchanged?

19. What is the legal basis for the spontaneous information exchange?

Other issues involve time limits, relevance of reciprocity, confidentiality, and feedback from the receiving country.

The framework for the compulsory spontaneous exchange of information contemplates the use of a mechanical filter methodology to reduce the level of discretion for spontaneous exchange. This means that a ruling would apply certain tests in which the answer is either yes or no. Only rulings that pass though the filter with all "yes" answers will be subject to compulsory spontaneous information exchange. Please see the annexed flow chart provided at the end of the article for spontaneous information exchange on rulings related to preferential regimes.

The tests in the mechanical filter ask the following questions:

20. Is the regime within the scope of the F.H.T.P.'s work?

21. Is the regime a preferential regime?

22. Does the regime meet the "no and low effective tax rate" factor?

If the answer to all three questions is "yes," and the ruling is specific to a taxpayer or group of taxpayers, a spontaneous exchange of information is required if a taxpayer is entitled to rely on the ruling. Examples include an Advance Tax Ruling ("A.T.R.") and an Advance Pricing Agreement ("A.P.A.").

Procedures for the Exchange of Information

A two-step procedure is contemplated in Action Item 5. The first step involves a disclosure generated by the country granting the preferential tax ruling. The second step is a follow-up by the country receiving the information.

The automatic exchange in the first step will contain the following information:

- Identification of the taxpayers and the entities involved in the cross-border transaction;

- Details of the transaction and the period covered by the transaction; and

- If the ruling is in the form of an A.P.A., the transfer pricing methodology that was applied and the price that was agreed upon.

For rulings other than an A.P.A., an additional filter is created so as not to overly burden either country taking part. Non-A.P.A. rulings are divided into three categories:

- Inbound investment into the county in which the taxpayer has obtained the ruling;

- Outbound investment from that country; or

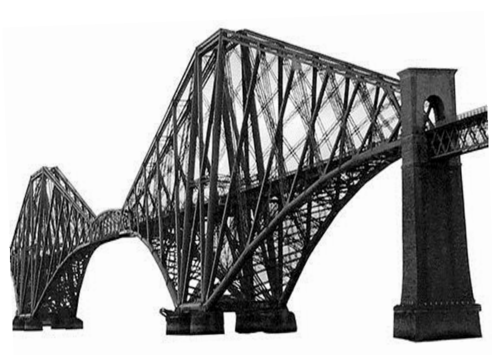
- Transactions or situations involving other countries.

The sending country will have discretion regarding how much information to share with the receiving country. The minimum that the sending country should provide is:

- The identity of the taxpayers and the accounting period covered by the ruling;

- A summary of the issues and income covered, preferably in English or any other language bilaterally agreed; and

- The tax administration's response and reasoning.[40]



Once the ruling is granted, it should be exchanged with all affected countries as soon as possible and not later than three months from the date the ruling became available. An appropriate system must be in place to provide the ruling to the appropriate authorities. Presumably, the taxpayer requesting the ruling will identify the affected countries.

Under the second step for compulsory spontaneous exchanges, the receiving country may request additional information related to the transaction. It is expected that feedback will improve spontaneous exchange of information procedures and may facilitate the identification of potential tax adjustments in the sending country.

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[40] Action 5.

Whether the country initiating the exchange will make the adjustment is an open question. Presumably, an adjustment will be made only if the facts provided by the taxpayer are not accurate and complete.

Confidentiality of the Information

Action Item 5 contemplates the necessity of legal protections for the information being exchanged. Countries that do not have appropriate domestic laws in place to protect the confidential tax information received will be expected to develop a legal framework for the protection of such information. All treaties and exchange of information instruments contain provisions for confidentiality and address the obligation to protect that information. International exchange of information instruments will prevail when the domestic law provides for a broader use of the exchanged information. It is contemplated that through continuous monitoring of exchanged information transparency procedures will continue to develop and improve.

In 2010, each member country of the F.H.T.P. was asked to respond to a survey of its preferential regimes. The self-evaluation was followed by extensive analysis and peer review. The F.H.T.P.'s work on preferential regimes in member and associate countries is an ongoing process that will continue beyond September 2014.

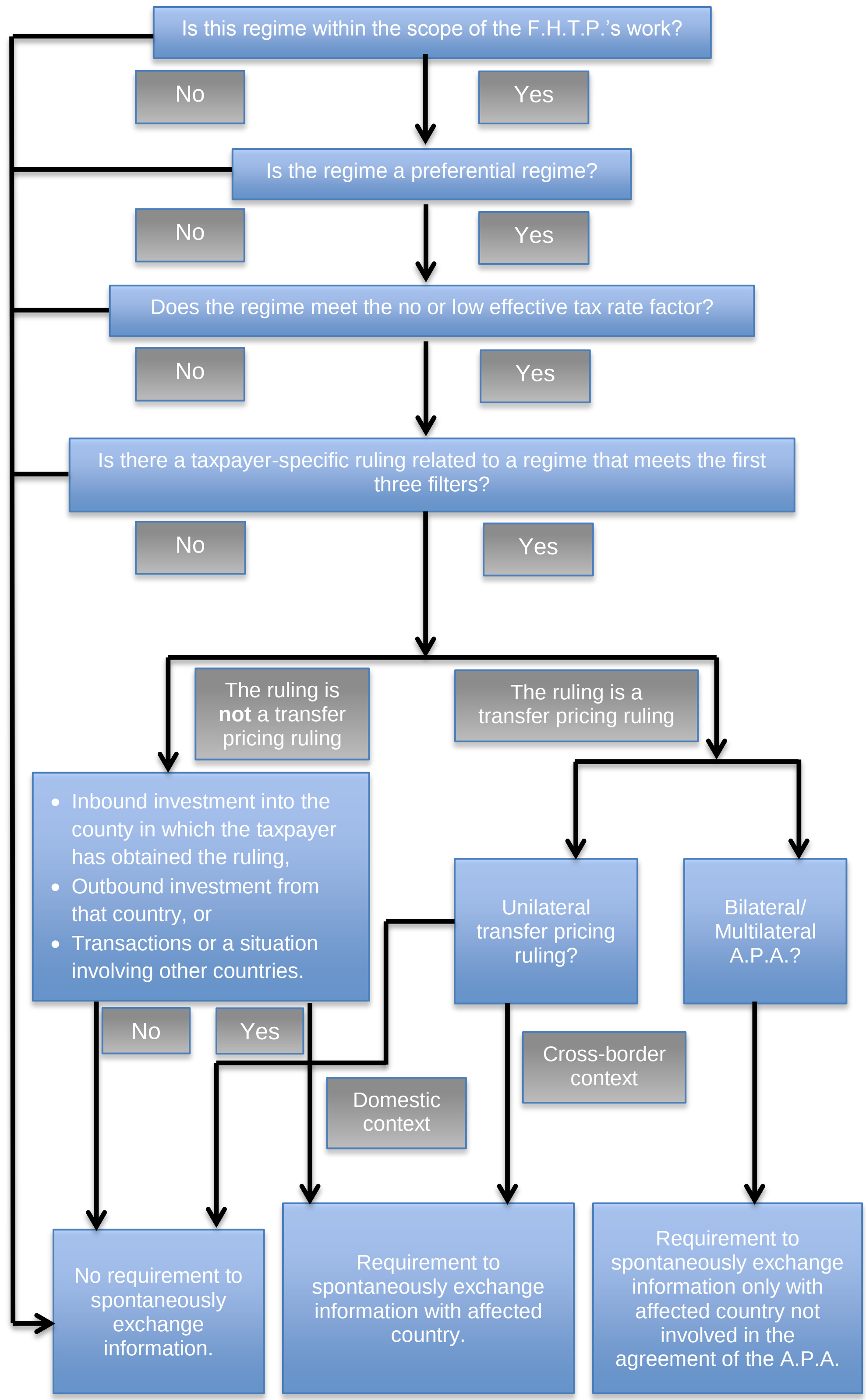
CONCLUSION

At this point, Action Item 5 is a work in progress – one clearly directed toward countries currently in the news, such as Luxembourg and Ireland. Eventually, countries that utilize double structures and substance officers will discover acceptable ways to comply with the O.E.C.D. system while only providing limited information in spontaneous exchanges. Alternatively, published guidance accompanied by proper caveats may also be considered, as well as a unification of tax rates and the elimination of withholding taxes in specified circumstances. At the same time, the F.H.T.P. will continue evaluating tax systems.

"The results the authors of Action Item 5 hope for are self-evident. However, as with many of the B.E.P.S. Action Items, questions remain regarding actual implementation and timing for compulsory spontaneous exchanges of information."

The results the authors of Action Item 5 hope for are self-evident. However, as with many of the B.E.P.S. Action Items, questions remain regarding actual implementation and timing for compulsory spontaneous exchanges of information.

Flow Chart: Spontaneous Information Exchange on Rulings Related to Preferential Treatments



ACTION ITEM 6:
ATTACKING TREATY SHOPPING

Authors
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Tags
B.E.P.S.
Double Non-taxation
GAAR
General Anti-Avoidance Rule
Limitation on Benefits
L.O.B.
P.P.T.
Principal Purpose Test
Treaty Abuse
Treaty Shopping

BACKGROUND

Action Item 6 addresses abuse of treaties, particularly focusing on treaty shopping as one of the most important sources of B.E.P.S. The approach adopted amends the O.E.C.D. Model Convention that borrows from the U.S.'s approach to treaties but expands upon it in a way that can be very helpful to the U.S. and other developed countries if adopted by the C.F.E. next year in their final report. Among other measures, the report recommends inclusion of a Limitation on Benefits ("L.O.B.") provision and a general anti-avoidance rule called the Principal Purpose Test ("P.P.T.") to be included in the O.E.C.D. Model Convention. While it is expected the report will be finalized next year, whether countries will adopt the recommendations is the crucial factor that is still unclear.

RECOMMENDATIONS

The key recommendations can be found in Paragraph 14. It contains two basic recommendations:

- Countries should agree to include in the tax treaties an express statement of the common intention to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance through use of treaties.

- Countries should demonstrate their commitment to this goal by adopting an L.O.B. provision and a P.P.T. provision in income tax treaties.

The report also notes that special rules may be needed to address application of these rules to collective investment funds ("C.I.F.'s"). The provision should be supplemented by a mechanism that would deal with conduit arrangements not currently dealt with in tax treaties.

Having established a goal, Paragraph 6 of Action Item 6 recognizes four constraints that may prevent full adoption of the recommendations in certain circumstances. This caveat will be helpful for a specific country that cannot fully adopt these measures. However, any exception that prevents wide acceptance of a recommendation may prevent the consistent approach needed to insure the success of the recommendations.

These four situations that may call for an exception are the following:

- Some countries have constitutional or E.U. law restrictions that prevent them from adopting the exact recommended wording.

- Some countries may have domestic anti-abuse rules that effectively prevent some of the treaty abuses described in the report. If those rules already address some of the issues in the report then treaty modification may not be needed. Nonetheless, a clear rule in an easily accessible treaty would be more helpful than having to explore the complexities of local law for guidance.

- The courts of some countries have developed judicial tools to combat these issues, such as an economic substance requirement and a substance over form doctrine, that effectively address these concerns. However, dealing with the local courts for relief is a major burden imposed on administrators.

- Limited administrative capacity of some countries might prevent implementation of a program involving detailed treaty rules. Instead, these countries might opt for more general anti-abuse provisions.

"The report recommends inclusion of a Limitation on Benefits ('L.O.B.') provision and a general anti-avoidance rule called the Principal Purpose Test ('P.P.T.')."

LIMITATION ON BENEFITS

The L.O.B. proposal recommends the adoption of a new Article X (Entitlement to Benefits) of the O.E.C.D. Model Convention. Paragraphs 1 through 6 of Article X address treaty shopping through a series of objective rules.

