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INSIGHTS

THE END OF THE NEGOTIATION: PROTOCOL TO INDIA-MAURITIUS TAX TREATY FINALLY RELEASED

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EDITORS' NOTE

In this month's edition of *Insights*, the following topics are addressed:

- **The End of the Negotiation: Protocol to India-Mauritius Tax Treaty Finally Released.** After several years of negotiations, a new protocol to the Mauritius-India Income Tax Treaty has been agreed between the parties. In a nutshell, India benefits from amended provisions that are in line with other bilateral treaties, while Mauritius benefits from the adoption of grandfathering provisions regarding capital gains from the disposition of certain shares. Investors in both countries will benefit from greater certainty in taxing outcomes. Anurag Jain and Parul Jain of Attorneys BMR & Associates L.L.P., Gurgaon, address the highlights of the new provisions.

- **French Life Insurance Policies: A U.S. Income Tax Perspective.** The world of available insurance policies on an individual's life is broad and complex within the context of only one country. Add a foreign element, and one is faced with a legal and tax labyrinth. Enter Fanny Karaman and Stanley C. Ruchelman, to explain how a typical French life insurance policy is taxed for a policy holder having contacts with both France and the U.S.

- **E.U. State Aid – The Saga Continues.** For several years, the European Commission has been on a mission to raise on a retroactive basis the income tax of large corporations that received favorable tax rulings from national authorities. Using as its tool the rules prohibiting State Aid, the Commission has gone after Fiat Chrysler, McDonald's, Starbucks, and others. Christine Long and Beate Erwin explore the Commission's latest push and the outcry it is causing on both sides of the Atlantic. Luxembourg and the Netherlands have appealed recent rulings and the mood in Washington, D.C. is chilly, at best.

- **Income Tax Treaties v. Domestic Law: An International Look at the Current Score.** Ask most tax advisers outside the U.S. about the way to resolve a conflict between the provisions of an income tax treaty and domestic law, and the almost universal view is to look to the treaty for resolution. However, in some countries, an income tax treaty is not the last word in resolving conflicts. In the U.S., the saving clause of a treaty preserves the supremacy of U.S. domestic tax rules as they affect U.S. citizens and residents, as defined in the treaty. In Brazil, a presidential decree may govern the outcome. And in India, a domestic tax provision may be crafted in such a way as to circumvent a treaty by altering the identity of the technical taxpayer. Elizabeth V. Zanet, Galia Antebi, and Neha Rastogi examine ways in which those three countries directly or indirectly override treaty provisions that are deemed domestically undesirable.

- **Required Taxable Inclusions from the Loss of §1248 Shareholder Status.** Rusudan Shervashidze and Andrew P. Mitchel continue their examination of U.S. tax rules applicable to cross-border reorganizations, formations, and liquidations. This month, they review the rules embodied in Code §1248, a provision that converts capital gain from the sale of shares in a C.F.C. into dividend income for certain shareholders. Although for individuals, the tax rates for qualified dividends and gains are the same, the source of the income is changed in a way that may allow a benefit for unused foreign taxes. If the dividend is not qualified, tax is imposed at a much greater rate. For corporations that are shareholders, dividend income may bring along indirect foreign tax credits. Code §1248 also defines the extent of a toll charge if a foreign corporation undergoes a tax-free reorganization that eliminates C.F.C. status.

- **Draft Valuation Rules for Indirect Transfers in India.** In May, draft rules were issued in India that implement legislation designed to reverse the holding in the *Vodaphone* case. There, a taxpayer sold shares of an offshore company having as its principal asset shares of a large Indian telecommunication company. When Indian tax authorities attempted to thax the gain of the sale of foreign shares, the Indian Supreme Court held in the taxpayer's favor and observed that the transaction was beyond India's territorial tax jurisdiction. The law was changed in 2012, and in 2015, certain valuation benchmarks were set that established when tax would be imposed. Neha Rastogi, Kenneth Lobo, and Nina Krauthamer explain how the value of Indian and global assetswill be determined. They also address associated reporting requirements.

- **Proposed Reporting Requirements for Foreign-Owned U.S. Disregarded Entities.** Recently-proposed regulations will require information reporting for single member L.L.C.'s that are owned by non-U.S. persons and treated as disregarded entities. Typically, this structure is used for the acquisition of an apartment by camera-shy, high net worth individuals and offshore trading companies wishing to appear as U.S. persons. The regulations are designed to supply the I.R.S. with information about the operations and ownership so that information may be exchanged with tax treaty partner jurisdictions. Philip R. Hirschfeld and Nina Krauthamer examine the proposed reporting rules.

- **Property Contributions to Partnerships with Related Foreign Partners.** The Tax Section of the American Bar Association recently commented on a set of proposed rules that appear in Notice 2015-54. When adopted, these rules would limit the ability of U.S. persons to transfer appreciated property to a partnership in a tax-free transaction when the partnership has a non-U.S. person as a partner. The I.R.S. is concerned that through special allocations of gain, built-in appreciation in contributed assets may escape taxation. The Tax Section makes a case for additional guidance concerning the methods proposed to eliminate that result. Philip R. Hirschfeld and Nina Krauthamer discuss the I.R.S. proposal and A.B.A. comments.

- **Disallowance for Failure to Withhold on Outbound Payment Violates India-U.S. Non-Discrimination Clause.** To withhold, or not to withhold: that is the question. Neha Rastogi and Nina Krauthamer review the Herbalife case in India that allowed an Indian subsidiary to deduct an administration fee paid to a related parent company for services performed in the U.S. without imposing an obligation on the company to withhold Indian tax. The case, which relates to the tax year 2000 to 2001, has dragged on for many years. In 2004, the law was changed, but the litigation continued.

- **B.E.P.S. Around the World.** This month, we review steps toward implementation of anti-B.E.P.S. provisions in various countries and the E.U. Kenneth Lobo and Nina Krauthamer look at the latest items, including French tax raids on local offices of U.S. companies, disagreement with the E.U. over the adoption of blacklists and the tax treatment of C.F.C.'s, and pushback against proposed Code §385 regulations that deal with debt and equity.

We hope you enjoy this issue.

- The Editors

THE END OF THE NEGOTIATION: PROTOCOL TO INDIA-MAURITIUS TAX TREATY FINALLY RELEASED

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The Mauritius government has released the text of a protocol seeking to amend the India-Mauritius tax treaty (the "Protocol" and "Mauritius Tax Treaty," respectively). While a press release[1] issued by the Indian government on May 10, 2016 details some of the key amendments,[2] the Protocol itself provides for significant additional amendments, which are addressed in this article. The Protocol will come into force once each governments has notified the other that it has completed the procedures required by its respective laws.

ARTICLE 1 – SERVICE P.E. CLAUSE

Article 1 of the Protocol amends Article 5 of the Mauritius Tax Treaty. Article 5 provides that only business profits attributable to a Permanent Establishment ("P.E.") located in the other contracting state can be taxed by that other state. The amendment pursuant to the Protocol provides that services furnished through employees or other personnel would also constitute a P.E. in the source state of the enterprise rendering services, where activities of that nature continue (for the same or connected project) for an aggregate of more than 90 days within any 12-month period.

This is commonly referred to as a service P.E. clause. A service P.E. clause is not included in the O.E.C.D. Model Tax Convention on Income and on Capital (the "O.E.C.D. Model Treaty"). However, it is expressly promoted by the U.N. Model Double Taxation Convention (the "U.N. Model Treaty"). The service P.E. caluse was included in a number of tax treaties concluded by India, including the treaties with the U.S., the U.K., and Singapore. While some of India's tax treaties (*e.g.*, the foregoing treaties) specifically carve out certain technical services from the service P.E. clause, no such exception was provided under the Protocol. In that sense, the service P.E. clause added to the Mauritius Tax Treaty is similar to the service P.E. clause included in tax treaties by India with Iceland, Georgia, Mexico, and Nepal.

With increasing mobility of employees in multinational organizations, the service P.E. clause has been a matter of dispute in a number of cases where employees are sent on secondment or deputation.

It is important to note that the language added in the Protocol does not explicitly limit the application of the service P.E. clause to services provided "within a contracting state." The potential implication is that the source state could assert the existence

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1 See "India-Mauritius Tax Treaty Re-negotiated – Indian Government Issues Press Release," *BMR Edge*, 5.2 (2016).

2 *E.g.*, the amendment to the source-based taxation of capital gains on disposition of shares, including the transitional benefits and the applicability of the Limitation of Benefits ("L.O.B.") article.

of a service P.E., even if services are rendered entirely outside that state, if they are performed by the relevant employees or personnel and meet the time threshold.

In 2008, the O.E.C.D. added paragraphs 42.11 to 42.48 to the commentary on Article 5 of the O.E.C.D. Model Treaty. These paragraphs discuss the taxation of services performed in the territory of a contracting state and provide that these services will not be taxed in that state if they are not attributable to a P.E. situated therein. Simultaneously, India expressed its position that it reserves a right to treat an enterprise as having a service P.E. without specifically including the words "within a contracting state." Hence, this omission seems to be in line with the position taken by India on the O.E.C.D. commentary and could even expose taxpayers without any physical presence to net income taxation in the source state and the resultant challenges.

ARTICLE 2 – TREATMENT OF INTEREST INCOME

Article 2 of the Protocol amends Article 11 of the Mauritius Tax Treaty, pertaining to taxability of interest income. The relevant changes are summarized below:[3]

Existing Provisions	Amended Provisions
• Interest arising in India and paid to a Mauritius resident could be taxed in India, according to its domestic tax law, without any ceiling on the tax rate. • Interest derived and beneficially owned by a Mauritius bank that carries on a *bona fide* banking business is exempt from tax in India.	• Interest arising in India and paid to a Mauritius resident can be taxed in India, according to its domestic tax law. However, if the Mauritius-resident payee is the beneficial owner of the interest, Indian tax shall not exceed 7.5% of the gross interest. • The exemption available to Mauritius banks is only available with respect to loans outstanding on or before March 31, 2017.

Limiting the tax rate applicable in the state of source, and the requirement that interest be "beneficially owned" by a resident of the other state, is in line with O.E.C.D. Model Treaty and the U.N. Model Treaty. Further, most tax treaties entered into by India provide similar benefits.

Under the current Mauritius Tax Treaty, interest income on instruments such as mandatory convertible debentures, non-convertible debentures, or loans issued by a Mauritius entity to a resident of India is subject to tax, with no limitation, at 40% in many cases, and a beneficial rate of 20% or 5%, in specific cases. Therefore, this amendment is certainly a welcome change, which provides the Mauritius Tax Treaty an edge above other treaties to which India is a party. This includes the treaties with Singapore, Cyprus, and the U.S., where the applicable tax is limited to 10% or 15%, as the case may be.

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3 The current Mauritius Tax Treaty (and the amended version pursuant to the Protocol) includes corresponding provisions for interest arising in Mauritius and paid to an Indian resident. However, for the sake of simplicity, this table refers to interest arising in India and paid to a Mauritius resident.

ARTICLE 3 – FEES FOR TECHNICAL SERVICES

While Article 12 of the Mauritius Tax Treaty provides for the treatment of royalties, unlike many other treaties to which India is a party, the Mauritius Tax Treaty did not include a provision discussing the tax treatment of Fees for Technical Services ("F.T.S."). Article 3 of the Protocol amends the Mauritius Tax Treaty and adds a new article, 12A, which provides for the tax treatment of F.T.S. Generally, Article 12A provides the following:

- Both the country of residence and the country of source have the right to tax F.T.S.
- The rate of tax in the source country is limited to 10% of the gross amount of the F.T.S., if the beneficial owner of the payment is a resident of the other contracting state.
- The definition of F.T.S. generally covers consideration paid for managerial, technical, or consultancy services, including the provision of services of technical or other personnel.

"In the event that income is paid with respect to managerial, technical, or consultancy services rendered by a Mauritius entity for a period of less than 90 days, the income would be taxed pursuant to the provisions of Article 12A."

The provisions of Article 12A are similar to the F.T.S. article included in other treaties to which India is a party. It is pertinent to note that neither the O.E.C.D. Model Treaty nor the U.N. Model Treaty provide a separate article discussing the treatment of F.T.S. In the absence of a separate article dealing with F.T.S., such income would typically not be taxed in the source state, unless the payee has a P.E. in that state. Pursuant to this change, F.T.S. income paid by an Indian resident to a resident of Mauritius would now be subject to tax in India.

Note that Article 12A does not include "make available" criteria in the definition of "included services," as is found in the treaties between India and the U.S., the U.K., and Singapore. This effectively expands the scope of taxable F.T.S. income to be on par with domestic Indian tax law.

To summarize, in the event that income is paid with respect to managerial, technical, or consultancy services rendered by a Mauritius entity for a period of less than 90 days, the income would be taxed pursuant to the provisions of Article 12A. Income arising from the rendering of all types of services for a period exceeding 90 days would be taxable under Article 7 of the Mauritius Tax Treaty, provided the services are for the same or connected projects.

ARTICLES 4 AND 8 – CAPITAL GAINS TAX EXEMPTION AND THE L.O.B. CLAUSE

With respect to the sale of shares of an Indian company by a Mauritius resident, Article 4 of the Protocol makes the following changes to Article 13 (Capital Gains) of the Mauritius Tax Treaty, effective as of April 1, 2017:

- Gains from the transfer of shares of a company resident in India, which are acquired on or after April 1, 2017, would be subject to tax in India.
- However, the tax rate applicable to gains arising from a sale of shares acquired after April 1, 2017 and sold between April 1, 2017 and March 31, 2019

shall not exceed 50% of the domestic tax rate otherwise applicable to such gains (see also below relating to Article 8 of the Protocol).

Article 8 of the Protocol adds new Article 27A (Limitation on Benefits) to the Mauritius Tax Treaty. The L.O.B. provision limits the availability of benefits under the Mauritius Tax Treaty to avoid treaty shopping and prevent conduit companies from obtaining benefits. The addition of this clause affects the transitional reduction of tax with respect to capital gains.

The new L.O.B. provision includes the following stipulations:

- An entity shall not be entitled to the benefits of the Mauritius Tax Treaty (including the newly inserted concessional capital gains taxation) if the entity's affairs are arranged in the country of residence primarily for the purpose of taking advantage of treaty benefits. This would include entities not having *bona fide* business activities.

- A shell or conduit company shall not be entitled to benefits under the Mauritius Tax Treaty. An entity will be treated as a shell or conduit company if, in the immediately preceding 12 months, it did not incur expenditures on operations in its country of residence of at least 1,500,000 Mauritian rupees or 2,700,000 Indian rupees, as the case may be. However, an entity is deemed not to be a shell or conduit company if it is listed on a recognized stock exchange in its country of residence.

According to Article 9 of the Protocol, Article 8 will be effective in India, for fiscal years beginning on or after April 1 of the year following the date on which the Protocol enters into force. In Mauritius, it will be effective for fiscal years beginning on or after July 1 of the same year. Article 4 of the Protocol (Capital Gains) shall be effective for assessment year 2018-19 and any subsequent assessment years.

The articles dealing with taxation of capital gains arising on sale of shares of an Indian company are in line with what has been stated in theMay 10, 2016 i press release.[4]

There are some open questions regarding the potential interplay between the General Anti-Avoidance Rule ("G.A.A.R.") and tax treaties, as well as the grandfathering of certain treaty benefits with regard to shares acquired after April 1, 2017 as a result of conversion of other instruments. Additionally, it seems that an indirect transfer of shares of a foreign (non-Indian) company whose value is derived substantially from Indian assets may not be subject to tax in India despite the changes made in the Protocol.

ARTICLE 5 – SOURCE RULE FOR TAXATION OF OTHER INCOME

Article 5 of the Protocol amends Article 22 (Other Income) of the Mauritius Tax Treaty to enable taxation in the source country of any "other income" arising in the country.

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[4] For a detailed analysis, see "India-Mauritius Tax Treaty Re-negotiated – Indian Government Issues Press Release."

According to Article 9 of the Protocol, Article 5 will be effective in India for fiscal years beginning on or after April 1 of the year following the date on which the Protocol enters into force. In Mauritius, it will be effective for fiscal years beginning on or after July 1 of the same year.

The amendment to Article 22 changes the rule for taxation of other income, and specifically ushers in "source-based" taxation. This seems to be an all-encompassing provision, which removes a preexisting safe harbor from Indian taxation for all other income derived in India by a Mauritius resident and vice-versa.

ARTICLE 6 – EXCHANGE OF INFORMATION

Article 26 (Exchange of Information) has been replaced to expand its scope. Significant provisions included in the new Article 26 vis-à-vis the existing exchange of information ("E.O.I") provisions are described below:

- In addition to the taxes covered under the treaty, the scope of E.O.I. has been enhanced to include "taxes of every kind and description," insofar as these taxes are not contrary to the provisions of the tax treaty.
- The information exchanged must no longer be "necessary," but it will be sufficient for the information to be "foreseeably relevant" for the purpose of carrying out the provisions of the tax treaty or the enforcement of a domestic law concerning tax.
- Information or documents received under the tax treaty, can also be shared with authorities or persons having "oversight" over the assessment, collection, and enforcement of taxes or prosecution with respect to these taxes or appeals thereof. Information so disclosed can also be used for "other" purposes if permitted by the laws of both states and authorized by the disclosing state. The provision enabling disclosure of information to the person to whom it relates has been deleted.
- The requested state cannot deny collection or disclosure of information on the ground that it does not need such information for its own tax purposes. Further, a requested state cannot decline to supply information solely because the information is held by a bank, other financial institution, nominee, or person acting in an agency or a fiduciary capacity; or because it relates to ownership interests in a person.

Efforts to increase tax transparency and E.O.I. have been gaining global momentum recently. Both Mauritius and India have been actively participating in global forums for E.O.I., are participating in the O.E.C.D.'s Common Reporting Standard ("C.R.S."), and are complying with the U.S. Foreign Account Tax Compliance Act ("F.A.T.C.A.").

Currently, Article 26 of the Mauritius Tax Treaty is being significantly revamped to widen the scope of E.O.I. and bring it on par with the provisions of the O.E.C.D. Model Treaty.

Further, information can also be disclosed to oversight bodies. Oversight bodies include authorities that supervise tax administration and enforcement authorities, as part of the general administration of the government. Neither having a purpose of carrying out the provisions of the tax treaty nor applicability of taxes covered in the tax treaty is a prerequisite for E.O.I. Instead, the Protocol states that E.O.I. shall not be restricted by Article 1 and 2 of the Mauritius Tax Treaty. This has the following potential ramifications:

- Information regarding an individual may be sought from a country, irrespective of whether the person is a resident of the requested country.
- E.O.I. may not be limited to taxpayer-specific information. Countries may also exchange other sensitive information related to tax administration and compliance improvement, *e.g.*, risk analysis techniques or tax avoidance or evasion schemes.

Moreover, under the existing E.O.I. provision, "persons with respect to whom the information or document relates" are specifically entitled to receive the information and documents that are obtained under Article 27. Under the new Article 27, such persons are not expressly mentioned. However, pursuant to the commentary to the O.E.C.D. Model Treaty, information obtained under this article may also be shared with the taxpayer, his/her proxy, or a witness deposed because such person is connected with the assessment or collection of taxes. It will be interesting to see how the Indian Revenue Authorities deal with information they obtain, either by sharing the information with taxpayers under the new Article 27 or refraining from doing so.

ARTICLE 7 – ASSISTANCE IN COLLECTION OF TAXES

In line with the O.E.C.D. Model Treaty and the U.N. Model Treaty, Article 26A (Assistance in the Collection of Taxes) has been added to the Mauritius Tax Treaty. Some of the notable features of the provision are as follows:

- Both countries shall lend assistance to each other in the collection of "revenue claims" arising out of any taxes.
- The term revenue claims refers to the amount owed with respect to taxes of every kind and description (including interest, administrative penalties, and costs of collection or conservancy related to such taxes), insofar as this taxation is not contrary to the provisions of the tax treaty or any other instrument signed by both countries.
- Both countries will be obliged to accept and collect revenue claims of the other country and take measures for conservancy, subject to the fulfillment of certain conditions.
- Revenue claims accepted by a country shall not be subject to time limits or accorded any priority applicable to a revenue claim under the laws of that country or accorded any priority applicable in the other country. No proceedings with respect to the existence, validity, or the amount of a revenue claim can be brought before the courts in the country accepting the revenue claim.

In an era of globalization, traditional approaches towards assistance in the collection of taxes have changed. This change was to some extent influenced by the development of electronic commerce and the concerns about the ability to collect V.A.T. (Value Added Tax) on such activities. The 1998 O.E.C.D. report *Harmful Tax*

Competition: an Emerging Global Issue also highlighted concerns about increased tax evasion, if one country will not enforce the revenue claims of another country. The report thus recommended that:

> Countries be encouraged to review the current rules applying to the enforcement of tax claims of other countries and that the Committee on Fiscal Affairs pursue its work in this area with a view to drafting provisions that could be included in tax conventions for that purpose.