Paragraph 1 provides the general rule:

> Except as otherwise provided in this Article, a resident of a Contracting State shall not be entitled to a benefit that would otherwise be accorded by this Convention (other than a benefit under paragraph 3 of Article 4, paragraph 2 of Article 9 or Article 25), unless such resident is a "qualified person", as defined in paragraph 2, at the time that the benefit would be accorded.

Paragraphs 2 through 5 address when a resident is a "qualified person" and, alternatively, when a resident is entitled to benefits even though it is not a qualified person. The standard used is comparable to that which is applied in an L.O.B. provision of a typical U.S. income tax treaty. Thus, the following are considered to be qualified residents or to be entitled to certain treaty benefits even if not qualified:

- An individual who is a tax resident of a treaty country;

- The Contracting States that are parties to the convention and sub-national governments;

- A corporation having shares that are regularly traded on a recognized exchange (a "Publicly Traded Corporation") for the entire tax period in which a benefit is claimed, provided either that the exchange is in the treaty country in which the corporation is tax resident or the primary place of management and control is in that country;

- A corporation in which shares representing at least 50% of the voting power and value are owned, directly or indirectly, by five or fewer Publicly Traded Corporations;

- Certain not-for-profit entities and pension arrangements;

- An entity meeting the following tests: (i) shares in the entity representing at least 50% of the voting power and value are owned, directly or indirectly, on at least half the days of the taxable year by any of the above qualified residents other than a Publicly Traded Corporation or an entity it owns, and (ii) it is not a conduit of income through deductible payments to a related party resident in a third country;

    - A conduit relationship exists if at least 50% of the entity's gross income is paid or accrued directly or indirectly to residents in third countries. Relationships are identified at the time of payment. Arm's length payments, made in the ordinary course of business for services or tangible property, are not considered to be part of a conduit arrangement.

    - Regrettably, neither the recommendation nor the commentary defines arm's length for this purpose. This may lead to a dichotomy of treatment if arm's length is defined in one country by reference to ownership – *viz*, a sister corporation can never be at arm's length from a payor – or by the terms of the transaction – *viz*., a payment of interest to a sister corporation under a loan agreement that sets interest at LIBOR plus an appropriate mark-up based on the credit rating of the borrower is *prima facie* made at arm's length terms and conditions. Payments to a local permanent establishment of a related person are not base eroding when the permanent establishment is a full taxpayer in the jurisdiction where it operates.

- A resident of Contracting State that is engaged in the active conduct of a trade or business, but only to the extent that the income is derived in connection with that business or is incidental to that business;

    - An entity generally will be considered to be engaged in the active conduct of a business only if persons through whom the entity is acting, such as officers or employees of a company conduct substantial managerial and operational activities.

    - There is no recognition given for the attribution to a holding company of active operations from an operating company.

    - The business of the person claiming the benefit must be substantial in relation to the business in the payor's state of residence, which is to be determined on a facts and circumstances basis. Where this provision applies, the resident is entitled to the benefit even if not a qualified person.

- A company that is at least 95% owned by seven or fewer persons that are equivalent beneficiaries, provided that in the case of indirect ownership, each intermediate owner is itself an equivalent beneficiary. The company

“For a U.S. tax adviser, the scope of the P.P.T. may be problematic because intent to obtain a treaty benefit is typically not enough to deny the benefit if it is accompanied by economic substance.”

must not be a conduit as previously defined. Where this provision applies, the resident is entitled to the benefit even if not a qualified person;

- A resident benefitting from discretionary relief afforded by the relevant tax authority as to its qualification as a treaty resident. Where this provision applies, the resident is entitled to the benefit even if not a qualified person.

PRINCIPAL PURPOSE TEST

While the L.O.B. proposal borrows heavily from the U.S. treaties, the P.P.T. general anti-avoidance rule adopts principles already recognized in the O.E.C.D.'s Commentary on Article 1 of the O.E.C.D. Model Convention. In contrast to the detailed and objective L.O.B. rules, the P.P.T. rule is a more general and subjective way to address treaty abuse cases. The P.P.T. provision appears in paragraph 7 of proposed Article X.

> Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

The P.P.T. is a rule that will deny tax treaty benefits if “one of the principal purposes of an arrangement or transaction” is to obtain tax treaty benefits “unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant” treaty provision. Where this is the case, however, the last part of the provision allows the person to whom the benefit would otherwise be denied the possibility of establishing that obtaining the benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

The P.P.T. supplements, and does not restrict in any way, the scope and application of the limitation-on-benefits rule. Consequently, a benefit that is denied in accordance with the L.O.B. provision is not a benefit that the P.P.T. would also deny. In comparison, the fact that a person is entitled to benefits under the L.O.B. provision does not prevent benefits from being denied under the P.P.T. Thus, for planning purposes, the L.O.B. and the P.P.T. provisions must be met.

CONCLUSION

Action Item 6 is a productive step forward in dealing with treaty shopping. From the viewpoint of the U.S. and any country that has an income tax treaty in effect with the U.S., the L.O.B. provisions are “old hat.” However, for a U.S. tax adviser, the scope of the P.P.T. may be problematic because intent to obtain a treaty benefit is typically not enough to deny the benefit if it is accompanied by economic substance.

ACTION ITEM 8:
CHANGES TO THE TRANSFER PRICING RULES IN RELATION TO INTANGIBLES – PHASE I

Author
Robert G. Rinninsland

Tags
B.E.P.S.
Comparable Market Method
Cost Method
Excess Profits Method
Intangible Property
I.P. Valuation
Net Present Cash Flow
Relief of Royalty Method
Transfer Pricing

INTRODUCTION

Unlike some of the other B.E.P.S Action Items, Action Item 8 has a basis in existing O.E.C.D. rules. In this regard, the O.E.C.D. Transfer Pricing Guidelines[41] have established the operating rules for transfer pricing. It is understandable that Action Item 8 merely presents a series of amendments to Chapters I, II, and VI of the *O.E.C.D. Guidelines.*

Action Item 8 states that it seeks to:

- Clarify the definition of I.P.,
- Provide guidance on identifying transactions involving I.P., and
- Provide supplemental guidance for determining arm's length conditions for transactions involving I.P.

Action Item 8 also considers the treatment of local market features and corporate synergies.

Action Item 8's recommendations intend to accomplish these three goals by:

- Adopting a broad and clearly delineated definition of I.P.,
- Ensuring that profits associated with the transfer and use of I.P. are appropriately allocated in accordance with (rather than divorced from) value creation,
- Developing transfer pricing rules or special measures for transfers of hard-to-value I.P.,
- Updating the guidance on cost contribution arrangements, and

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[41] O.E.C.D Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("the O.E.C.D. Guidelines").

- Adopting transfer pricing rules or special measures to ensure inappropriate returns will not accrue to an entity solely because it contractually assumed risks or provided capital.

THRESHOLD ISSUES

Definition of Intangible Property

Intangible property ("I.P.") for both O.E.C.D. and U.S. tax purposes is broadly defined. It includes

- Patents, inventions, formulae, designs, patterns, or know-how;
- Copyrights, such as for literary, musical, or artistic compositions;
- Trademarks, trade names, or brand names;
- Franchises, licenses, or contracts;
- Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
- Items similar to these listed.[42]

Further guidance regarding the definition of I.P. is found in the U.S. tax law provisions regarding the amortization of I.P. acquired as part of a trade or business.[43] Intangible assets include:

- Workforce in place;
- Business books and records;
- Patents, copyrights, formulae, etc.;
- Customer-based I.P.;
- Supplier-based I.P.; and
- Any similar items.

Goodwill is recognized under these U.S. tax law principles as an item of I.P. and is defined as the value of a business attributable to the continued expectancy of customer patronage, due to name reputation or any other factor.[44] Note that

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42 Code §936(h)(3)(B). These items are considered separately identifiable intangible property where they have substantial value independent of the services of any individual.

43 Code §197(d)(1)(C); Treas. Reg. §1.197-2(b) provides detailed descriptions of the Section 197 intangible property.

44 Treas. Reg. §1.197-2(b)(1).

goodwill for this purpose is not accounting goodwill or the goodwill embedded in another item of I.P. such as trademarks. Rather, it must be a standalone item of property.[45]

"The purpose of the valuation controls the choice of method used to value I.P."

Valuation of I.P.

The purpose of the valuation controls the choice of method used to value I.P. These purposes include:

- Transaction Strategy**:** Consideration of buying, selling, or transferring the I.P. in a licensing arrangement or acquisition;

- Financial Reporting**:** Valuing prescribed intangible assets for reporting on public financial statements;

- Litigation Strategy: Computation of damage awards in infringement suits; and

- Bankruptcy: Valuing assets to properly repay creditors or to reorganize the company.

Various methods may be used to value I.P. From a transfer pricing perspective, the most important methods are:

- Relief of royalty,

- Excess profits,

- Net present cash flow,

- Comparable market, and

- Cost.

The relief from royalty method assumes that if a business loses ownership of a particular I.P., it would be forced to pay a royalty to the owners of the I.P. for the right to use the property. This royalty rate can be based on a number of variables, but is most often based on revenues. The percentage rate for the royalty will differ depending on the characteristics of the asset considered and the industry in which that asset is deployed. The value of the I.P. under this method is the capitalized value of the after-tax royalties that the company is relieved from paying because it is the owner of the asset. Determining the appropriate royalty rate is the key consideration. Ideally it is calculated by reference to standard industry values and practices or comparable transactions.

The excess profits method is used primarily to determine the value of a brand to a business and involves determining a fair market value of the net tangible assets used in producing the branded product. A rate of return is then used to estimate

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45 *International Multifoods Corp. v. Commr.*, 108 TC 25, supplemental op., 108 TC 579 (1997).

the profits required to promote investment in those assets. Any return in excess of this amount represents the maximum royalty payable. That amount is capitalized to compute the value of total intangible assets. This approach is a variation of the method in which the business is valued as a whole. The current market value of the business's net tangible assets is subtracted from that overall value. It assumes that the entire excess return can be attributed to the presence of the brand name alone. It ignores the possibility that other intangible factors, such as an established distribution network or statutory protection from competition, may influence the return.

Under the net present cash flow value method, the value of the I.P. comprises the present value of cash flows generated by the asset over its useful life. The useful life of an asset depends on its economic life. Critical factors include life cycle, rate of technological change, and barriers to entry. This method has been considered to have the strongest theoretical foundation because it is based on the economic measure of cash flow, including a focus on the future risks associated with the assets, and the duration of the economic life of the assets. The key is to readily identify the net cash flows that are directly associated with the I.P. These include cash flows attributable to a library of film, music, or program copyrights or royalty income from licensing a brand name.

The comparable market methodology values the I.P. by referring to prices obtained for comparable assets in recent similar transactions and licensing arrangements.[46] The method is credible, objective, and relevant in the context of market-based valuation exercises. Major requirements are:

- An active market,
- An exchange of comparable assets,
- Access to price information at which assets are exchanged, and
- Transactions that reflect market values.

There may be difficulties in valuing I.P. using this methodology even when information is available because particular transactions may be affected by non-value related factors. These factors include:

- Different levels of relevant knowledge,
- Different negotiating skills between the parties, and
- Fundamental differences between the assets used in the comparable analysis and the asset that is valued in the subject transaction, which may have the effect of over-pricing or underpricing the value of the I.P.

The cost-based approach seeks to measure future benefits of owning I.P. by quantifying the amount spent on developing an I.P. asset to its present form or the

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46 The residential real estate market is a market where these conditions are usually present, albeit for real property.

amount required to replace the future service capability of that asset. The issue here is whether or not it is correct to assume that the value of the I.P.'s development costs, usually incurred over a lengthy period of time, reflects its ability to derive future economic benefit.