As a result of these concerns, the O.E.C.D. Council approved the inclusion of a new Article 27 on assistance in tax collection in the 2003 update of the O.E.C.D. Model Treaty. The new Article 26A is in *pari materia* with Article 27 of the O.E.C.D. Model, and thus, it may help the Indian government to recover tax dues from willful defaulters. India has also inserted a similar provision for assistance in collection of taxes in recent tax treaties with Sri Lanka, Fiji, Bhutan, Albania, Croatia, Latvia, Malta, Romania, and Indonesia. Further, the tax treaties with the U.K. and Poland have been amended to insert an article of this nature.

"This is a landmark move by the Modi-led government, which finally claims victory over long-drawn treaty negotiations that have lasted several years."

Both India and Mauritius have also signed the Convention on Mutual Administrative Assistance in Tax Matters. Moreover, similar to the new Article 26, assistance in collection of taxes is not restricted by Article 1 and 2 of the tax treaty.

CONCLUSION

This is a landmark move by the Modi-led government, which finally claims victory over long-drawn treaty negotiations that have lasted several years. Taking a myopic view, as a result of the Protocol and the additional tax cost for Mauritian investors, Mauritius may lose its sheen as a preferred jurisdiction for investments into India. However, a broader view reveals that foreign investors are likely to welcome the certainty of the new tax regime and the lack of retroactive taxing provisions with respect to capital gains, as evidenced by the grandfathering rules.

The Indian government has been wise to grandfather investments made before April 1, 2017 and to align this date with the proposed introduction of G.A.A.R. Albeit, the interplay of the L.O.B. clause and G.A.A.R. is still unclear. The addition of two-year transitional provisions with respect to the taxation of capital gains is another welcome step. Other major changes provided in the Protocol are in line with the O.E.C.D. Model Treaty and with recent tax treaties entered into by India. This, therefore, makes the existing Mauritius Tax Treaty more robust while re-emphasizing the importance of Mauritius as a source of investments into India.

The only loose thread seems to be the fate of the capital gains exemption under the India-Singapore tax treaty (the "Singapore Tax Treaty"). From media reports, it appears that the Indian government may soon initiate negotiations with its Singaporese counterparts. With Singapore overtaking Mauritius as the largest source of foreign direct investment in 2015,[5] the Indian government would be well-advised to bilaterally negotiate the Singapore Tax Treaty well in time, in order to provide a level playing field for investments made from Singapore and those made from Mauritius.

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[5] Department of Industrial Policy & Promotion, "Fact Sheet on Fact Sheet on Foreign Direct Investment (FDI), from April, 2000 to December, 2015."

FRENCH LIFE INSURANCE POLICIES: A U.S. INCOME TAX PERSPECTIVE

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Tags
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Income Tax
Life Insurance

The world of available insurance policies on an individual's life is broad and complex within the context of the tax law in the insured individual's country of residence. Add a foreign element, and one is faced with a legal and tax labyrinth. Certain important terms are lost in legal translation, and the task of applying the policy's term in another country is not easy.

For a U.S. tax adviser, the mere use of the label "life insurance" is not itself sufficient to cause a non-U.S. life insurance contract to be characterized as life insurance for U.S. income tax purposes. Rather, accurate characterization requires a thorough analysis of the terms of the policy based on an understanding of the foreign and U.S. tax regimes. This is because a non-U.S. policy is crafted to meet non-U.S. tax rules, unless drafted specifically for U.S. tax purposes.

This article aims at summarizing the U.S. and French tax regimes applicable to life insurance policies during the insured individual's lifetime and analyzing the U.S. tax implications for a U.S. citizen or tax resident holding a French life insurance policy designed for French residents. Applicable tax regimes triggered by the death of the insured will be the subject of a companion article, which will appear in a later edition of *Insights*.

FRENCH LIFE INSURANCE

The starting point is a summary of the more important tax consequences for a French resident setting up a French life insurance policy.[1] For purposes of illustration, we focus on a popular and typically-encountered life insurance policy.

The individual subscriber is the insured individual who is the lifetime beneficiary of the life insurance policy. The policy guarantees a certain payout at the earlier of (i) the time of death of the insured individual or (ii) an agreed upon date. The life insurance policy has a cash surrender value, and the subscriber has identified beneficiaries in the event of death.

The subscription of a life insurance policy by an individual triggers the potential application of two types of taxes during lifetime: income tax and wealth tax.[2] French social charges (comparable to social security tax or net investment income tax under U.S. law) are also taken into account.

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1 Although specific French tax provisions apply to French residents who subscribe to non-French life insurance policies, those provisions are outside the scope of the present article.

2 At the time of the death, two additional taxes, borne by the beneficiaries, may apply. A discussion of those taxes is outside the scope of this article. Note that life insurance companies frequently act as withholding agents for collection of applicable taxes at death.

French Life Insurance for French Tax Purposes

In order to benefit from the favorable tax regime currently applicable to French life insurance policies, the life insurance company must be established in France[3] and the policy must be taken out after December 31, 1982.[4] As previously mentioned, the policy generally has a cash surrender value or a guaranteed payout at the end of the contract – generally equivalent to the cash surrender value at the time of death.[5] In addition, certain life insurance policies are set up to meet specific underlying investment requirements in order to benefit from even more favorable tax treatment.[6]

General Income Tax Rules Applicable to French Life Insurance Proceeds

Once the basic criteria are met, life insurance proceeds are subject to French income taxation only upon withdrawal or the maturity date of the policy. Thus, barring early withdrawal, the insured subscriber will not incur taxation throughout the contract. This means that all reinvestment of income and gains within the policy is made on a pre-tax basis, thereby increasing the effective yield. The taxable amount equals the withdrawn or received amount, less the paid-in premiums. In other words, the increase in value over the paid-in premiums is subject to French income tax.

French income tax is levied at the following rates:[7]

Net Taxable Income Bracket	Applicable Tax Rate
Up to €9,700	0%
€9,700 – €26,791	14%
€26,791 – €71,826	30%
€71,826 – €152,108	41%
More than €152,108	45%

However, at the election of the taxpayer, withholding tax can be levied by the insurance company issuing the policy. The election must be made not later than at the time proceeds are received. The withholding of tax discharges the taxpayer from any further income tax liability with respect to the proceeds received under the policy.

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3 Article 125-0 A of the French Tax Code, as currently in effect.

4 BOI-RPPM-RCM-10-10, June 30, 2014, no. 80.

5 BOI-RPPM-RCM-10-10, June 30, 2014, no. 40.

6 Article 125-0 A of the French Tax Code, as currently in effect.

7 Please note that high income taxpayers are subject to an additional income tax levy at a marginal rate of 4%.

The rate of withholding tax varies depending on the age of the policy. The following table summarizes the applicable withholding rates:

“The withholding of tax discharges the taxpayer from any further income tax liability with respect to the proceeds received under the policy.”

Taxpayer Reporting	Age of the Policy[8]	Withholding Tax Rate
Taxpayers disclosing identity & residence to the tax authorities	< 2 years	45% or 35% (for policies subscribed to as of January 1, 1990)
	≥ 2 years < 4 years	25% or 35% (for policies subscribed to as of January 1, 1990)
	4 years	15%
	≥ 6 years (for policies subscribed to between January 1, 1983, and December 31, 1989) or ≥ 8 years (for policies subscribed to as of January 1, 1990)	7.5% (unless the policies are otherwise exempt)[9]
Taxpayers not disclosing identity & residence to the tax authorities	N/A	60%[10]
Taxpayers residing in deemed non-cooperative countries	N/A	75%[11]

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8 The age is calculated as of the setting up of the policy (BOI-RPPM-RCM-30-10-20-20, June 30, 2014, no. 70) or as of the first premium payment (BOI-RPPM-RCM-30-10-20-20, June 30, 2014, no. 70).

9 BOI-RPPM-RCM-30-10-20-20, June 30 2014, no. 110 &130

10 Article 125, II, 2 of the French Tax Code, as currently in effect.

11 Article 125, II bis of the French Tax Code, as currently in effect.

When the taxpayer is not a French resident for French income tax purposes, the withholding tax obligation is mandatory for the financial institution issuing the life insurance policy.[12]

Available Deductions for French Income Tax Purposes

The taxable life insurance proceeds are decreased annually, provided the taxpayer did not elect to be subject to withholding on taxable distributions. If the policy has been in existence for at least eight years (or six years for policies subscribed to between January 1, 1983, and December 31, 1989), taxable proceeds are decreased by the following amounts:[13]

- €9,200 for married individuals and civil unions
- €4,600 in all other scenarios[14]

The foregoing deductions are only available to French tax residents.[15]

Available Exemptions for French Income Tax Purposes

Exemptions are available for those who qualify under French tax law. Qualification is generally linked to the holding period of the policy, the underlying investments, or certain life events. Broadly speaking, the following factors are key elements of qualification:

- The life insurance policy was subscribed to before or after specific dates and was held for six or eight years, depending on the applicable regime.[16]
- The life insurance premiums were paid prior to specific dates or the proceeds were received prior to specific dates, and the policy was held for six or eight years.[17]
- Withdrawals are made as a result of[18]
  - employment termination,[19]
  - early forced retirement, or[20]
  - disability.[21]

"When the taxpayer is not a French resident for French income tax purposes, the withholding tax obligation is mandatory for the financial institution."

12 Article 125, II bis of the French Tax Code, as currently in effect.

13 BOI-RPPM-RCM-20-10-20-50-20140211, no. 330.

14 Article 125-0 A, I, 1 of the French Tax Code, as currently in effect.

15 BOI-RPPM-RCM-20-10-20-50-20140211, no. 240.

16 BOI-RPPM-RCM-10-10-80, June 30, 2014, no. 80.

17 *Id.*

18 *Id.*, no. 100

19 *Id.*, no. 102.

20 *Id.*, no. 105.

21 *Id.*, no. 107.

- The life insurance payout takes the form of a life annuity, rather than a lump-sum payment.[22]
- The policy invests in specified classes of investments at specific ratios, as defined by French tax laws, and the policy was held for eight years.[23]

With regard to the last factor, two different regimes exist under French tax law that provide for a full exemption of the life insurance proceeds, provided the policy invests in specified classes of investments at specific ratios. The first regime is called the "D.S.K." (Dominique Strauss-Kahn) regime; the second is the "N.S.K." (Nicolas Sarkozy) regime.