HISTORICAL PERSPECTIVE

The O.E.C.D. has had a long-standing project to revise Chapter VI of the 2010 O.E.C.D. Guidelines relating to I.P. Discussion drafts were released in June and September 2012. Almost simultaneous with the release of the B.E.P.S. Action Plans in 2013, the O.E.C.D. issued the "Revised Discussion Draft" on Transfer Pricing Aspects of Intangibles. The revised draft was consistent with the 2012 discussion drafts. The groundwork provided by the discussion drafts has enabled Action Item 8 to move at an accelerated pace, focusing the deliverable on the revision of Chapter VI of the O.E.C.D. Guidelines.

The 2013 Revised Discussion Draft discussed the definition of I.P., location savings, synergies, and pricing methods. The public debate focused on the allocation of income from the exploitation of I.P. among the members of a related party group. This contrasted with the prior discussion drafts, which placed more emphasis on functions performed and control over risk and less emphasis on I.P. ownership, funding, and contractual terms. For example, in the 2013 Revised Discussion Draft, emphasis was placed on certain important functions such as control over research and marketing programs, budgets, or strategic decision-making. These were key factors in valuation and were given special significance.

The 2013 Revised Discussion Draft diminished the role of capital by proposing to restrict the return that a related party should expect from bearing a funding risk. These risks typically appear in calculations supporting a cost sharing or contract R&D arrangement. In that regard, it provided,

> Bearing a funding risk, without the assumption of any further risk, and without any control over the use of the contributed funds or the conduct of the funded activity, generally would entitle the funder to a risk-adjusted rate of anticipated return on its capital invested but not more.

What this return should be is left open, but the implication is that it should be modest.

By the end of May, it was reported that Working Party 6 completed a revised text for Chapters I, II and VI to the Transfer Pricing Guidelines.

ACTION ITEM 8 AND THE THRESHOLD ISSUES

Action Item 8 addresses these threshold issues in its amendments to the O.E.C.D. Guidelines, Chapters I and II and VI, and is supplemented by a number of examples.

Chapters I and II Key Points

- Location savings, assembled workforce, and group synergies are to be taken into account to determine comparability of functions and risks in benchmarking the controlled transaction at issue to the appropriate set of comparables. The existence and relevance of each of these factors to transfer pricing is to be determined by a robust functional and comparative analysis.

- Location savings (*i.e.*, cost reductions from operating in a given market having comparatively cheap labor) may or may not be passed on to the customer. If not passed on to the customer, it is assumed that the members of the multinational group will share in the location savings based on their relative contributions to the benefits derived from the location savings.

- Assembled workforces with unique skills may differentiate the multinational group's controlled transaction from potential comparables. Where these workforces can be transferred from one entity/location to another, the associated cost savings to the recipient entity (time and expense of recruiting) would most likely represent an adjustment that would need to be made in determining the group's transfer pricing for purposes of the comparables' benchmarking.

"Both positive and negative effects of organizational synergies should be considered, a point often overlooked by taxation authorities when dealing with multinational corporations."

- Both positive and negative effects of organizational synergies should be considered, a point often overlooked by taxation authorities when dealing with multinational corporations. Positive synergies might include the ability to purchase raw materials at a bulk discount or other indicia of economies of scale. Negative synergies might include bureaucratic hurdles to necessary business decisions or outdated company standards in comparison to the competition.

- The functional and comparable analysis to identify the existence and relevance of location savings, assembled workforce, and organizational synergies should identify any I.P. developed or used by the multinational group in the transaction. For example, location savings may be attributable to a license to conduct business within a given jurisdiction or market, which would be in and of itself I.P., depending on whether that license represents a barrier to entry of the market for other competitors. Transfer of an assembled workforce might include transfer of I.P. in the form of the business know-how resident in the workforce. Group synergies may result from concerted efforts by the multinational organization to achieve structural advantages over the competition. These efforts will necessitate a determination of, (i) the nature of the advantage or disadvantage, (ii) the amount of the benefit or detriment provided, and (iii) how that benefit or detriment should be divided among members of the group. Thus, the implication is that I.P. can be developed as a result of internal corporate organizational initiatives.

Chapter VI

Action Item 8 has amended Chapter VI in its entirety, replacing the old with the new. The new Chapter VI focuses on special situations in transfer pricing due to the nature of I.P. and emphasizes that the procedures set forth in the earlier chapters regarding robust functional analyses and determination of comparable transactions especially applies to I.P. The functional and comparability analyses must consider:

- The identification of specific I.P.;
- The legal ownership of I.P.;
- The contributions of multinational group members to their development, enhancement, maintenance, protection and exploitation; and
- The nature of the controlled transactions involving I.P., including the manner in which such transactions contribute to the creation of value.

On these four threshold points, Chapter VI provides the following guidance:

- Chapter VI identifies I.P. as including anything that can be owned or controlled by parties in a commercial setting and whose use or transfer would be compensated for by independent parties in comparable circumstances. That certainly includes the items noted above and most likely others, as Chapter VI points out that the definition of I.P. for transfer pricing purposes should not be limited to accounting definitions or to items for which R&D expenses have been incurred and expensed rather than booked to a balance sheet account. Note that separate transferability is not necessary for something to be considered an intangible item. Chapter VI notes that I.P. can be transferred along with non-I.P. and that they are not tied to contractual rights but can exist separately.

"Action Item 8's Working Group 6 was concerned with the issue of whether legal ownership of an intangible determined share of anticipated income from the intangible."

- Action Item 8's Working Group 6 was concerned with the issue of whether legal ownership of an intangible determined share of anticipated income from the intangible. In sum, Chapter VI provides that legal ownership will entitle the owner to such income if the legal owner of an intangible, in substance:
    - Performs and controls all of the functions (including the important functions described in paragraph 6.56) related to the development, enhancement, maintenance, protection and exploitation of the intangible;
    - Provides all assets, including funding, necessary to the development, enhancement, maintenance, protection, and exploitation of the I.P.; and
    - Bears and controls all of the risks related to the development, enhancement, maintenance, protection, and exploitation of the intangible.
- Determination of group members' assumption of functions and risks related to the development and exploitation of an intangible will be based on a function and risk analysis performed pursuant to the principles laid out in the earlier chapters. To the extent use of the I.P. or performance of these activities are carried out by other members of the multinational group, those members would be entitled to share in the anticipated returns from the I.P.

in the form of arm's length consideration for their efforts. Chapter VI notes that this compensation may constitute all or a substantial part of the anticipated return from the I.P., depending on the facts and circumstances. Chapter VI notes that entitlement to profit or loss relating to unanticipated events will depend on the terms and conditions of relevant contracts and on the functions performed, assets used and risks assumed by each member.

- Chapter VI sets out the basis for identifying and analyzing the transactions involving I.P. The required steps are:

    - Identifying the legal owner of I.P. based on the terms and conditions of legal arrangements, including relevant registrations, license agreements, other relevant contracts, and other indicia of legal ownership;

    - Identifying the parties performing functions using assets, and assuming risks related to developing, enhancing, maintaining, protecting, and exploiting the I.P. by means of the functional analysis;

    - Confirming the consistency between the conduct of the parties and the terms of the relevant legal arrangements regarding intangible ownership through a detailed functional analysis; and

    - Identifying the controlled transactions related to the development, enhancement, maintenance, protection, and exploitation of I.P. in light of the legal ownership of the I.P. under relevant registrations and contracts, and the conduct of the parties, including their relevant contributions of functions, assets, risks and other factors contributing to the creation of value.

    In principle, an accurate determination of an arm's length price reflecting each party's contribution will result when the foregoing steps are followed.

Chapter VI has certain transactions in mind that require this type of analysis, including:

- Development and enhancement of marketing I.P.;

- Research, development, and process improvement;

- Use of the company name;

- Transfers of I.P. or rights to I.P.;

- Transfers of combinations of I.P.;

- Transfers of I.P. or rights to I.P. in combination with other transactions, such as services or tangible property.

Chapter VI provides supplemental guidance for transactions most likely to reflect incorrect application of the transfer pricing guidelines. Points to be checked include:

- The quality of the intangible transfer – such as the exclusivity, geographic scope, useful life, and stage of development – for purposes of checking comparability of I.P. transactions;

- Inherent risks regarding the likelihood of future benefits from the exploitation of the I.P.; and

- Obsolescence of the intangible or infringement.

I.P. Valuation

Valuation of I.P. is integral to the determination of income attributable to the intangible, particularly where no third party comparable transactions can be identified. In this regard, Chapter VI reflects the general O.E.C.D. direction of recommending close scrutiny of the value of the intangible transferred out of a highly taxed jurisdiction to a low tax jurisdiction. Here again, Chapter VI gravitates away from reliance on accounting concepts, noting that accounting assumptions may be too conservative in order to avoid overstating the balance sheet. Chapter VI instead relies on realistic alternatives that take into account the perspective of the parties and attribution of risk. Income valuation methods such as discounted cash flow are considered particularly useful when properly applied. Chapter VI anticipates that valuation methods will also be used within the context of proper application of the approved O.E.C.D. transfer pricing methods related to I.P. as those methods have been outlined in Chapter II.

NEXT STEPS & OPEN ISSUES

Work remains on related Action Items, such as Action Item 9 on Risks and Capital, and Action Item 10 on Other High Risk Transactions. Work on these two Action Items anticipates a December 2014 discussion draft. Developments on Action Items dealing with permanent establishments, deductibility of interest, the C.F.C rules, and the digital economy are also anticipated to have an effect on I.P. In 2015, work is anticipated on special measures related to:

- Providing tax administrations with authority in appropriate instances to apply rules based on actual results to price transfers of hard-to-value I.P. and potentially other assets;

- Limiting the return to entities whose activities are limited to providing funding for the development of I.P., and potentially other activities, for example, by treating such entities as lenders rather than equity investors under some circumstances;

- Requiring contingent payment terms or the application of profit split methods for certain transfers of hard-to-value I.P.; and

- Requiring application of rules analogous to those applied under Article 7 of the O.E.C.D. Model Tax Convention and the Authorized O.E.C.D. Approach to certain situations involving excessive capitalization of low function entities.

As far as open issues are concerned, one query is whether further work needs to be done on the definition of I.P. Chapter VI seemed to conclude that I.P. should be limited to assets that are proprietary in nature, meaning that rights related to the I.P. are protected by law or contract. Chapter VI defined goodwill as I.P. for most I.P. transactions. An over-emphasis on the discounted cash flow valuation method could be detrimental in situations where other valuation methods are more appropriate.

From the U.S. perspective, it seems that the core U.S.-centric concern remains in issue. That concern is whether the favored methodologies in Chapter VI yield the most accurate arm's length result. If Action Item 8 is nothing more than an emphasis on functions and risks and a de-emphasis on capital investment, then the U.S. concern has not been addressed. Chapter VI's approach to I.P. transfer pricing may become overly political as each jurisdiction applies different methodologies based on factors that favor its position.

From the multinational group perspective, the author's advice has consistently reflected the following approach:

- Align transfer pricing strategy for tax purposes with the enterprise's business model. Do this in the context of a function and risk analysis.

- Monitor written intercompany agreements and procedures and amend them if necessary to reflect changes in the business. Do this in the context of affirmatively identifying the intangible and the intangible transaction.

- The quality of a transfer pricing analysis depends on the quality of the comparables. Note the increased focus on identifying proper comparables for use in benchmarking the I.P. transaction being valued.

- Know the comparables. Identify why a given comparable company has been selected and how that company's functions and risk allocations relate to the tested party's functions and risks. The I.R.S. analysis of comparables is often based on brief excerpts of 10-K reports that do not shed light on the ways in which the comparable companies conducted business.

- When push comes to shove, substance trumps writing. In this regard, stay faithful to your agreements as noted above.

"From the U.S. perspective, it seems that the core U.S.-centric concern remains in issue. That concern is whether the favored methodologies in Chapter VI yield the most accurate arm's length result."

ACTION ITEM 13:
GUIDANCE ON TRANSFER PRICING DOCUMENTATION AND COUNTRY-BY-COUNTRY REPORTING

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Tags
B.E.P.S. Documentation
CbC Reporting
Transfer Pricing

INTRODUCTION

On July 19, 2013, the Organization for Economic Cooperation and Development ("O.E.C.D.") released its full *Action Plan on Base Erosion and Profit Shifting* (the "B.E.P.S. Action Plan"), with expectations to roll out specific items over the subsequent two years. According to the O.E.C.D., the B.E.P.S. Action Plan will allow countries to draft coordinated, comprehensive, and transparent standards that governments need to prevent B.E.P.S., while at the same time updating the current rules to reflect modern business practices. Of the 15 action items listed in the B.E.P.S. Action Plan, four relate specifically to transfer pricing and several others indirectly address this area, as well. The four with direct impact on transfer pricing are Action Items 8, 9, 10, and 13:

- **Action Items 8, 9, and 10 (Assure that Transfer Pricing Outcomes are in Line with Value Creation)** develop rules to prevent B.E.P.S. by (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles, capital, or other high-risk transactions are appropriately allocated in accordance with value creation; (iii) developing transfer pricing rules for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.

- **Action Item 13 (Re-examine Transfer Pricing Documentation)** develops rules regarding transfer pricing documentation to enhance transparency for tax administrations, taking into consideration the compliance costs for multinationals.

With these and the 11 other Action Items, the O.E.C.D. aims to foster (i) coherence of corporate income taxation at the national level; (ii) enhanced substance, through bilateral tax treaties an in transfer pricing; and (iii) transparency and consistency of requirements.

Further guidance on the transfer pricing Action Items 8-10 is not expected until September of 2015. On September 16, 2014, however, the Centre for Tax Policy and Administration, part of the O.E.C.D., released its first round of recommendations under the B.E.P.S. project (the "B.E.P.S. recommendations"), including for Action Item 13 (as well as 6 other Action Items discussed in this issue). Though these deliverables are not finalized, the recommendations are perceived to represent the consensus of 44 countries (O.E.C.D., G20, plus Columbia and Latvia).[47]

TRANSFER PRICING DOCUMENTATION & COUNTRY-BY-COUNTRY REPORTING

In keeping with the third pillar of the B.E.P.S. initiative listed above – transparency and consistency – Action Item 13 calls for a revamp of transfer pricing documentation. The new guidance calls for a three-tiered approach to global transfer pricing documentation, including:

1. A Master File – a high-level overview of the multinational group business;
2. A Local File – detailed information on specific group transactions for a given country; and
3. A Country-by-Country ("CbC") report – a matrix of specific data for each jurisdiction, ostensibly to be used as a risk assessment tool by tax authorities (as well as, potentially, taxpayers).

Each of these proposed documentation elements is described below.

Master File

The Master File is meant to provide tax authorities with high-level information about a multinational's global business and transfer pricing policies. The latter can include entity characterizations (*e.g.*, distributors, manufacturers, service companies), nature of intercompany transactions, and data used to benchmark remuneration.

This recommendation endorses a practice already being followed by many multinationals concerned with efficiently presenting a consistent "story" to any tax authority that may institute a tax audit or otherwise challenge transfer pricing arrangements.

In general, the Master File should include:

- An organization chart;
- A description of the multinational's business operations;
- A description of primary intangible assets;
- A description of intercompany financial activities (*e.g.*, loans, guarantees, cash pools); and
- Relevant financial and tax information.

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[47] There is overlap between O.E.C.D. and G20 member countries.

- The B.E.P.S. recommendation includes specific requirements for each of these items.

Local File

In addition to the Master File, multinationals would be required to prepare local-country transfer pricing reports that would describe business operations and intercompany transactions relevant to entities operating in that country. These reports would describe the transfer pricing method(s) applied to evaluate each transaction, the benchmarks used (comparable companies or transactions), and the conclusions reached as to the arm's length nature of the related-party dealings. (Depending on the country, the Local File may need to be prepared in the local language.)

"The Master File . . . recommendation endorses a practice already being followed by many multinationals."

The Local File should include:

- An organization chart for the local entity(ies), along with a description of the management structure;
- A description of the local business(es) and key competitors;
- A description of material intercompany transactions, including corresponding intra-group payments;
- Identification of affiliates involved;
- Copies of all relevant intercompany agreements;
- Detailed functional analysis of the local multinational(s) and relevant affiliates;
- A description of the transfer pricing methods applied for each transaction and the financial information utilized;
- A description of the economic/benchmarking analysis, including key assumptions and adjustments made to market benchmarks;
- Conclusions as to the arm's length nature of the intercompany transactions;
- Local entity audited or unaudited financial accounts and their links to the financial information used in the transfer pricing analysis; and
- Information on any existing Advance Pricing Agreements or other tax rulings not involving the local entities that may impact the pricing of the controlled transactions under review.

In practice, the detailed information provided in the Local Files should be entirely consistent with the more general information provided in the Master File.

CbC Report

Among the three recommended documentation elements, the CbC report has garnered the most attention. It would include the following items to be listed by jurisdiction:

- Revenues;
- Profit/loss before tax;
- Income tax (paid & accrued);
- Capital and accumulated earnings;
- Number of employees;
- Tangible assets;
- Main business by activity; and
- Country of organization/incorporation.

The information can come from any source (statutory accounts not a priority), as long as it is consistent across the relevant jurisdictions.

CHALLENGES & STRATEGIES

Master & Local Files

The Master File and Local File concepts are familiar to many multinationals that have been following a similar strategy. In many cases, a Master File is prepared at the end of a transfer pricing planning analysis[48] to memorialize the relevant business information and the corresponding transfer pricing policies being implemented. That planning report can then be updated on an annual basis (reflecting any changes in business operations and incorporating new financial information) and serve as the basis for any Local Files needed. This "wheel and spokes" approach ensures consistency and maximizes efficiency in the preparation of needed documentation.

As a practical matter, a multinational will not prepare a Local File annually for each country in which it operates. Rather, potential exposure (based on audit risk, volume of intercompany flows, complexity of transactions, types of transactions) should be evaluated on a regular basis in order to decide how resources should be deployed in preparing local documentation, especially for companies that do not have relatively large tax departments containing tax lawyers, accountants, and economists. Consideration should also be given to specific country practices regarding time limits imposed by the tax authority once documentation is requested and possible requirements to translate documentation into the local language.

48 That is, an exercise aimed at determining the proper transfer pricing structure, as opposed to justifying one already in place.

“Filling out the template now, at least for major jurisdictions in which a multinational does business, will help ascertain the ease with which the needed data can be collected. It also can be used to expose potential audit risks.”

CbC Reporting

The new documentation standards, particularly the CbC reporting template, have the stated purpose of providing enough information for tax authorities to determine “whether companies have engaged in transfer pricing and other practices that have the effect of artificially shifting substantial amounts of income into tax-advantaged environments.”[49] As such, it is intended to be used as a “risk assessment” tool by tax administrations, perhaps helping to focus attention and resources on particular transactions and jurisdictions.

Given that CbC reporting standards have not been finalized or formally adopted by individual countries, it may be prudent for multinationals to adopt a wait-and-see approach before adjusting transfer pricing documentation strategies. On the other hand, since it is likely that something comparable to the proposed template will be put into use in a significant number of jurisdictions, internal CbC reporting may be a viable part of the risk assessment process for multinational tax departments wishing to plan ahead. Filling out the template now, *at least* for major jurisdictions in which a multinational does business, will help ascertain the ease with which the needed data can be collected. It also can be used to expose potential audit risks or, at a minimum, the business and geographic areas that are likely to invite detailed inquiries from tax authorities. Further, since broad measures in the CbC reporting template – such as total number of employees and profits broken down on a country-by-country or entity-by-entity basis – do not shed light on whether transfer pricing policies are supportable, a global group might consider augmenting the CbC template with additional information that clarifies and is consistent with its transfer pricing. Any such additional information, as with the basic CbC data provided, should be fully consistent with contents of the Master File and Local Files.

The B.E.P.S. recommendations expressly discourage tax administrations from using the CbC information “to propose transfer pricing adjustments based on a global formulary apportionment of income.”[50] However, there is considerable, and perhaps reasonable, trepidation among the multinational community that use of the CbC template will move past general assessment into some sort of apportionment argument, at least in some jurisdictions. For example, some less developed countries might take the position that local taxable income should be in direct proportion to the total share of employees.[51] This or a similar approach would bypass any insights gained through a comprehensive functional analysis of the multinational enterprise, which would go beyond superficial numbers to identify the true profit-generating activities and assets of the global business.[52] Global groups will likely benefit by proactively conducting an adjusted analysis that identifies value drivers and meticulously documenting the facts and resulting transfer pricing policies under the three-tiered structure described in the B.E.P.S. recommendations.

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49 OECD/G20 Base Erosion and Profit Shifting Project, *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*, Action Item 13: 2014 Deliverable, pages 9-10.

50 *Ibid*., page 20.

51 This could be an indirect way for countries where routine functions are centralized, such as India or China, to capture a share of the “location savings.”

52 Multinationals that have centralized ownership of valuable intellectual property might be particularly vulnerable to a simplified apportionment argument.

“Adoption of the Action Item 13 recommendations will require consideration of such issues as confidentiality, timeliness, and usefulness of the information collected.”

NEXT STEP – IMPLEMENTATION

Though there is consensus on the content, there remains substantial uncertainty as to how the B.E.P.S. recommendations on Action Item 13, particularly CbC reporting, will be implemented by individual countries. For example, let us take a selective survey as follows:

- United States officials, while stepping up transfer pricing enforcement efforts in recent years (particularly with respect to intangibles and services), have adopted a wait-and-see attitude regarding the Action Item 13 proposed documentation standards.[53]

- France has been requesting consolidated accounts and management reports during audits and is widely expected to introduce CbC reporting in some form.

- Germany has already implemented some B.E.P.S. measures and is in favor of consistent adoption by all countries.

- The United Kingdom views its current transfer pricing audit practices as consistent with the B.E.P.S. initiative and is likely to adopt the Action Item 13 recommendations as part of a coordinated international effort.

- The “B.R.I.C.” countries (Brazil, Russia, India, China) have identified incomplete information disclosure as a primary reason for tax-base erosion and are, therefore, proponents of the CbC report.

In each country, adoption of the Action Item 13 recommendations will require consideration of such issues as confidentiality, timeliness, and usefulness of the information collected (particularly through the CbC template). Taxpayers also have concerns with respect to how the information would be disseminated. At this point, it is unclear whether there will be any thresholds (size/type) with respect to affiliates and countries that should be covered in the Master File, Local File, or CbC documentation.

Finalization of all B.E.P.S. Action Plans will focus on these implementation and coordination challenges; unilateral action by countries would be counterproductive. The O.E.C.D. has made it clear that the recently-released B.E.P.S. recommendations, including those on Action Item 13, may be impacted by decisions made with regard to the remaining eight elements of the B.E.P.S. Action Plan, which are scheduled to be presented to the G20 for final approval in 2015.

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[53] Many U.S. multinationals and transfer pricing practitioners have voiced reservations.

ACTION ITEM 15:
DEVELOPING A MULTILATERAL INSTRUMENT TO MODIFY BILATERAL TAX TREATIES

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Tags
B.E.P.S.
International Law
Multilateral Instrument
Opting in
Opting out
Tax Treaties

AN EXERCISE IN "POINT/COUNTERPOINT"

Implementation of many of the B.E.P.S. Action Items would require amending or otherwise modifying international tax treaties. According to the O.E.C.D., the sheer number of bilateral tax treaties makes updating the current treaty network highly burdensome. Therefore, B.E.P.S. Action Item 15 recommends the development of a multilateral instrument ("M.L.I.") to enable countries to easily implement measures developed through the B.E.P.S. initiative and to amend existing treaties.[54] Without a mechanism for swift implementation of the Action Items, changes to model tax conventions merely widen the gap between the content of the models and the content of actual tax treaties.

Discussion of Action Item 15 has centered on the following issues:

- Whether an M.L.I. is necessary,
- Whether an M.L.I. is feasible, and
- Whether an M.L.I. is legal.