A D.S.K. policy is a life insurance policy subscribed to between January 1, 1998, and December 31, 2004. Among other criteria, the policy's cash surrender value or the guaranteed amount must be converted into "account units." Stated simply, every account unit is indexed to the value of specific underlying investments. The insurance company is liable for the number of account units the policy guarantees to the subscriber or other beneficiaries. The insurance company is not liable for the value of the underlying investments.[24] Every account unit is made up of specific investments. The insurance company is the legal owner of these underlying investments.[25] As a general rule, the underlying investments must be one or more O.P.C.V.M.'s (*Organisme de Placement Collectif en Valeurs Mobilières*) or certain similar European investment funds. O.P.C.V.M.'s essentially constitute investment funds, thus generating passive income. In order to be a qualifying O.P.C.V.M. for purposes of this specific life insurance regime, the O.P.C.V.M. must invest in certain types of investments, at specific ratios, as listed by French law.

An N.S.K. policy is a life insurance policy subscribed to between January 1, 2005, and December 31, 2013. Under this type of life insurance policy, either all or some of the premiums must be converted into account units. If only some of the premiums are converted, the balance must be directly invested.[26] Here again, a certain ratio of account units must be invested in certain O.P.C.V.M.'s meeting investment ratios proscribed by French law.

French Social Charges

French social charges apply to French life insurance proceeds. Depending on the nature of the life insurance policy, these social charges are levied at a 15.5% rate (i) throughout the life of the policy or (ii) upon withdrawal.

The 15.5% rate is the aggregate amount of a multitude of social charges that generally apply to French passive income, and the following breakdown highlights its various components:

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22 *Id.*, no. 90.

23 BOI-RPPM-RCM-10-10-90, June 30, 2014.

24 BOI-RPPM-RCM-10-10-90-10-20120912, no. 20.

25 *Id.*

26 BOI-RPPM-RCM-10-10-100-10-20130107, no. 10.

Social Charge	Rate
C.S.G.	8.2% (5.1% is tax deductible)
C.R.D.S.	0.5%
Prélèvement Social	4.5%
Contribution Additionnelle au Prélève-ment Social	0.3%
Prélèvement de Solidarité	2.0%
Aggregate Amount	**15.5%**

French Wealth Tax

A French tax resident can be subject to French wealth tax if, on January 1 of the applicable tax year, his or her worldwide net assets have a fair market value exceeding a certain threshold. For the 2016 tax year, this threshold equals €1.3 million.[27]

If a French resident's worldwide net assets exceed the threshold, the fair market value is taxed at the following rate:

Asset Valuation Bracket	Applicable Tax Rate
< €800,000	Exempt
€800,000 – €1,300,000	0.50%
€1,300,000 – €2,570,000	0.50%
€2,570,000 – €5,000,000	1.00%
€5,000,000 – €10,000,000	1.25%
> €10,000,000	1.50%

27 Article 885 A of the French Tax Code, as currently in effect.

Life insurance policies are subject to French wealth tax according to the following rules throughout the term of the policy:[28]

- If the policy has no cash surrender value, only the premiums paid after the taxpayer has reached the age of 70 must be included in the taxable base.
- If the policy has a cash surrender value, this cash surrender value, as determined on January 1 of the applicable year, must be included in the taxable base.
- If the policy temporarily prevents the taxpayer from an early cash-out, the policy must still be included in the taxable base.

"If a life insurance policy meets the statutory definition, its yearly increase in value is not subject to income tax."

U.S. LIFE INSURANCE

Section 7702 of the Internal Revenue Code of 1986, as currently in effect, (the "Code") defines life insurance for purposes of U.S. income taxation. It defines a life insurance contract to mean any contract that is a life insurance contract under the applicable law, but only if such contract meets the following requirements:

- **Cash Value Accumulation Test:** Under this test the cash surrender value of the contract may not at any time exceed the net single premium that would have to be paid at that time to fund future death benefits under the contract, assuming that the contract matures no earlier than the policyholder's 95th birthday and no later than the day the insured attains age 100. This test is intended to permit traditional whole-life insurance contracts to qualify as life insurance contracts, even though cash values accumulate at reasonable interest rates.
- **Guideline Premium Requirement with Regard to Premiums Paid Under the Contract and Specified Cash Value Corridor:** The guideline premium limitation as of any date is the greater of (i) the guideline single premium or (ii) the sum of the guideline level premiums to that date. The former is the premium that is necessary at the date the policy is issued, and certain other times to fund the future benefits under the contract, plus charges for any of four qualified additional benefits. The calculation must be based on reasonable mortality and expense charges. The guideline level premium is the level annual amount payable over a period of time, not ending before the insured person attains age 95 years, that is necessary to fund future benefits under the contract. The cash value corridor test ensures that the contract contains at least a minimum amount of pure insurance protection at all times, as specified by certain tables. To illustrate, for an insured person with an attained age of 40 years, the death benefit must be 250% of the cash value. For attained ages from 41 to 45 years, the required percentage decreases ratably to 215%.

In addition, specific diversification rules exist that must be respected in order to qualify for owner-directed investments.[29]

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[28] *Id.*

[29] Code §817(h).

The purpose of the provision is to counter a general concern over the proliferation of investment-oriented life insurance products.[30] If a life insurance policy meets the statutory definition, its yearly increase in value is not subject to income tax.[31] In addition, upon a payout before death, the investment in the contract – *viz.*, the aggregate amount of premiums paid into the policy reduced by the aggregate amount received under the contract that was excluded from gross income – is not subject to income tax, leaving only the amount in excess of the investment in the contract as amounts of a payout that would be taxed.[32]

Upon the death of the insured, proceeds attributable to the death benefit of the life insurance contract are generally not subject to income tax in the hands of the estate or heirs receiving the payment.[33] However, where a life insurance contract has been transferred for valuable consideration to a third party, the contract resembles an investment product and amounts in excess of the value paid for the policy plus the premiums paid after the transfer are fully taxable in the hands of the recipient.[34] This rule does not apply in certain business circumstances, such as upon the retirement of the insured in relation to a contract owned by his or her employer.[35]

U.S. TAXATION OF FRENCH LIFE INSURANCE

The first step in analyzing the status of the French life insurance policy involves reading the document, which is typically written in French. The goal is to analyze the general conditions of the contract and the special conditions applicable to the insured. The second step is to understand the foreign tax regime generally applicable to the documents. Finally, the foreign document must be analyzed in light of applicable U.S. tax law.

Typical Fact Pattern

In a typically-encountered fact pattern, a French national and resident moves to the U.S. for work-related reasons. The individual may hold an H-1B or an L-1 visa, but not a green card – a term commonly used to describe a permanent resident visa. The individual is a U.S. resident for income tax purposes, under the substantial presence test of Code §7701(b). The individual may hold several assets in his or her estate, including a French life insurance policy. The terms of the policy provide that the individual is the beneficiary of the policy, entitled to a payout during life that is capped at the cash surrender value. At death, the death benefit must be paid to the surviving spouse or children.

Typically, a French contract is not designed to provide a death benefit. Instead, the French life insurance policy serve as an investment tool for French residents.

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30 Staff of the Joint Committee on Taxation, "General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984," December 31, 1984, p. 646.

31 Code §7702(e)(5). This treatment is also subject to the provision that (i) the policy does not constitute a modified endowment contract as defined by Code §7702A and (ii) no annuities have been paid under the contract.

32 Code §§72(e)(2)(B) and 72(e)(5)

33 Code §101(a).

34 Code §101(a)(2)

35 Code §101(a)(2)(B).

Viewed in this light, French life insurance policies generally do not meet the Code §7702 tests mentioned above. The premium payment is front loaded so as to accelerate tax savings on the investment feature.

U.S. Income Tax Regime Applicable to Non-Qualifying Life Insurance Policies

As previously stated, Code §7702 has a two-pronged test. For a life insurance policy to qualify, the policy must

- be designated as a life insurance contract under the applicable law, and
- meet either (i) the cash value accumulation test or (ii) the guideline premium requirement and the specified cash value corridor.

Regarding the first test, which requires the contract to be a life insurance contract under the applicable law, the Code does not specify whether that law can be foreign law. However, the "General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984," published by the Joint Committee of Taxation ("J.C.T."), states that the law may be foreign law:

> A life insurance contract is defined as any contract, which is a life insurance contract under the applicable State *or foreign law*, but only if the contract meets either of two alternatives: (1) a cash value accumulation test, or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement. [emphasis added]

Thus, a French life insurance contract is a life insurance contract for U.S. tax purposes. However, it cannot meet either of the tests in the second prong. Consequently, Code §7702(g)(1)(A) becomes applicable. It provides for the tax regime applicable to non-qualifying policies, in the following terms:

> If at any time any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract . . . the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year.

In our example, the French life insurance policy would be taxed on a current basis in the hands of the expat French individual who resides in the U.S. The yearly income on the contract will be treated as ordinary income of that individual. The income on the contract is the increase in the net surrender value of the contract during the taxable year, as increased by the cost of life insurance protection provided under the contract during the taxable year and reduced by the premiums paid under the contract during the taxable year.

Avoiding Double Taxation

As mentioned above, French life insurance companies must withhold French income tax on life insurance distributions when the distributions are made for the benefit of individuals who are not considered to be French residents for French income tax purposes. In our scenario, this would result in taxation in France at maturity, in addition to the tax paid in the U.S. during the premium's buildup period.

To prevent double taxation from occurring, the France-U.S. Income Tax Treaty (the "Treaty") contains a provision designed to allow the tax authorities of the two countries to agree, between themselves, as to the country having the primary right to tax.[36] Regrettably, the Treaty is silent as to the specific tax treatment applicable to life insurance proceeds. Faced with growing concerns from the French expat community, the French government published a statement declaring that only the U.S. has the right to tax life insurance proceeds. The declaration is premised upon the view that income from payments under a life insurance policy is akin to interest and that, pursuant to Article 11 (Interest) of the Treaty, this income is taxed only in the country of residence of the recipient.[37] The same result would be reached under Article 22 (Other Income) if the payment is not defined to be interest for U.S. tax purposes. Article 22 allocates, to the country of residence, the exclusive right to tax income not covered by other provisions of the Treaty.

"The Treaty allows policies issued by a French insurer or reinsurer that is a French resident to be exempt from the excise tax."

U.S. Excise Tax on Foreign Life Insurance Premiums

Code §4371 provides for an excise tax of 1% applicable to insurance premiums paid to foreign life insurers or reinsurers, unless the premiums are taxed as income effectively connected with the conduct of a U.S. trade or business.

The insurance excise tax must be paid by any person who makes, signs, issues, or sells any of the documents and instruments subject to the excise tax, or for whose use or benefit documents and instruments are made, signed, issued, or sold.[38] Generally, the person making a premium payment to a foreign insurer or reinsurer must file Form 720, *Quarterly Federal Excise Tax Return*, and remit the excise tax to the I.R.S.[39]

The Treaty allows policies issued by a French insurer or reinsurer that is a French resident to be exempt from the excise tax.[40] In order to qualify for the exemption, the foreign life insurer to whom the premiums are paid (i) must have entered into a closing agreement with the I.R.S., (ii) must not reinsure the risks with a person not qualifying for Treaty benefits, (iii) must be a resident of France, and (iv) must qualify under the applicable L.O.B. (Limitation on Benefits) provision of the Treaty.[41] The I.R.S. publishes a list of foreign life insurance companies that have entered into qualifying closing agreements.[42] Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*, may have to be filed in order to claim the Treaty exemption.[43]

Here again, although the Treaty grants an exemption from the excise tax, the analysis remains factual and the appropriate path forward depends on the specific policy

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36 Article 26 (Mutual Agreement Procedure) of the France-U.S. Income Tax Treaty (in effect as of the June 1, 2016).

37 "Réponse du Ministère des finances et des comptes publics publiée dans le JO Sénat du 02/07/2015," p. 159.

38 Code §4374.

39 Treas. Reg. §46.4374-1(c).

40 Articles 2 and 30 of the France-U.S. Income Tax Treaty.

41 Rev. Proc. 2003-78, November 10, 2003.

42 I.R.S., "Exemption from Section 4371 Excise Tax," last reviewed or modified June 14, 2016.

43 Code §6114.

and the issuing insurer. However, this type of scenario is seldom seen, given that generally the premium payments are made prior to moving to the U.S. and no subsequent payments are made.

Treatment of French Life Insurance for F.B.A.R. and F.A.T.C.A. Purposes

Every U.S. tax resident and every U.S. citizen must annually report all interests held in all foreign financial accounts. The report is made to the Financial Crimes Enforcement Network ("FinCEN") of the I.R.S. on a yearly basis, using FinCEN Form 114, *Report of Foreign Bank and Financial Accounts (F.B.A.R.)*.[44] The definition of "foreign financial accounts" includes an account that is an insurance or annuity policy with a cash surrender value.[45] Under this definition, a French life insurance policy constitutes a foreign financial account for F.B.A.R. purposes and is subject to annual reporting.

The same reporting obligation is generally applicable for purposes of F.A.T.C.A. and Form 8938, *Statement of Specified Foreign Financial Assets*, provided the life insurance policy is a cash value insurance policy having a value that exceeds a certain amount, which varies based on the marital status of the individual,[46] and that the policy is not a term life insurance contract.[47]

The following table summarizes the filing thresholds for U.S. tax residents:

Filing Status	Applicable Threshold
Single	> $50,000 (on the last day of the tax year) or > $75,000 (at any time during the tax year)
Married Filing Jointly	> $100,000 (on the last day of the tax year) or > $150,000 (at any time during the tax year)
Married Filing Separately	> $50,000 (on the last day of the tax year) or > $75,000 (at any time during the tax year)

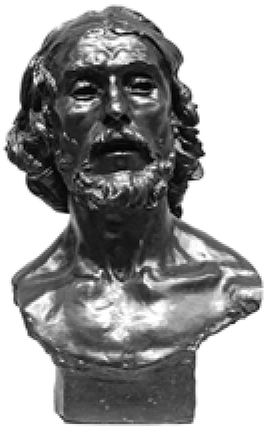
44 Code §1010.350 of Title 31 of the Code of Federal Regulations.

45 Code §1010.350(c)(3) of Title 31 of the Code of Federal Regulations.

46 Treas. Reg. §1.1471-5(b)(2)(ii).

47 Treas. Reg. §§1.1471-5(b)(1)(iv) and 1.1471-5(b)(3)(vii).

Treatment of P.F.I.C. Investments Within the Life Insurance Policy



Premiums paid into the life insurance policy are used to make investments. If a particular investment takes the form of collective investment vehicles (among which are O.P.C.V.M.'s), the vehicle likely will be categorized as a Passive Foreign Investment Company ("P.F.I.C."). A foreign corporation will be classified as a P.F.I.C. if either (i) 75% or more of the corporation's gross income is passive income (*e.g.*, income from interest, dividends, or capital gains) or (ii) 50% or more of the corporation's assets are held for the production of passive income (*e.g.*, stocks, bonds, or cash).[48] A typical P.F.I.C. is an offshore investment company or mutual fund.

Pursuant to Code §1298 and temporary regulations issued by the I.R.S.,[49] a U.S. shareholder of a P.F.I.C. must generally report the P.F.I.C. interest on Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, on a yearly basis, even if no tax is due with regard to the investment.[50] The question then becomes whether the owner of the policy is considered to be the owner of the P.F.I.C. in which the insurance company invested.

A shareholder is a U.S. person that directly owns stock of a P.F.I.C. (*i.e.*, a direct shareholder) or that is an indirect shareholder.[51] As previously mentioned, certain French life insurance policies must meet mandatory underlying investment requirements in order to qualify for favorable tax treatment. The underlying investments made by French insurance companies with regard to premiums received are often funds that typically meet the definition of a P.F.I.C.

Code §1298(a)(2) provides, in general, that attribution of ownership from a foreign corporation to a shareholder requires ownership of at least 50% of the value of the foreign corporation unless that foreign corporation is itself a P.F.I.C. This is reflected in Temporary Treasury Regulations that provide:[52]

> An indirect shareholder of a PFIC is a United States person that indirectly owns stock of a PFIC. A person indirectly owns stock when it is treated as owning stock of a corporation owned by another person, including another United States person, under this paragraph (b)(8). In applying this paragraph (b)(8), the determination of a person's indirect ownership is made on the basis of all the facts and circumstances in each case; the substance rather than the form of ownership is controlling, taking into account the purpose of sections 1291 through 1298.

The temporary regulations then address ownership through a foreign corporation, a partnership or entity treated as a partnership for U.S. tax purposes, an S-corporation, a trust, and an estate. Other regulations that address the disposition of an indirect interest in a P.F.I.C. refer only to transactions in which indirect ownership

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48 Code §1297(a).

49 Treas. Reg. §1.1298-1T(b)(1)(i).

50 Exceptions exist for certain P.F.I.C.'s with an aggregate value not exceeding $25,000. See Treas. Reg. §1.1298-1T(c)(2)(ii).

51 Treas. Reg. §1.1291-1T(b)(7).

52 Treas. Reg. §1.1291-1T(b)(8)(i).

is described by the temporary regulations.[53] Hence, if the indirect ownership is not covered by the proposed regulations, presumably there can be no indirect disposition. In that way, the regulations on dispositions are closely linked to the definition of indirect ownership.

In general, foreign insurance companies are not considered to be P.F.I.C.'s under an exception carved out in Code §1297(b)(2)(B).[54] Under a relatively recent set of proposed regulations, this exemption does not apply to hedge funds attempting to fit investment operations into an insurance company wrapper.[55] Passive income is carved out only for foreign corporations that actively conduct an insurance business. The standard that appears in Treas. Reg. §1.367(a)-2T(b)(3) is applied to test whether the business is actively carried on:

> [A] corporation actively conducts a trade or business only if the officers and employees of the corporation carry out substantial managerial and operational activities. A corporation may be engaged in the active conduct of a trade or business even though incidental activities of the trade or business are carried out on behalf of the corporation by independent contractors. In determining whether the officers and employees of the corporation carry out substantial managerial and operational activities, however, the activities of independent contractors shall be disregarded.

"If the indirect ownership is not covered by the proposed regulations, presumably there can be no indirect disposition. In that way, the regulations on dispositions are closely linked to the definition of indirect ownership."

A provision in the §1.367(a)-2T regulations that allows for shared officers and directors is not applicable in the insurance company context.

In these circumstances, it is reasonable to believe that investments made by a French insurance company carrying on an active insurance business are not attributed to the owner of a life insurance policy, even if the income under the contract is currently taxable in the U.S.

This conclusion is consistent with the holding in Rev. Rul 2003-33, which addressed the I.R.S. view of circumstances in which the holder of a variable life insurance contract would be considered to be the owner, for U.S. income tax purposes, of the assets that fund the variable contract. In this ruling, an individual ("Holder") purchased a life insurance contract under which he retained the right to allocate the premium paid among the available investment accounts. The Holder could change the allocation of premiums at any time within certain limitations, but had no legal or inferred rights regarding the investment strategy of any investment account, or the assets to be held by a particular account. All investment decisions concerning the investment accounts were made by the insurance company and its investment advisor. The I.R.S. concluded that in the facts presented, the Holder did not have any legal, equitable, direct, or indirect interest in any of the assets held by in an investment account, although he had a contractual claim against the insurance company to collect cash in the form of death benefits or cash surrender values under the contract.[56]

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53 Treas. Reg. §1.1291-3(e)(2).

54 Under proposed regulations,

55 Prop. Treas. Reg. §1.1297-4.

56 See also *Christoffersen v. U.S.*, 749 F.2d 513 (8th Cir. 1984); P.L.R. 200601007;

This conclusion is also consistent with the process followed by the I.R.S. when U.S. persons participate in the Offshore Voluntary Disclosure Program regarding unreported financial accounts. There, the insurance policy is treated as a financial account held by a U.S. person in the insurance company. The assets of the insurance company are not considered to be held by the U.S. individual.

In sum, as long as the policy holder does not have effective control over the investments maintained by the insurance company, the risk to the policy holder should be minimal with regard to P.F.I.C. reporting.

CONCLUSION

In today's world, one cannot provide solid tax advice without factoring in potential international tax aspects. The present article is a good example for the adverse tax consequences non-internationally-structured tax advice can have on a taxpayer acting in good faith. While life insurance policies benefit from a favorable tax regime under French tax laws, the situation may become quite the opposite when exposed to foreign law. Pre-immigration tax planning thus becomes essential when a taxpayer is suddenly faced with a change in tax residency.

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and P.L.R. 201240018. Private letter rulings issued by the I.R.S. may be relied on only by the taxpayer to whom they are issued. Nonetheless, a private letter ruling can be claimed as authority for purposes of avoiding penalties. It also demonstrates the views of the I.R.S. at the time issued.