In the spirit of these ongoing discussions concerning Action Item 15, we offer our commentary in a "point/counterpoint" format.

POINT:

Action Item 15 is Impractical on its Face

Of all the B.E.P.S. Action Items, Action Item 15 is subject to the highest degree of vagueness and ambiguity because agreement must be reached on other Action Items before drafting can begin on the M.L.I. To compensate for this ambiguity, the

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[54] OECD (2014). *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing p. 9-10.

O.E.C.D. addresses various methods by which an M.L.I. can come into effect. But in doing so, the O.E.C.D. highlights the main dilemma that is faced. The M.L.I. must be flexible so that countries are incentivized to sign. In addition, it must supersede all existing bilateral treaties not reflecting the terms of the M.L.I. in order to enhance effectiveness. These two principles naturally come into conflict: if the M.L.I. has mandatory terms and supersedes all existing bilateral treaties, it may not be attractive.

The main weakness of Action Item 15 is that this conundrum is not addressed. Due to the uncertainty inherent in the scope of the other Action Items, the O.E.C.D. often uses vague language to note economic principles. It is not clear that a country will wish to override all its bilateral treaties in order to achieve an uncertain result beyond the scope of its control.

The following is a list of criticisms of the various principles and ideas which the O.E.C.D. has mentioned in its recommendations:

23. **More Conferences v. Increased Efficiency**: The O.E.C.D. recommends holding a conference to negotiate the M.L.I. This conference would presumably occur after the other Action Items have been addressed. At the same time, the O.E.C.D. wishes for the M.L.I. to be implemented quickly. These two principles are somewhat in conflict. Inviting yet another negotiating conference will likely delay the implementation of B.E.P.S. measures through an M.L.I.

24. **Conflict between Efficiency and Sovereignty**: As indicated above, another conflict arises from the suggestion that a superseding clause should be placed in the M.L.I. to increase effectiveness. This proposal occurs prior to adoption of all the terms of the M.L.I. and is, in part, designed to encourage countries to assign power to override bilateral treaties in advance of the understanding what those overriding terms will look like. The O.E.C.D. suggests that the M.L.I. will be couched in so-called "soft language" to encourage cooperation. However, with the wide reach expected for B.E.P.S. legislation, countries will likely desire more clarity and less ambiguity.

25. **Problems without Solutions**: Often, the B.E.P.S. recommendations note problems but do not addressing solutions. For example, the report recommends that developing countries should be more involved in the implementation of the B.E.P.S. legislation. While a laudable point, the O.E.C.D. does not address how to involve developing countries, nor does it address whether developed countries would be encouraged to surrender economic sovereignty as a concession to developing country support. This conflict has not been resolved in other international arenas, such as climate change or the W.T.O. negotiations on agriculture. If the law of past performance holds true, loss of sovereignty may again be a stumbling block.

26. **Opt-In/Opt-Out and Competitiveness**: To calm fears that the signing of the M.L.I. will result in the breach of territorial and economic sovereignty, the O.E.C.D. recommends that the M.L.I. should be made "flexible" by including "opt-in" and "opt-out" clauses. Of course, countries will only opt in or opt out if to do so is in their best interest and will likely be wary of opting in and subjecting their economies to stringent standards, which would

render them unable to compete in the global marketplace unless other major economic players, like the U.S., also opt-in. Secondly, the O.E.C.D. may be of the view that once a country signs the M.L.I., opting out will not be politically easy.

27. **Transparency**: The annex allows for public access to the M.L.I. in a bid to increase both flexibility and transparency. Increasing transparency through public record access is a commendable objective, but there are few ways to interpret "public access" beyond offering to issue a treaty online with a comparison of the M.L.I. and other bilateral agreements. Most treaties are already issued online, rendering the objective moot. Action Item 15 does not address whether the actual conversations, concessions, and negotiations would be made available to the public at a later point in time, which may be of interest to domestic stakeholders and historians.

28. **Monitoring Implementation**: To enforce the provisions of the M.L.I., the O.E.C.D. desires to monitor whether countries are properly implementing B.E.P.S. legislation through the creation of a multilateral implementation board. This raises additional questions: who would sit on such a panel, and would an economically powerful country allow other member countries to decide the fate of its tax base? While the U.S. is a party to other international treaties where monitoring groups exist, the M.L.I. monitoring with other treaties. Moreover, the U.S. tax system has more at risk than others with regard to such a board. Any multilateral implementation board that encourages smaller countries to impose more tax on foreign members of a U.S.-based multinational group would reduce the U.S. tax base. While the U.S. eliminates double taxation through a foreign tax credit mechanism, most other countries eliminate double taxation through an exemption system. For them, increased tax in a foreign trading-partner country will not reduce revenue, especially if a bilateral transfer pricing agreement is not reached with that trading partner. Finally, the negotiations to determine which countries would sit on such a board may further delay the agreement coming into effect.

"The O.E.C.D. has indicated that the M.L.I. should allow for reservations only on 'non-core' items. The O.E.C.D. has not identified core issues and non-core issues."

29. **Reservation**: Simply put, a reservation excludes a provision of the treaty from applying. A reservation is allowed so long as it is not prohibited by the M.L.I. The O.E.C.D. has indicated that the M.L.I. should allow for reservations only on "non-core" items. The O.E.C.D. has not identified core issues and non-core issues. The likelihood is that mostly core issues will be controversial. If this proves true, the ability to reserve will be limited to the inconsequential issues. The U.S. has already hinted that there are several issues where it may declare a "reservation" if it does not agree with the O.E.C.D. Some of these issues have been mentioned in a previous article, which can be seen by clicking here. Again, where an economically powerful country like the U.S. decides to opt out of several provisions, there is a likelihood that other countries will follow – rendering the clause in question effectively null in practice.

30. **Other Multilateral Agreements are Not Relevant to the M.L.I.:** A credible case has not been made that earlier multilateral agreements facing similar issues in relation to then-existing bilateral treaties are comparable to income tax treaties and the M.L.I. An income tax treaty embodies a careful set of compromises where specific countries negotiate to allocate the right to impose tax and to endeavor to prevent double taxation. The result is that

tax revenue flows into one country's treasury but not to the treasury of the other country. In this scenario, the interests of the two states are adverse with regard to most matters other than those viewed to be purely administrative. Their interests and views are adverse in the same way that the interests of a buyer and a seller of property are adverse. Absent unusual circumstances, a seller typically believes the initial offering price for the property is too low and the buyer believes the final price is almost too high. Bilateral tax treaties reflect similar interests of the signatory states: (i) is each giving up too much tax revenue; (ii) is each state a capital importer or exporter; (iii) how will the treaty affect tax residents and the local economy? In comparison, the multilateral agreements currently in existence, and discussed below, have not been adopted in the context of adverse interests. Most countries have the same interest in extradition of purported criminals and the repatriation of minors abducted by one parent or the other. Whether the agreement is multilateral or bilateral, the issue is whether an acceptable procedure will be in existence to carry out the purpose of the treaty.

In conclusion, much of the uncertainty and vagueness of Action Item 15 results from timing. Negotiations on the other action plans have yet to begin. Once those negotiations are completed, prospects for a successful M.L.I. may be clearer. Nonetheless, the O.E.C.D. will encounter significant challenges in determining the proper balance between effectiveness and flexibility. Many commentators across the world have suggested that U.S. agreement to the M.L.I. is key to its effectiveness. Others believe that whether or not an M.L.I. is agreed upon, Action Item 15 has achieved its goal of motivating consensus to action.

COUNTERPOINT:

The M.L.I. is Both Feasible and Necessary Given the Current Geopolitical and Macroeconomic Environment & Precedent Exists Under International Law

Although objections exist to the feasibility of the M.L.I. due to its complexity and the derogation of sovereignty for the signatory nations, a multilateral approach is a practicable way to streamline implementation of the B.E.P.S. action plans. The Annex of Action Item 15 provides a toolbox of theoretical options that may be utilized to develop the M.L.I. into a vehicle for the implementation of B.E.P.S. measures. According to the Annex, these tools are based upon three principles:

- The M.L.I. can implement B.E.P.S. measures and modify the existing bilateral treaties;
- The M.L.I. can provide for flexibility in the parties' level of commitment; and
- The M.L.I. can ensure transparency and clarity for all stakeholders.

These principles derive from the success of their ongoing existence in other multilateral treaty instruments in international public law. If these same principles and tools are used in the creation of the B.E.P.S. M.L.I., it should be feasible for the O.E.C.D. to create an instrument that respects sovereignty, is created legally, and achieves its goal.

The M.L.I. would not terminate any part of the pre-existing network of bilateral treaties, but instead, would try to achieve a concurrent and cohesive application of the provisions of the instrument and the bilateral treaties as they relate to B.E.P.S. There have been several situations in which states have implemented multilateral conventions to introduce common international rules and standards, thus harmonizing the network of bilateral treaties. These conventions rely on tools of international law to achieve their goals, namely, (i) compatibility clauses, (ii) flexibility of provisions, and (iii) transparency and clarity. However, it is not clear that there are many multilateral treaties that have as their principal purpose the override of a host of bilateral treaties.

Compatibility Clauses

The Annex cites the use of compatibility clauses (or "conflict clauses") to explicitly define the relationship between the multilateral instrument and the existing bilateral treaties. These have been used in several other agreements in which the provisions of a multilateral instrument have superseded the provisions of an existing network of bilateral treaties.

A multilateral agreement can supersede provisions of a bilateral treaty covering the same specific subject matter, as can be seen in the *European Convention on Extradition* (1957)[55] and the *European Convention on the Repatriation of Minors* (1970).[56]

It may also grant an exception to the general principal that the provisions of the multilateral instrument supersede those of prior agreements. Certain treaties stipulate that "more favorable" provisions of a bilateral treaty existing at the time of conclusion will not be affected.[57] Others go a step further and indicate which provisions are added to the bilateral agreements or which provisions are modified and how.[58]

"A compatibility clause may provide for the supremacy of the multilateral agreement over existing treaties on the condition that the rights and obligations of other treaties are not affected to the extent they are compatible with the multilateral agreement."

A compatibility clause can also modify the provisions of a pre-existing treaty insofar as they differ from or are incompatible with the provisions of the multilateral agreement. These can be seen in treaties such as the *European Convention on the Suppression of Terrorism* (1977).[59] In some cases, any difference in the provisions can invoke this type of compatibility clause. However, in other cases, it requires inconsistency or incompatibility between the provisions.

Furthermore, a compatibility clause may provide for the supremacy of the multilateral agreement over existing treaties on the condition that the rights and obligations of other treaties are not affected to the extent they are compatible with

55 *European Convention on Extradition* (1957), Article 28(1).
56 *European Convention on the Repatriation of Minors* (1970), Article 27(1).
57 See *International Convention of the Protection of the Rights of All Migrant Workers and Members of their Families* (1990), Article 81(1).
58 See *Convention for the Suppression of Unlawful Acts against the Safety of Maritime Navigation* (1988).
59 *European Convention on the Suppression of Terrorism* (1977), Article 8(3).

the multilateral agreement. Such a variation can be seen in the *European Convention on Mutual Assistance in Criminal Matters* (1959).[60]

Some may argue that a single instrument would be unable to address complex situations where there are several variations of scope, wording, and paragraph numbering between bilateral treaties. However, there are precedents in which compatibility clauses address these issues and do so by identifying the provisions to be modified using a specific description, which then removes the necessity to refer to a certain provision or paragraph number in the bilateral treaties.

It is also possible for the compatibility clause to describe the exact effect of its provisions on those bilateral treaties through the inclusion of terms such as "in place of," "in addition to," or "in the absence of."[61] For example, a multilateral agreement may include a clause which allows parties to take on further commitments with another party on the condition that the subsequent agreements can only confirm, supplement, extend, or amplify the provisions of the multilateral agreement.[62] Alternatively, it may take the opposite approach and state that any subsequent agreements may not contradict the provisions or purpose of the treaty.[63] Both mechanisms are used in treaties that are currently in effect and allow for parties to prepare and commit to further objectives in their own time.