E.U. STATE AID – THE SAGA CONTINUES

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Tags
European Commission
State Aid
T.F.E.U.

The drama continues with the E.U. State Aid[1] investigations by the European Commission for Competition (the "Commission"). In the past month, the competition commissioner, Margrethe Vestager, met with Luxembourg officials to discuss the outcome of the Amazon investigation, and the Commission ordered Fiat Chrysler Automobiles to pay about €30 million in back taxes to Luxembourg and released a public letter regarding the investigation of McDonald's alleged State Aid violations in Luxembourg. An even more bold attack on multinational tax practices came not from the Commission but from the French authorities, who raided the offices of Google and McDonald's in May.

As the Commission's probe expands, E.U. Member States are increasingly expressing objections to being forced to recoup back taxes from multinational enterprises ("M.N.E.'s") that allegedly received illegal State Aid. States, including the United States, question whether the Commission is acting beyond its authority and impeding Member States' sovereignty to directly tax persons within their jurisdictions.

The European Parliament has even formed a special tax committee to investigate the Commission's role, as well as Member States' roles, in failing to enforce laws that would have prevented entities and individuals from sheltering money in offshore havens to avoid paying taxes.[2] Although the Commission itself will be a subject of these investigations, a Commission spokesperson applauded the creation of a special tax committee to assist in combatting harmful tax practices.

The Commission has argued that it is acting within the authority granted by E.U. law and that it has not infringed on the jurisdiction of Member States, the U.S., or any other country. Since 2013, the Commission has been investigating various Member States' individual tax rulings with U.S. companies, including Starbucks in the Netherlands,[3] Apple in Ireland, Google in the U.K., Amazon in Luxembourg, and McDonald's in Luxembourg. The Commission has alleged that these companies' tax arrangements with different Member States amount to unjustifiable State Aid in violation of E.U. anti-competition laws. If the Commission determines that a Member State provided a selective tax advantage, and thus illegal State Aid, to an entity, the Member State is forced to retroactively, not prospectively, recoup taxes from the

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1 For the definition of E.U. State Aid see Beate Erwin and Christine Long, "Apple in Europe – The Uphill Battle Continues," *Insights* 2 (2016), pp. 9-15; and Beate Erwin, "Tax Rulings in the European Union – State Aid as the European Commission's Sword Leading to Transparency on Rulings," Insights 6 (2015), pp. 13-14.

2 Joe Kirwin, "EU Parliament to Probe Intermediaries, Members on Havens," *BNA International Tax Monitor*, June 2, 2016.

3 Although the Commission's ruling was issued In October 2015, the text of its decision was first released in late June 2016.

entity over a ten-year period. Enforcement of this requirement to recoup back taxes is arguably beyond the Commission's regulatory power.

LATEST ON U.S. REACTIONS

The U.S. reaction to the Commission's State Aid investigations has also intensified. Several U.S. senators and Treasury Department officials continue to express concern and frustration with the Commission's probe into U.S. M.N.E.'s, arguing that the Commission has overstepped its bounds, as the retroactive imposition of tax "is improper and plainly undermines legal certainty and the rule of law."[4] In a May 23 letter to the Treasury Department, Senators Hatch, Wyden, Portman, and Schumer contended that the Commission "appears to be ignoring the national practice and law of its Member States and to be imposing its own new standard for transfer pricing determinations."[5] Furthermore, the Commission's actions confirm "our suspicion that these cases are about more than objectively enforcing existing competition policies."[6] The targeting of U.S. enterprises could potentially undermine U.S. rights in bilateral tax treaties with Member States and the retroactive payment for back taxes would likely prevent a U.S. M.N.E. from receiving a tax credit towards its U.S. income.

U.S. officials have been asserting that Commissioner Vestager is unfairly targeting U.S. M.N.E.'s and that the Commission has no right to claim the offshore profits of U.S. companies. Commissioner Vestager has repeatedly rejected such criticism, claiming that potential State Aid violations involving several non-U.S. companies are currently being examined. U.S. senators have been encouraging the U.S. Treasury Department to strike back by increasing taxes on European companies through enforcement of Internal Revenue Code (the "Code") §891.[7] Code §891 was implemented in U.S. tax law in1938, but it has never been invoked.[8] Under this rule, the tax rates for foreign citizens and corporations could be doubled in "retaliation" against unfair treatment of U.S. persons by these countries.

IS THE COMMISSION EXCEEDING ITS AUTHORITY?

In addition to the U.S., an increasing number of E.U. Member States are concerned that the Commission is overstepping its bounds by retroactively, rather than prospectively, imposing Member State taxation of M.N.E. earnings, particularly those of U.S. entities. Many states argue that the Commission is using the State Aid investigations as a disguise to impede on Member States' taxing power. Therein lies the difficulty with the E.U. system – balancing the right of Member States to directly tax, with the right of the Commission to protect the E.U. single market from anti-competitive tax practices.

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4 "Hatch, Wyden: EU State Aid Probe Violates Rule of Law," *BNA Daily Tax Report*, May 24, 2016.

5 Letter to Secretary Jacob Lew, U.S. Senate Committee on Finance, May 23, 2016.

6 *Id.*

7 Erwin and Long, "Apple in Europe," pp. 9-15.

8 It appears that this rule was intended rather as a tool in treaty negotiations to achieve reciprocal concessions than a weapon for unilateral use.

The Commission has since argued that it is acting within its authority. As if to justify this position, in May the Commission released "Commission Notice on the Notion of State Aid as Referred to in Article 107(1) TFEU" (the "Notice").[9] The Notice should provide guidance to clarify the definition of State Aid.

The Notice is allegedly a reaction to pleas made by the Netherlands in its appeal of the Starbucks outcome. The Netherlands has argued that the arm's length principle is not covered by E.U. law and, thus, could not be subject to State Aid infringement proceedings. To better understand the context of the Notice, the Commission's investigation of Starbucks's arrangement in the Netherlands is outlined below.

The Starbucks Case

In 2008, the Netherlands issued a tax ruling for Starbucks, approving the company's transfer pricing methods. The Commission alleged that the Dutch transfer pricing ruling provided a selective advantage to Starbucks in violation of E.U. anti-trust laws and began investigating the case in 2013. In October 2015, the Commission issued a final decision, finding that Starbucks received illegal State Aid because the Dutch transfer pricing ruling artificially lowered the company's tax burden in the Netherlands, thereby distorting competition. As a result, the Commission has ordered the Netherlands to recoup between €20 and €30 million in back taxes from Starbucks.[10]

The Dutch Finance Ministry appealed the Commission's decision in December 2015 and argued that Starbucks did not benefit from illegal State Aid. The Dutch appeal included five "pleas in law," alleging:

> (A) Incorrect application of Article 107(1) TFEU to the extent that the European Commission finds that the transfer pricing ruling (specifically, an APA) is selective in nature, as the Commission referenced the wrong Dutch tax legislation and failed to demonstrate that the selectivity criterion was fulfilled;
>
> (B) Incorrect application of Article 107(1) TFEU in relation to the European Commission's assessment of the existence of an advantage by reference to the arm's length principle under EU law, as no arm's length principle exists under E.U. law and is not part of the EU State aid assessment;
>
> (C) Incorrect application of Article 107(1) TFEU in relation to the European Commission's finding that the transfer pricing ruling confers an advantage on Starbucks due to the selection of the 'Transactional Net Margin Method' to establish pricing;
>
> (D) Incorrect application of Article 107(1) TFEU in relation to the European Commission's statement that the transfer pricing ruling confers an advantage on Starbucks as a result of the manner under which the 'Transactional Net Margin Method' was applied; and

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9 European Commission, "Commission Notice on the Notion of State Aid as Referred to in Article 107(1) TFEU," (Brussels: 2016)

10 "European Commission Reclarifies the Scope of EU State Aid Rules," *Checkpoint International Taxes Weekly* 21 (2016).

(E) Breach of the duty to exercise due care in so far as the European Commission did not assess and include all the relevant information in the decision and also uses as a basis anonymous information, or at least information that has never been shared with the Netherlands government.[11]

The pleas articulated by the Netherlands reflect the positions of other Member States, which argue that, through State Aid decisions, the Commission is acting beyond its capacity and forcing Member States to retroactively impose tax on multinationals. In particular, the fact that pricing methods and the arm's length principle are not doctrines of E.U. law puts them beyond on the scope of the Commission's assessment.

"The Notice is allegedly a reaction to pleas made by the Netherlands in its appeal of the Starbucks outcome."

The Commission Notice on the Notion of State Aid

The Commission published general guidance on all aspects of the definition of State Aid as part of the Notice, which comes under the State Aid Modernisation initiative that was launched in 2012.[12] The Notice clarifies the scope of the State Aid rules, and its stated purpose is to "provide legal certainty and cut red tape for public authorities and companies, and focus the Commission's resources on enforcing State aid rules in cases with the biggest impact on the Single Market."[13] As previously mentioned, the Notice is alleged to have been published in reaction to the Dutch appeal of the Commission's decision in the Starbucks case.

The Notice simplifies the interpretation of T.F.E.U. Article 107(1), as established by the E.U. Court of Justice and the General Court. The Notice explains the Commission's decision-making practice and how the Commission construes the notion of State Aid when issues have not yet been interpreted by the courts.[14] The Notice elaborates on the following fundamental notions of State Aid:

- The presence of a State Aid undertaking with respect to economic activity
- The imputability of a state measure to the Member State in question
- The notion of advantage and financing through State resources
- The selectivity, *i.e.*, selective advantage of the state measure
- The effect of a state measure on trade and competition between Member States[15]

To date, the Commission's State Aid investigations have focused on tax rulings granted by Member States to M.N.E.'s. However, the Commission is expected to expand its State Aid investigations to tax settlements. This adds to the uncertainty taxpayers face when operating within an E.U. Member State.[16]

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11 *Id.*

12 European Commission, "State Aid: Commission Clarifies Scope of E.U. State Aid Rules to Facilitate Public Investment," press release, May 19, 2016.

13 *Id.*

14 "Commission Notice on the Notion of State Aid."

15 *Id.*; "European Commission Reclarifies the Scope of EU State Aid Rules."

16 Ali Qassim, "Uncertainty Ahead: Tax Settlements Seen as Next EU State Aid

Authority of Tax Rulings

A Member State's grant of a tax ruling to a company must respect the State Aid rules. Tax rulings, such as A.P.A.'s or comfort letters, enable Member States to provide taxpayers with legal certainty and predictability on the application of a Member State's general tax rules. The Notice points out that a Member State's tax rulings are best ensured if its administrative ruling practice is transparent and the rulings are published. The Notice reiterates that the Commission has authority where a tax ruling may confer a selective advantage upon a company, in so far as that selective treatment results in a lowering of that company's tax liability in the Member State as compared to companies in a similar factual and legal situation.[17]

The Notice refers to the Court of Justice's rulings as support for the Commission's rationale for investigating individual rulings issued by Member States. The Court of Justice's rulings on transfer pricing cases have held that a Member State's tax ruling which endorses a transfer pricing methodology for determining a corporate group entity's taxable profit that does not result in a reliable approximation of a market-based outcome in line with the arm's length principle confers a selective advantage upon its recipient. The Notice elaborates on the phrase "reliable approximation of a market-based outcome," interpreting it to mean any deviation from the best estimate of a market-based outcome must be limited and proportionate to the uncertainty inherent in the transfer pricing method chosen or the statistical tools employed for that approximation exercise.[18]

"If a transfer pricing arrangement complies with the provisions of the O.E.C.D. Transfer Pricing Guidelines . . . a tax ruling endorsing that arrangement is unlikely to give rise to State Aid."

According to the Notice, this arm's length principle necessarily forms part of the Commission's assessment of tax measures granted to group companies under T.F.E.U. Article 107(1), independent of whether a Member State has incorporated this principle into its national legal system and, if so, in what form. A tax ruling that approves of a methodology that produces a reliable approximation of a market-based outcome, ensures that that company is not treated favorably under the ordinary rules of corporate taxation of profits in the Member State as compared to standalone companies that are taxed on accounting profit. The arm's length principle the Commission applies in assessing transfer pricing rulings under the State Aid rules is therefore an application of T.F.E.U. Article 107(1), which prohibits unequal treatment in taxation of undertakings in a similar factual and legal situation. This principle binds the Member States, and the national tax rules are not excluded from its scope.[19]

The Notice explains that, when the Commission examines whether a transfer pricing ruling complies with the arm's length principle inherent in T.F.E.U. Article 107(1), the Commission may refer to the guidance provided by the O.E.C.D., in particular the "O.E.C.D. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" (the "O.E.C.D. Transfer Pricing Guidelines"). Those guidelines do not deal with matters of State Aid per se, but they capture the international consensus on transfer pricing. The guidelines also direct tax administrations and M.N.E.'s on how to ensure that a transfer pricing methodology produces an outcome in line with market conditions. Consequently, if a transfer pricing arrangement complies with

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Inquiry Target," *Checkpoint International Tax Monitor*, June 7, 2016.

17 "Commission Notice on the Notion of State Aid," p. 50.

18 *Id.*, p. 51.

19 *Id.*, pp. 51-52.

the provisions of the O.E.C.D. Transfer Pricing Guidelines, including guidance on selecting the most appropriate method that leads to a reliable approximation of a market-based outcome, a tax ruling endorsing that arrangement is unlikely to give rise to State Aid.[20]

The Notice summarizes that, in particular, a tax ruling confers a selective advantage on an entity where

- the ruling misapplies national tax law, and this results in a lower amount of tax;
- the ruling is not available to undertakings in a similar legal and factual situation;[21] or
- the Member State's administration applies a more favorable tax treatment compared with other taxpayers in a similar factual and legal situation.[22]

The Notice's clarification of a selective advantage supports the Commission's argument that it has legal authority to enforce the State Aid decisions. The bulk of the Commission's State Aid investigations have been on transfer pricing rulings, with a focus on the arm's length principle. Although the arm's length principle may not be codified under E.U. law, it is established in the O.E.C.D. Transfer Pricing Guidelines, which have been adopted by the Member States. The Commission has already decreed that the Starbucks's transfer pricing ruling from the Netherlands amounted to unlawful State Aid, but the Commission is still investigating transfer pricing rulings between Ireland and Apple, Luxembourg and Amazon, and Luxembourg and McDonald's.

Authority of Tax Settlements

The Notice also justifies the Commission's authority to investigate tax settlements between Member States and taxpaying entities, by clarifying the scope of these settlements under E.U. law. Tax settlements have yet to be the subject of State Aid investigations, but the Notice's explanation of how tax settlements provide a selective advantage establishes grounds for future Commission investigations.

The Notice defines tax settlements as a common practice in many Member States that generally occurs in the context of disputes between taxpayers and the tax authorities concerning the amount of tax owed. Tax settlements allow tax authorities to avoid long-standing disputes before the domestic courts and ensure quick recovery

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20 *Id.*, p. 52.

21 The Notice provides, as an example, that this would be the case if some undertakings involved in transactions with controlled entities are not allowed to request tax rulings, contrary to a pre-defined category of undertakings.

22 For instance, this will be the case where the tax authority accepts a transfer pricing arrangement that is not at arm's-length, because the methodology endorsed by that ruling produces an outcome that departs from a reliable approximation of a market-based outcome (as in the Starbucks decision). The same applies if the ruling allows the taxpaying entity to use alternative, more indirect methods for calculating taxable profits (*e.g.*, the use of fixed margins for a cost-plus or resale-minus method for determining an appropriate transfer pricing, while more direct ones are available). ("Commission Notice on the Notion of State Aid," p. 54.)

of the tax due. While the competence of Member States in this field is not in dispute, State Aid may be involved in the conclusion of a tax settlement. In particular, it may arise where the amount of tax appears to have been reduced without clear justification (such as optimizing the recovery of debt) or in a manner that is disproportionately beneficial to the taxpayer.[23]

"As the Commission's State Aid investigations into tax rulings become more robust, it is only a matter of time before the investigations extend to tax settlements."

The Notice explains that a transaction between a Member State's tax administration and a taxpayer may, in particular, entail a selective advantage in the following situations:

(a) in making disproportionate concessions to a taxpayer, the [Member State's] administration applies a more 'favourable' discretionary tax treatment compared to other taxpayers in a similar factual and legal situation;

(b) the settlement is contrary to the applicable tax provisions and has resulted in a lower amount of tax, outside a reasonable range. This might be the case, for example, where established facts should have led to a different assessment of the tax on the basis of the applicable provisions (but the amount of tax due has been unlawfully reduced).[24]

The Commission is expected to start investigating tax settlements between Member States and multinational taxpayers. For example, many thought the multimillion-pound tax settlement between the U.K. and Google should have been several billion pounds instead. Such tax settlements could be construed as sweetheart tax deals that provide favorable treatment, and thus unlawful State Aid, to multinational taxpayers.[25] The Notice lays out the legal authority for the Commission to examine such settlements. As the Commission's State Aid investigations into tax rulings become more robust, it is only a matter of time before the investigations extend to tax settlements.

OBSERVATIONS FROM A U.S. PERSPECTIVE

The Commission's State Aid decisions raise various complex issues with significant importance to U.S. companies currently or potentially under investigation.

E.U. Law Superseding Income Tax Treaties with Non-E.U. Countries

Within the E.U., E.U. law supersedes the domestic laws of the Member States. If the Commission finds that a Member State provided a taxpayer with illegal State Aid, that state must act without delay to recover that aid from the taxpayer.[26] Generally, rules on State Aid therefore trump bilateral income tax treaties. From a U.S. legal perspective, the T.F.E.U. and State Aid-related rules are not, and cannot, be granted this quasi-constitutional status.

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23 *Id.*, p. 53.

24 *Id.*, p. 55.

25 Ali Qassim, "Uncertainty Ahead."

26 "Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty," *Official Journal of the European Communities* L 083 (1999), art. 14, para. 3.

U.S. Foreign Tax Credit on State Aid Assessment Payments – Timing

Under U.S. Federal income tax law, a foreign tax credit is subject to the condition that all legal remedies, including appeals, have been exhausted.[27] Consequently, a foreign tax credit, if deemed applicable in this context,[28] may not be available under U.S. tax rules as long as the appeals procedures are pending. Another interesting aspect is that, upon an appeal of the Commission's State Aid decision, the courts may only accept or reject the Commission's decision in its entirety. If the decision is accepted, the courts are not entitled to decide on adjustments of the amount of State Aid that must be recovered by the Member State.

A New Arm's Length Standard Introduced by the Commission

In the Commission's decisions on Belgian tax rulings and the Luxembourg Fiat case, it made a notable statement, which based on the Netherland's reaction, also appears in the Starbucks decision:

> The arm's length principle therefore necessarily forms part of the Commission's assessment under Article 107(1) of the TFEU of tax measures granted to group companies, independently of whether a Member State has incorporated this principle into its national legal system. It is used to establish whether the taxable profits of a group company for corporate income tax purposes has been determined on the basis of a methodology that approximates market conditions, so that that company is not treated favourably under the general corporate income tax system as compared to non-integrated companies whose taxable profit is determined by the market.[29] *Thus, for any avoidance of doubt, the arm's length principle that the Commission applies in its State aid assessment is not that derived from Article 9 of the OECD Model Tax Convention, which is a non-binding instrument, but is a general principle of equal treatment in taxation falling within the application of Article 107(1) of the TFEU, which binds the Member States and from whose scope the national tax rules are not excluded.*[30] [emphasis added]

Does this mean the European Commission introduces a new arm's length standard? If so, how would it deviate from the standard found in the O.E.C.D. Model Convention and O.E.C.D. Tranfer Pricing Guidelines? Does the T.F.E.U. provide authority for the Commission on Competition – previously a non-tax focused body – to set forth an arm's length standard for transfer pricing (*i.e.*, tax purposes)? According to

27 Treas. Reg. §1.901-2(e)(5).

28 Note that it is still unclear whether assessment payments under State Aid procedures should qualify as creditable tax payments for U.S. foreign tax credit purposes or as (non-creditable) damages.

29 The same language appears in Commission Decision no. SA.37667 (*Belgium*), para. 150 (January 1201, 16), except that it refers to the O.E.C.D. Transfer Pricing Guidelines in addition to Article 9 of the O.E.C.D. Model Convention.

30 "See Joined Cases C-182/03 and C-217/03, *Belgium and Forum 187 v. Commission*, ASBL ECLI:EU:C:2006:416, paragraph 81. See also Case T-538/11 *Belgium v. Commission* EU:T:2015:188, paragraphs 65 and 66 and the case-law cited." (Commission Decision no. SA.38375 (*Luxembourg Fiat*), para. 228 (October 21, 2015))

the view held by the Netherlands in its appeal, this is definitely not the case. That the Notice includes clarifications in this respect is unlikely to provide sufficient legal basis and thus change the Dutch view. The constraints that the State Aid decisions put on the taxing authority of the Member States have already been pointed out. With these State Aid decisions, this would rise to another – international – level, in particular in view of dismantling competent authority procedures with non-E.U. countries.