The M.L.I. could draw from other multilateral instruments and their compatibility clauses in the following ways:

1. **Negotiable Start Date**: Allowing for the participating states to negotiate the date when the M.L.I. would come into force would allow the states to maintain sovereignty. Such a provision has been implemented in the *Convention of Mutual Administrative Assistance in Tax Matters* (1988).[64] It is also possible to provide for different dates with regard to different provisions of the treaty, if necessary. Doing so can reduce complications for those parties with differing tax years.[65] It can also provide for an allowable time gap for a party joining at a later time.

2. **Accompanying Commentaries**: Also, to ensure consistency in interpretation and implementation of the multilateral agreement, many treaties are accompanied by commentaries that are agreed to by all parties and that provide background information and guidance as a supplement to the provisions. A discussion between the parties on implementation of the M.L.I. will allow for ease of monitoring with regard to practical implementation.[66] Additionally, if desired by the parties, more specific questions can be addressed by providing for mechanisms such as

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60 *European Convention on Mutual Assistance in Criminal Matters*, Article 26(1-2).
61 See *Agreement on Extradition between the European Union and the United States of America* (2003).
62 See *European Convention on Extradition* (1957), Article 28(2).
63 See *Convention on International Civil Aviation* (1944), Article 83.
64 Article 28(2).
65 See *Convention on Mutual Administrative Assistance in Tax Matters* (1988), Article 28(5, 6).
66 See id., Article 24(3).

consultation procedures in the M.L.I. These mechanisms exist in most bilateral treaties to resolve any difficulties that may arise.[67]

3. **Use of Amendments**: Finally, to preserve the sovereignty of individual states when implementing the M.L.I., the states may agree to future amendments of the M.L.I. – but only those to which they have consented.[68]

In sum, there are many examples of compatibility clauses in existing multilateral agreements that have prevailed without challenge. The multiple variations in these clauses allow them to be flexible and invoked where and when they are necessary. Such clauses allow for the pre-existing treaties to endure while addressing only those areas that are in conflict with the new provisions of the multilateral instrument. Also, the obligations previously agreed upon by the treaty partners are not affected. This has clearly been shown to be successful when used in multilateral agreements.

Flexibility of Provisions

Where certain tax policies cannot be harmonized among the parties, it is possible to provide flexibility in the level of commitment the parties are prepared to undertake. Flexibility of provisions supports the idea that parties maintain their sovereignty in choosing to be part of the M.L.I.

Flexibility in the level of commitment can apply to the substance of specific provisions or it can depend on the partner jurisdiction. Also, a multilateral agreement could allow for the parties to implement a specific regime among themselves, if certain conditions are met through the use of a disconnection clause. Such clauses have been used in treaties with the European Union.

1. **Opt-out Mechanisms**: Types of flexibility mechanisms that can be implemented are opt-out mechanisms, opt-in mechanisms, or a choice between provisions. The opt-in and opt-out mechanisms are commonly used devices in treaties that allow flexibility and are standard in treaties developed within several international organizations.

   Opt-out mechanisms are frequently used and can be limited to a defined period of time.[69] The use of reservations allows for the possibility to opt out of certain provisions of a treaty and is done when a unilateral declaration is made by a state when signing, ratifying, accepting, approving, or acceding to a multilateral agreement, and it purports to exclude or to modify the legal effect of certain provisions of the agreement. To prevent parties from opting out of core provisions, the M.L.I. could allow for the formulation of

[67] See *United Nations Framework Convention on Climate Change* (1992), Article 13.

[68] See *United Nations Convention Against Transnational Organized Crime* (2000), Article 39(5).

[69] See *International Labour Convention No. 63, Concerning Statistics of Wages and Hours of Work* (1938), Article 2(1).

reservations only on certain provisions, as was done in the *Convention on Mutual Administrative Assistance in Tax Matters* (1988).[70]

2. **Alternate Provisions**: Another mechanism to allow for flexibility that has been used in the past involves choosing between alternative provisions. Parties could be given the choice between alternative provisions or a list of provisions from which they would select a defined minimum, as in the *European Social Charter* (1961) or the *Bali Agreement on Trade Facilitation* (2013). Opt-in mechanisms allow parties that are ready to do so to commit to pursue the objectives of the treaty. This can be achieved by opting into added commitments that go beyond an outlined set of minimum commitments required by the multilateral treaty. The parties can be offered the option to accept being bound by specific provisions by making a unilateral declaration. Alternatively, the parties may add optional protocols to the instrument at the same time the main treaty is adopted or at a later date.[71]

3. **Flexible Wording**: The level of commitment can also be defined by the wording of the provisions and by the types of obligations contained in the provisions. The use of "will," "shall," and "must" can be used to achieve core objectives of the treaty, and more flexible wording can be used for more desirable objectives that are not necessarily required to achieve the main objective, such as "may" or "as appropriate." These more flexible terms can be found in many treaties, such as the *Convention of Mutual Administrative Assistance in Tax Matters* (1988)[72] or in the *United Nations Convention on the Law of the Sea* (1982).[73]

"It is important that a high level of transparency and clarity exists regarding the commitments undertaken by the parties and for all those involved and affected. Mechanisms are available to ensure clear and publicly accessible information."

<u>*Transparency and Clarity*</u>

Considering the complexity of the current network of bilateral tax treaties, it is important that a high level of transparency and clarity exists regarding the commitments undertaken by the parties and for all those involved and affected. Mechanisms are available to ensure clear and publicly accessible information. The objectives of the multilateral treaty can be achieved based on the law of treaties and existing precedents in international law. Focus on the following points is necessary.

1. **Publications**: To ensure clarity and transparency, there should be a publication of consolidated versions of bilateral treaties on publicly accessible databases. Further, an M.L.I. depository is imperative for receiving and maintaining information, notifications, and communications relating to the treaties. A viable option would be to require written

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70 See Article 30.

71 The *European Convention for the Protection of Human Rights and Fundamental Freedoms* (1950) includes the *Second Optional Protocol to the International Covenant on Civil and Political Rights, aiming at the abolition of the death penalty* (1989), as well as the *Optional Protocol to the Convention on the Rights of the Child on the involvement of children in armed conflict* (2000).

72 Article 13.

73 Article 123.

notifications to the depository by the parties involved, setting out the effect on the bilateral treaty, as it was done for the Agreement on Extradition between the European Union and the United States of America (2003).[74] As is common practice, opt-out measures are communicated to the depository, which then notifies all the parties to the treaty and can, upon request, notify other groups of all or certain communications. This same mechanism can be used for opt-in or choice-of-alternative measures.

2. **Translation**: Multilateral agreements are only negotiated and signed in a limited number of languages for practical purposes. Although it may not be possible to have official texts of the M.L.I. in all relevant languages, they may be translated at a later time. This has been done to universal human rights treaties, and the translations did not create major difficulties.

In conclusion, the many objections attacking the feasibility of the M.L.I. can be addressed by mechanisms that have been successfully used in other multilateral agreements currently in existence in public international law. Those agreements have been implemented and utilized predominantly without challenge over the many years they have been existence. Although instituting the B.E.P.S. initiative will be a complex and expansive undertaking, all concerns have already been addressed by past instruments and can be minimized by much the same mechanisms in previous cases.

POINT & COUNTERPOINT:

Treaty Provisions at Issue

The question raised by the Action Item 15's M.L.I. concept is whether or not the existing bilateral treaty network is equipped to deal with many different factors that may arise in today's global market. The treaty provisions at issue focus on a world where different countries have different standards, where each country is entitled to create its own standard, and where the disparity between standards can lead to the mismatching of tax results. The overriding question is whether the M.L.I. addresses real or imagined issues.

1. **Multi-country Disputes**: The goal of an article on Mutual Agreement Procedure ("M.A.P.") in a bilateral income tax treaty is to resolve disputes between the two countries that are parties to the bilateral agreement. The M.A.P. provision in the O.E.C.D. Model Convention provides guidance for a taxpayer where taxation in accordance with the provisions of a treaty is at issue. The M.A.P. provision establishes rules for two countries to follow with the goal of resolving the dispute. Action Item 15's position is that the M.A.P. needs to be improved to address issues where more than two countries are stakeholders and where international arbitration outside the protocols of the treaty itself may be appropriate. Perhaps this reflects a view that where major economies and global financial institutions are called upon to bail out the banking systems of other countries with failing

[74] Article 3(2).

“The O.E.C.D. is concerned about the commitment of many countries to make the required changes in domestic laws to eliminate the abuse. The M.L.I. would address potential gaps in domestic legislation and existing treaty provisions.”

economies, the major economies and the global institutions have an interest in the collection of tax in the countries receiving support.

2. **Dual Residency**: Action Item 15 suggests that it would be more efficient for countries in a bilateral context to address these issues on a case-by-case basis that reflects an anti-abuse structure in effect across the existing bilateral tax treaty network. In the residence article of the O.E.C.D. Model Convention, the proper residence of a dual-resident corporation is the state in which the corporation’s place of “effective management” is situated. An entity may have more than one place of management, but it can only have one place of effective management at any one time. Action Item 15’s position is that the M.L.I. can be used to create factors that control the manner in which this issue is resolved.

3. **Linking Rules**: Hybrid mismatching has created double non-taxation or low taxation in many instances. The O.E.C.D. is concerned about the commitment of many countries to make the required changes in domestic laws to eliminate the abuse. The M.L.I. would address potential gaps in domestic legislation and existing treaty provisions – an attractive goal for the O.E.C.D.

4. **Profit Shifting**: The standard by which the existence of a permanent establishment is determined can vary in application from country to country. This disparity can result in the shifting of profits to countries that impose tax at a lower rate or that permit tax to be deferred indefinitely. These so-called “triangular situations” may be outside the scope of a bilateral treaty if taxation in a given jurisdiction is not addressed in identical fashion by treaties or domestic law in all three countries. The M.L.I. will define permanent establishment in a consistent way that can provide flexibility for countries to tailor tax policy in a way that achieves compatible domestic policies. This could be accomplished while ensuring consistency and coherency for all multinational taxpayers.

5. **Treaty Shopping**: The M.L.I. could be used to prevent treaty shopping. Bilateral treaties give specific tax benefits, which are provided on reciprocal basis to appropriate taxpayers. Treaty shoppers seek to obtain treaty benefits by effectively using a treaty resident that channels income to a head office in a low tax jurisdiction having no comprehensive income tax treaty in effect. The M.L.I. might be appropriate as a backstop to the limitation on benefits provisions, such as those now in place in virtually all U.S. income tax treaties.

CONCLUDING POINTS

An M.L.I. could be beneficial if it quickly and efficiently address B.E.P.S. However, an M.L.I. is not possible without O.E.C.D. countries and associate countries committing to the cause, even if that means possibly giving up some sovereignty. In addition, the M.L.I. is, as of now, dependent on proposed rules that have been discussed and approved in general terms but lack the finer details which provide the proper context for the M.L.I.

The issue is one of balancing principle versus practicality. Many countries rely on multinational business structures to generate commercial activity, employment, and related tax revenues. The creation of the M.L.I. and its effect on a given multinational enterprise is yet to be demonstrated by consensus. If it is true that taxation is the core right of a given country and that a country can impose laws as its government sees fit, an M.L.I. that infringes upon this right will be resisted. This is especially true for the associate countries and other developing countries. This would not be a problem if a consensus is reached among all countries, including those with adverse interests. However, it is not clear that consensus has been reached.

On the other hand, if it is true that the provisions at issue with the bilateral treaty network cannot be amended in a timely manner and the risk of continued B.E.P.S. is too great, consideration of the M.L.I. is appropriate. The M.L.I. could address gaps that are created between bilateral agreements and domestic laws while co-existing with agreements already in place. It would be aligned with a country's given right to exercise its taxation authority. Whatever the size or shape of the M.L.I., a country's fundamental right to tax will not be changed. The right to tax includes the right to forbear from taxing.

We anticipate that a draft M.L.I. will be forthcoming in 2015. The points and counterpoints that will be addressed or deferred remain to be seen.

CORPORATE MATTERS: COVERING YOUR PARTNER'S TAX TAB

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Tags
Joint and Several
Partnerships
Secondary Liability
Withholding Tax

A district court, affirming a bankruptcy court decision, recently held that a partner can be secondarily liable for a partnership's unpaid employment taxes and that the I.R.S. could proceed with collection without having commenced specific individual action against the partner.

Case History

In *Pitts v. U.S.,*[75] Wendy K. Pitts, a California resident, was a general partner of DIR Waterproofing ("DIR"), a California general partnership. On March 1, 2012, Pitts filed a Chapter 7 bankruptcy petition in the U.S. Bankruptcy Court for the Central District of California. As of that date, DIR had unpaid Federal Insurance Contribution Act taxes and unpaid Federal Unemployment Tax Act taxes for various quarters in 2005, 2006, and 2007. It also had unpaid penalties.

Commencing in 2007, the I.R.S. recorded a number of tax liens naming DIR and Pitts as the taxpayers for the unpaid amounts. The I.R.S. identified Pitts as a DIR partner on the liens. At the time of the district court proceeding, the liens still encumbered the property of Pitts.

On June 21, 2007 and August 7, 2007, the I.R.S. issued Notices of Federal Taxes Due naming DIR as the taxpayer and Pitts as a partner.

As of the time of the summary judgment proceeding in June 2013, DIR still owed at least $114,859 in tax debt, plus unassessed interest. However, the I.R.S. never assessed DIR's taxes against Pitts or brought a judicial action against her.

On May 31, 2012, Pitts filed an adversary proceeding against the government to determine the dischargability of debts; the nature, extent, and validity of liens; and whether the I.R.S. violated the discharge injunction under applicable bankruptcy provisions.

On June 11, 2012, Pitts received a bankruptcy discharge. On June 26, 2013, she and the government filed cross-summary-judgment motions. After a hearing, the bankruptcy court denied her motion and granted the government's motion. On

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[75] *Pitts v. U.S.*, (DC CA 08/12/2014) 114 AFTR 2d, ¶ 2014-5171.

October 23, 2013, the bankruptcy court issued a judgment in favor of the U.S. The court determined, *inter alia*, that the liens filed by the I.R.S. against Pitt's property were valid and perfected, and that the I.R.S. did not violate the discharge injunction.

Pitts appealed the bankruptcy court's ruling to the district court.

Background

"A partner can be secondarily liable for a partnership's unpaid employment taxes."

Under Code §3402, an employer must deduct and withhold certain tax amounts from the wages it pays its employees. The employer is then liable for paying those withholdings to the I.R.S. under Code §3403.

Under Code §6672(a), if an employer fails to properly pay over its payroll taxes, the I.R.S. can seek to collect a trust fund recovery penalty equal to 100% of the unpaid taxes from a "responsible person," *i.e.*, a person who (i) is responsible for collecting, accounting for, and paying over payroll taxes; and (ii) willfully fails to perform this responsibility.

Pitts Liable for DIR's Unpaid Tax Debts

Pitts admitted that she was liable for DIR's obligations as a general partner, per California partnership law, but argued that under *U.S. v. Galletti*[76] a general partner is not a "taxpayer" with respect to the payroll tax withholding liabilities of his or her general partnership under Code §3403. She therefore contended that the I.R.S. could not rely on §3403 to support her liability for DIR's tax debts.

She further asserted that the I.R.S. had two main avenues for making her liable for such debts: either under federal or state law. To establish her liability as a responsible party under §6672, Pitts said that the I.R.S. had to separately assess her within the applicable three year statute of limitations. Since the I.R.S. never assessed Pitts' tax liability, she claimed that she was not responsible for DIR's tax debt under federal law. Additionally, she argued that since general partners are not "taxpayers" under Code §3403, the I.R.S. cannot separately assess them when it assesses the partnership for those tax withholdings. Pitts also contended that, although she was jointly and severally liable for DIR's obligations under California law, she was merely liable for DIR's debt and not its "tax" liability under the Code.

The I.R.S. argued that once it assesses a tax against a general partnership, it need not separately assess the general partners in order to make them liable. The I.R.S. asserted that since Pitts is liable for DIR's debts under California law, the tax assessment against DIR for its unpaid employment tax withholdings suffices to create a tax debt owed by Pitts to the I.R.S. Furthermore, I.R.S. stated that it did not have to proceed against Pitts under §6672 but rather could separately pursue her under state law.

The district court noted that the Supreme Court, in *Galletti*, had already weighed in on many issues relevant to the current appeal. Interpreting Code §3403, the Supreme Court held that the "employer" liable for paying the tax withholdings to the

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[76] *U.S. v. Galletti*, (S Ct, 3/23/2004) 93 AFTR 2d 2004-142593 AFTR 2d 2004-1425 (See: Weekly Alert ¶ 1 03/25/2004).

I.R.S. is the general partnership. It specifically rejected the argument that imposing a tax on the general partnership is equivalent to imposing a tax directly on the general partners because, under California law, a general partnership is an entity distinct from its partners. However, the Supreme Court went on to hold that the general partners may be secondarily liable for the general partnership's Code §3403 tax debts by operation of state law – all without a separate tax-liability assessment. Otherwise stated, under *Galletti*, once the I.R.S. assesses a general partnership for employment tax-withholding liability under Code §3403, the ten year statute of limitations for collection runs against the partners without separate assessment.

The district court thus found that when the I.R.S. seeks to hold a general partner liable via state law for a general partnership's Code §3403 tax liability, the general partner is liable for a federal tax obligation. Since the underlying obligation at issue in this action – employment tax withholdings under Code §3403 – arose under federal law, Pitts was therefore liable under federal law. The means by which the I.R.S. had chosen to hold her accountable for that obligation – state law – did not change that result.

Other Issues

After examining and rejecting arguments put forth by Pitts, the district court also found that the I.R.S. could properly employ administrative-collection procedures set forth in Code §6321 (lien for taxes) through Code §6326 (administrative appeal of liens) against a general partner to collect employment tax withholdings due from a general partnership under Code §3403, where the general partner is secondarily liable under state law for those obligations. It also found that the I.R.S. did not have to obtain a judgment against Pitts in order to hold her liable for DIR's tax debts.

Pitts also put forth a statute of limitations argument, which was not successful. The Court found that the liens were valid against Pitts. In addition, it agreed with the bankruptcy court's non-dischargability findings and found that the bankruptcy court did not err in determining that the I.R.S. did not violate the discharge.

New York Partnership Law

Under New York Partnership law,[77] the same outcome would have been reached. Although no partner has been held secondarily liable for unpaid partnership taxes, in New York the rule of "joint and several liability" would apply to recover the unpaid obligations from the general partner(s).

Unless provided, all partners are jointly and severally liable for all the debts and obligations of the partnership. What can be recovered from one is recoverable from all and vice versa. This means that the I.R.S. would be able to claim unpaid taxes and penalties from a general partner based on the argument that he is jointly and severally liable for all the debts and obligations of the partnership. Furthermore, the Court also held that the I.R.S. was neither obligated to furnish notice that it was

[77] N.Y. PTR LAW §26.

going to levy the taxes upon the plaintiff's personal assets nor was the Secretary of the Treasury required to enter into an installment agreement for the taxes.[78]

In *Young v. United States I.R.S.*,[79] the I.R.S. was allowed to levy taxes upon the personal individual retirement account of Sidney Young, a New York resident, for the payment of outstanding federal taxes from a dissolved California partnership. The Court held that under both New York and California law, Mr. Young was jointly and severally liable as a general partner for the partnership's liabilities.

Furthermore, the I.R.S. has specifically passed that Trust Fund Recovery Penalty ("T.F.R.P.") taxes[80] (*i.e.*, withheld income, employment taxes, social security taxes, railroad retirement taxes, and collected excise taxes) may be assessed against anyone who is a responsible or willful person, including a member of a partnership. The term "responsible person" is what links the partners in a partnership to a duty to pay partnership taxes. When examining whether a particular person is a responsible person, the I.R.S. will consider access, control, and authority, among other factors. A general partner will be considered "responsible" unless he can show otherwise. For example, a general partner who is not directly involved in the business or who does not have control over the bank account or the person who maintains the account may not be responsible because he does not have power over paying creditors.

CONCLUSION

In New York, general partners would also be held liable for the unpaid taxes of a partnership because they are considered accountable under the state rule of joint and several liability.

78 26 U.S.C.S. §6159.
79 *Young v. U.S. I.R.S.,* 387 F. Supp.2d 143 (E.D.N.Y. 2005).
80 http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Employment-Taxes-and-the-Trust-Fund-Recovery-Penalty-TFRP.

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Tag
F.A.T.C.A.

TREASURY ACCEPTS CANADIAN NARROWING OF INVESTMENT ENTITY DEFINITION

Canada's recently published guidance with respect to F.A.T.C.A. provides that only "listed financial institutions" should be considered investment entities subject to F.A.T.C.A. under the intergovernmental agreement ("I.G.A.") with Canada ("U.S.-Canada I.G.A."). The U.S. Treasury has accepted this position.

The U.S.-Canada I.G.A. provides that the definition of "investment entity" is to be interpreted in a manner consistent with the definition of "financial institution" in the recommendations of the Financial Action Task Force ("F.A.T.F."). The F.A.T.F. provides that any natural person or legal entity that conducts, as a business, one or more listed activities or operations for, or on behalf of, a customer, would be treated as a "financial institution." The F.A.T.F. also provides a list of designated nonfinancial businesses and professions, including certain trust and company service providers that are not otherwise financial institutions and act as trustees for trust entities. Canada's anti-money laundering rules interpret this standard to treat the unlisted financial institutions as designated nonfinancial businesses. The Canadian F.A.T.C.A. guidance treats only the expressly listed financial institutions as investment entities, and as mentioned above, the I.R.S. has approved this position.

The Treasury Office of International Tax Counsel explained earlier this month that this is one example of complexities raised by the multiple models of I.G.A.'s and multiple rules across jurisdictions that are not always consistent. The result is that most Canadian personal investment companies and trusts will not be considered F.F.I.'s, and thus, they will not be required to report U.S.-owned accounts to the I.R.S. and will not face a 30% withholding tax.

I.R.S. WARNS FOREIGN BANKS: SCAM ARTISTS PHISHING FOR F.A.T.C.A.-RELATED ACCOUNT DATA

As if to add insult to injury, the I.R.S. is now cautioning foreign financial institutions against scam artists who are posing as I.R.S. agents and fraudulently seeking out account information from foreign institutions fulfilling their F.A.T.C.A. compliance requirements. These fraudulent solicitations are known as "phishing" scams, and based on a news release from September 24th, the I.R.S. has affirmed reports of such scams from multiple countries and continents.

In light of current events, the I.R.S. stresses that F.A.T.C.A. requirements do not include providing specific information about accounts, or those who hold them, over the phone, by fax or by e-mail. Furthermore, the I.R.S. reminds institutions that it does not solicit F.A.T.C.A. registration passwords or similar confidential account access information. In the September 24th news release, I.R.S. Commissioner John Koskinen warns that "people should always be cautious before sending sensitive information to anyone."

Foreign financial institutions or their representatives that suspect they are the subject of a "phishing" scam should report the matter to the Treasury Inspector General for Tax Administration ("T.I.G.T.A.") at 800-366-4484 or through the T.I.G.T.A.'s secure website. Any suspicious emails that contain attachments or links in the message should not be opened, and the emails should be forwarded to phishing@irs.gov.

"F.A.T.C.A. requirements do not include providing specific information about accounts, or those who hold them, over the phone, by fax or by e-mail."

Just as a matter of note, persons outside the U.S. are now regularly subject to phishing scams regarding bank accounts in the U.S. through bogus W-8BEN requests. As I.R.S. information reporting obligations grow, so do the opportunities for hackers and thieves.

E.U. EXPECTED TO APPROVE F.A.T.C.A.-INSPIRED LEGISLATION

The European Union is expected to take its next major step in combating tax evasion when E.U. finance ministers vote this month on a F.A.T.C.A.-inspired law that would require automatic exchange of data relating to dividends, capital gains, and other income generated from assets held in a financial account.

The E.U.'s administrative cooperation legislation was approved several years ago and is due to take effect as of January 1, 2015. According to the administrative cooperation legislation, E.U. member states will be required to exchange data on nonresident E.U. citizens concerning employment, directors' fees, life insurance products, pensions, and ownership and income from immovable property.

The E.U. now moves towards expanding the administrative cooperation legislation to include F.A.T.C.A.-inspired exchange of information. This expansion will also incorporate the Organization for Economic Cooperation and Development's Common Reporting Standard adopted in July 2014.

SUBSTITUTIONS FOR FORM W-8

On September 25, 2014, the I.R.S. updated its list of F.A.T.C.A. F.A.Q.'s to explain the "similar agreed form" which can be used instead of the self-certification made on Form W-8 (Certificate of Foreign Status), as provided in Annex I of both the Model 1 and Model 2 I.G.A.'s. In addition, the I.R.S. also clarified when a non-reporting financial institution in a Model 1 I.G.A. jurisdiction is treated as a certified deemed-compliant F.F.I. and isn't required to register.

Similar Agreed Form

Under "General Compliance," the I.R.S. added a new F.A.Q. 8 to address what would be considered a "similar agreed form." The I.R.S. said that a similar agreed form could include, for example, a substitute Form W-8BEN, W-8BEN-E, W-8ECI, W-8EXP, or W-8IMY if its content is substantially similar to I.R.S.'s official Form W-8BEN, W-8BEN-E, W-8ECI, W-8EXP, or W-8IMY, and the partner jurisdiction doesn't decline such treatment. A substitute Form W-8 is generally valid only if it contains the same penalties of perjury statement and certifications as the official forms and the required signature. The substitute form does not have to include all of the Chapter 4 statuses provided on the Form W-8, as long as it includes any Chapter 4 status for which withholding may apply, *e.g.*, the categories for a nonparticipating F.F.I. or passive N.F.F.E. The substitute form may be incorporated into other business forms customarily used, such as account signature cards, if the required certifications are clearly set out. However, filers cannot use a substitute form that requires the payee to agree to provisions unrelated to the required certifications or to imply that a person may be subject to 30% withholding or backup withholding, unless that person agrees to provisions on the substitute form that are unrelated to the required certifications.

Lastly, filers could develop and use a substitute form that is in a foreign language, if an English translation of the form is made available to the I.R.S. upon request.

Registration for Certified Deemed-Compliant F.F.I.'s

Under the "I.G.A. Registration" F.A.Q.'s, the I.R.S. added a new F.A.Q. 7. It addresses registration requirements for a Model 1 I.G.A. entity that relies upon the definition of a non-reporting F.F.I. under the applicable I.G.A. to determine that it qualifies as a certified deemed-compliant F.F.I. or an exempt beneficial owner.

The I.R.S. said that a Model 1 I.G.A. non-reporting F.F.I. would nevertheless have to register on the F.A.T.C.A. registration website if:

- The F.F.I. is subject to a registration requirement under its qualified intermediary ("Q.I.") agreement or its withholding foreign partnership ("W.P.") or withholding foreign trust ("W.T.") agreement;
- The F.F.I. will act as a sponsoring entity (*i.e.*, an entity that agrees to perform the due diligence, withholding, and reporting obligations of one or more sponsored entities);
- The F.F.I. will act as a Lead F.I. for one or more related entities (a Lead F.I. is a designated participating F.F.I. in an expanded affiliated group that initiates the F.A.T.C.A. registration process for other members of the group and is generally authorized to carry out most aspects of its members' F.A.T.C.A. registrations);
- The F.F.I. is explicitly required to register under the applicable I.G.A.; or
- The F.F.I. has a financial account on which it will report to the Model 1 jurisdiction under the requirements of the applicable I.G.A.

"A substitute Form W-8 is generally valid only if it contains the same penalties of perjury statement and certifications as the official forms and the required signature."

I.R.S. ANTICIPATES JANUARY 2015 LAUNCH OF DATA EXCHANGE SYSTEM

The International Data Exchange Services ("I.D.E.S.") is a system that will allow the I.R.S. to exchange taxpayer information with other tax authorities under F.A.T.C.A. It is a key part of implementing I.G.A.'s, and is set to go live on January 12, 2015. On September 17, 2014, the I.R.S. updated the F.A.Q.'s dealing with the technical aspects of the services.

The I.R.S. said it is planning to publish an overview on data transmission to the I.D.E.S. "as soon as possible" and that the system is designed to be "always on" and available to receive the files.

The updated F.A.Q.'s also addressed the International Compliance Management Model ("I.C.M.M.") system. The I.C.M.M. will allow the I.R.S. to receive, process, store, and manage F.A.T.C.A.-related data it collects from various sources to support needed compliance activities. The I.C.M.M. will allow the I.R.S. to request information on recalcitrant accounts on an "ad-hoc" basis as Host Country Tax Administrations receive the data from F.F.I.'s.

SINGAPORE RELEASES PROPOSED REGULATIONS TO IMPLEMENT F.A.T.C.A.

Singapore's authorities have released proposed regulations and draft guidance to help financial institutions in Singapore comply with F.A.T.C.A. Singapore agreed on a Model 1 I.G.A. with the U.S. in May 2014, and the two parties are expected to sign the agreement before the end of the year. The full text of the agreement will be released after it is signed.

The draft[81] sets out the due diligence and reporting obligations of Singapore-based financial institutions in relation to the I.G.A. Combined with the supporting *e-Tax Guide*,[82] which provides further explanation of those obligations, the documents include the following information:

- Financial institutions that are obligated to submit information under F.A.T.C.A. and those that are exempt;
- Account holders and financial accounts that are subject to reporting requirements and those that are exempt;
- Due diligence procedures required to identify the reportable accounts;

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81 The draft legislation can be reviewed here: http://app.mof.gov.sg/data/cmsresource/public%20consultation/2014/2014_FATCA/ITEM%20A_FATCA%20Reg_19%20September%202014_For%20PC.pdf

82 The e-Tax Guide can be reviewed here: http://app.mof.gov.sg/data/cmsresource/public%20consultation/2014/2014_FATCA/e-Tax%20Guide_SG%20US%20FATCA.pdf

- Information to be reported; and
- Timelines for reporting the necessary information to the I.R.S.

Singapore's finance ministry has stressed that the guidance does not provide an exhaustive list of the topics covered but instead seeks to convey broad principles, which can be applied to different circumstances.

Interested parties can comment on the proposed regulations and guidance until October 17, 2014. The ministry will then release a summary of the comments received and its accompanying responses by December 2014. The finance ministry has said that where the draft regulations and guidance refer to persons, products, and accounts that are not found in the Model I.G.A., respondents should provide comments based on their F.A.T.C.A. status and treatment as set out in the documents.

SWITZERLAND NEGOTIATES TRANSITION TO MODEL 1 I.G.A.

On October 8th, Switzerland announced that it has adopted negotiation mandates to begin talks regarding a Model 1 I.G.A. It would replace the current Model 2 I.G.A., signed in 2013, which requires Swiss F.F.I.'s to report U.S. account information directly to the I.R.S.

This announcement is a milestone in global transparency efforts. Historically, Switzerland was known for its secrecy and would exchange financial information upon specific request and only in limited circumstances. But now, Switzerland is proposing to exchange significant financial information automatically. It seems that this move towards transparency is a result of the worldwide focus on ending tax evasion and strengthening global financial scrutiny.

BRAZIL SIGNS RECIPROCAL MODEL 1 I.G.A.

Even though Brazil and the U.S. did not sign an I.G.A. until September 23, 2014, a Model 1 I.G.A. between Brazil and the U.S. is treated as "in effect" by the U.S. Treasury as of April 2, 2014. The Brazilian government announced it has signed an I.G.A. with the U.S. as part of Brazil's adoption of F.A.T.C.A. According to a government announcement, the agreement was signed September 23rd in Brasilia by Finance Minister Guido Mantega and U.S. Ambassador Liliana Ayalde, and expands on the U.S.-Brazil tax information exchange agreement that took effect in May 2013.

The Brazilian government said that the I.G.A. signed provides that information on U.S. taxpayers residing in Brazil will be sent by Brazilian financial institutions to Brazil's federal tax department, which will then pass on the information to the I.R.S. Reciprocally, the I.G.A. also calls for the I.R.S. to provide Brazilian tax authorities with financial information on Brazilian taxpayers living in the U.S.

POLAND SIGNS RECIPROCAL MODEL 1 I.G.A

Even though Poland and the U.S. did not sign an I.G.A. until October 7, 2014, a Model 1 I.G.A. between Poland and the U.S. is treated as "in effect" by the U.S. Treasury as of April 2, 2014. The U.S. Treasury published the text of the I.G.A. between Poland and the U.S. earlier this month and according to the I.R.S.'s website, the I.G.A. signed follows the Model 1 I.G.A.

CURRENT I.G.A. PARTNER COUNTRIES

At this time, the countries that are Model I partners by execution of an agreement or concluding an agreement in principle are:

Algeria	Denmark	Jersey	Portugal
Anguilla	Dominica	Kosovo	Qatar
Antigua & Barbuda	Dominican Republic	Kuwait	Slovenia
Australia	Estonia	Latvia	South Africa
Azerbaijan	Finland	Liechtenstein	South Korea
Bahamas	France	Lithuania	Spain
Barbados	Greenland	Luxembourg	St. Kitts & Nevis
Bahrain	Grenada	Malaysia	St. Lucia
Belarus	Georgia	Malta	St. Vincent & the
Belgium	Germany	Mauritius	Grenadines
Brazil	Gibraltar	Mexico	Sweden
British Virgin Is.	Guernsey	Montenegro	Romania and
Bulgaria	Guyana	The Netherlands	Thailand
Cabo Verde	Haiti	New Zealand	The U.K.
Canada	Hungary	Norway	Turkey
Cayman Islands	Honduras	Panama	Turkmenistan
China	India	Peru	Turks & Caicos
Colombia	Indonesia	Poland	United Arab
Costa Rica	Ireland	Saudi Arabia	Emirates
Croatia	Isle of Man	Serbia	Ukraine
Curacao	Israel	Seychelles	Uzbekistan
Czech Republic	Italy	Singapore	
Cyprus	Jamaica	Slovak Republic	

The countries that are Model II partners are: Armenia, Austria, Bermuda, Chile, Hong Kong, Iraq, Japan, Moldova, Nicaragua, Paraguay, San Marino, Switzerland, and Taiwan.

This list is expected to continue to grow.

About Us

We provide a wide range of tax planning and legal services for foreign companies operating in the U.S., foreign financial institutions operating in the U.S. through branches, and U.S. companies and financial institutions operating abroad. The core practice of the firm includes tax planning for cross-border transactions. This involves corporate tax advice under Subchapter C of the Internal Revenue Code, advice on transfer pricing matters, and representation before the I.R.S.

The private client group of the firm also advises clients on matters related to domestic and international estate planning, charitable planned giving, trust and estate administration, and executive compensation.

The tax practice is supported by our corporate group, which provides legal representation in mergers, licenses, asset acquisitions, corporate reorganizations, acquisition of real property, and estate and trust matters. The firm advises corporate tax departments on management issues arising under the Sarbanes-Oxley Act.

Our law firm has offices in New York City and Toronto, Canada. More information can be found at www.ruchelaw.com.

Disclaimers

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