"The only certainty for M.N.E.'s operating in the E.U. is that there is uncertainty in the outcome of any tax ruling or tax settlement that these entities may have with Member States."

CONCLUSION

The Commission has great latitude in investigating all aspects of State Aid, including when a Member State provides an individual tax ruling or tax settlement to a multinational taxpayer. As the Commission's State Aid probe expands, more Member States are taking the position that the Commission is impeding domestic sovereignty and acting beyond the scope of E.U. law. The tension is growing between protecting the right of a Member State to directly tax its constituents and the Commission's mandate to protect the E.U. single market from anti-competitive tax practices. From a U.S. legal perspective, the impact of the State Aid decisions is far reaching – timing of foreign tax credits, if applicable at all; dismantling of income tax treaties; and a new arm's length standard are just some examples. The only *certainty* for M.N.E.'s operating in the E.U. is that there is *uncertainty* in the outcome of any tax ruling or tax settlement that these entities may have with Member States.

INCOME TAX TREATIES V. DOMESTIC LAW: AN INTERNATIONAL LOOK AT THE CURRENT SCORE

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Tags
Brazil
India
Israel
Saving Clause
Tax Treaties

Income tax treaties are said to promote international trade and investment, primarily by minimizing double taxation. Double taxation arises when more than one jurisdiction asserts taxing authority over the same income. Under an income tax treaty, double taxation may be eliminated or reduced in several ways. One important way is by allocating, to one of the contracting states, the sole authority to tax certain items of income by exempting the income from taxation in the other contracting state. For example, under an income tax treaty, a contracting state may exempt from taxation income of its residents that is sourced within the other contracting state and permitted to be taxed in that other contacting state on the basis of source.[1]

Another way that income tax treaties promote international trade and investment is by reducing or even eliminating source-based taxation. Many countries impose withholding taxes on investment income, such as interest and dividends, earned by nonresidents. Withholding taxes can be significant because they generally are applied on gross investment income, without an allowance for expense deductions.[2]

As the world's economies have become more connected, income tax treaties have become more prevalent and more important, especially for developing countries seeking to attract investment. At the same time, there are examples of contracting states reducing an income tax treaty's effectiveness at eliminating double taxation or source-based taxation through domestic law measures.

This article will describe three instances in which treaties are overridden by a country in order to preserve a power to tax that has not been clearly granted. The countries are the U.S., Brazil, and India.

- In the U.S., one of the most important ways that domestic tax law retains the power to impose tax on U.S. citizens is through the "saving clause" found in all U.S. income tax treaties. A recent U.S. Tax Court decision illustrates the application of the saving clause, which specifically allows the U.S. to impose tax in most instances, notwithstanding the existence of a treaty.
- In Brazil, a recent court ruling interpreted a presidential decree as overriding certain double taxation provisions in Brazil's income tax treaties.
- In India, a domestic tax, known as the Dividend Distribution Tax ("D.D.T."), effectively undermines the provisions in India's income tax treaties by providing for the reduction or elimination of source-based taxation on dividends.

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[1] Richard Andersen, *Analysis of United States Income Tax Treaties*, (Thompson Reuters), para. 1.01.

[2] *Id.*

THE LONG-ARM OF THE SAVING CLAUSE IN U.S. INCOME TAX TREATIES

The saving clause is a provision in U.S. income tax treaties that preserves – or "saves" – the right of each of the contracting states to tax its own citizens and residents as if the treaty does not exist. The saving clause in a treaty may include one or more exceptions to its scope. That is, certain treaty provisions are not subject to the saving clause. So, for example, the saving clause may not apply to the provision of the treaty that provides relief from double taxation, because to not exclude that provision from the saving clause would render the treaty meaningless. Other treaty provisions that are generally exempt from the saving clause are the article regarding the mutual agreement procedure (designed to provide a process for the resolution of international tax disputes) and articles applicable to certain individuals who are neither citizens nor permanent residents of a contracting state, such as Article 20 (Students and Trainees) or Article 27 (Diplomatic Agents and Consular Officers).[3]

The U.S.-Israel Income Tax Treaty (the "Israel Treaty"), like every U.S. income tax treaty, contains a saving clause. Article 6, paragraph 3 of the Israel Treaty includes the usual saving clause language, as follows:

> Notwithstanding any provisions of this Convention except paragraph (4), a Contracting State may tax its residents (as determined under Article 3 (Fiscal Residence)) and its citizens as if this Convention had not come into effect.

Recently, the saving clause in the Israel Treaty was the subject of litigation involving a U.S. citizen residing in Israel. The conflict was resolved by the U.S. Tax Court, which upheld the application of the saving clause. The parties in *Cole v. Commissioner*[4] submitted the case to the court for decision without trial. According to the facts stipulated in the summary opinion, the petitioner was a U.S. citizen who moved to Israel in 2009. As a result of the move, under local Israeli law, he was entitled to a ten-year "tax holiday,"[5] which provided an exemption from Israeli tax on non-Israeli-source capital gains.[6] When he moved to Israel, the petitioner held U.S. stock, which he later sold in 2010. The petitioner realized long-term capital gains of over $100,000. He reported the sale on his U.S. tax return but did not include it in his taxable income, offering the following explanation: "No tax should be administered on this transaction pursuant [sic] to treaties [sic] between the United States and taxpayers [sic] resident country (Israel)." The I.R.S. issued the taxpayer a notice of deficiency requiring that he pay U.S. tax on the capital gains.

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3 See the 1996 U.S. Model Treaty.

4 T.C. Summary Opinion 2016-22, 05/21/2016

5 Section 97(b) of the Israeli Income Tax Ordinance provides new immigrants and certain returning Israelis a ten-year tax holiday from Israeli tax, which would otherwise be imposed on foreign-source income.

6 The case also raises an interesting question that was not addressed by the court: If an Israeli resident is entitled to the ten-year tax holiday, is he/she a "person resident in Israel" for purposes of the Israeli Treaty? Paragraph 3 of the Exchange of Notes provides that this term is understood to refer to persons on whom Israel imposes tax on foreign-source income, pursuant to the Income Tax Ordinance, by virtue of their being Israeli citizens.

The petitioner claimed that Article 15 of the Israel Treaty provides that a resident of one of the contracting states shall be exempt from tax by the other contracting state on gains from the sale, exchange, or other disposition of capital assets. He further argued that disallowing the exemption pursuant to the saving clause is unreasonable because such treatment nullifies the capital gains exclusion under the Israel Treaty. The Tax Court disagreed and ruled that "the saving clause operates to deny certain treaty benefits to U.S. citizens and it is valid." The court explained that the saving clause does not nullify the Israel Treaty. Rather, it prevents certain provisions of the Israel Treaty from applying to citizens and residents of the contracting states. The court noted that the Israel Treaty provides that certain articles take precedence over the saving clause; however, exclusion for capital gains under Article 15, the subject of the litigation, is not among them. The court also stated that the Technical Explanation clearly provides that the saving clause is intended to apply to Article 15.

"As the world's economies have become more connected, income tax treaties have become more prevalent and more important, especially for developing countries seeking to attract investment."

BRAZIL'S TAX COURT APPLIES PRESIDENTIAL DECREE TO IMPOSE DOUBLE TAXATION ON PETROBRAS

In a recent Brazilian tax department appeals court ruling, Brazil's state oil company, Petrobras, lost an action involving taxation of profits from certain foreign subsidiaries located in the Netherlands and Argentina. The Brazilian tax authority asserted that Petrobras owed corporate income tax (at a rate of 25%) and social contribution tax (at a rate of 9%) on its profits from foreign subsidiaries, even though Brazil has income tax treaties with the Netherlands and Argentina that prevent Brazil from imposing tax on such profits.

The Brazilian court based its decision on a presidential decree issued in 2011, titled "MP 2158," which stated that "the profits earned by a firm controlled abroad are considered available for the controlling firm in Brazil on the date of the balance for which they were determined."

The *Petrobras* case stands in contrast to the case against Vale, the Brazilian mining multinational. The issue in *Vale* was the same as the issue in the recent Petrobras case. However, in *Petrobras*, the Brazilian tax authority did not argue for direct taxation of the subsidiaries' profits; the availability of foreign earnings merely served to increase Petrobras' value. The court agreed with the Brazilian tax authority, which argued that the taxation of overseas profits should be permitted at the time those profits are made available to the controlling company in Brazil. The court's ruling means that the presidential decree takes precedence over Brazil's income tax treaties, if a reasonable justification is possible.

INDIA'S DIVIDEND DISTRIBUTION TAX MAKES INCOME TAX TREATIES SEEM REDUNDANT

Prior to 1997, the Indian Income-tax Act, 1961 (the "I.T. Act") taxed shareholders on dividends distributed by an Indian corporation[7] at ordinary Indian tax rates. The

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7 Section 2(26) of the I.T. Act defines an Indian corporation as a company registered under the Indian corporate laws.

corporation withheld the tax on dividends, which was allowed as a credit against the shareholder's final tax liability. However, the Finance Act, 1997 brought about a significant transformation to the system of taxing dividends in India. It levied what is known as the D.D.T.[8] on Indian corporations paying dividends, and exempted shareholders from tax on dividends.

Though the D.D.T. is a tax imposed on an Indian corporation, it has the effect of being an indirect tax on the shareholders, since it is paid from the funds identified as dividends. In order to meet its D.D.T. liability, the corporation reduces the dividends payable to the shareholders. Thus, although the D.D.T. is statutorily paid by Indian corporations, the economic burden is borne by the shareholders. Further, unlike withholding taxes, shareholders are not entitled to a credit for the D.D.T., since the tax is paid by the Indian corporation.

The legislative history explained that the D.D.T. was introduced to simplify the tax collection mechanism. The government deemed it administratively convenient to collect tax at the level of the Indian corporation and to reduce paperwork associated with tax returns filed to claim a refund for tax withheld at source in excess of the final tax liability.

The D.D.T. is imposed at a statutory rate of 15%, increased by an applicable surcharge[9] and an "education cess."[10] In 2014, the D.D.T. computation method was amended, requiring Indian corporations to gross up the dividends for computing the D.D.T. by the 15% D.D.T. As a result of this gross up, the maximum effective D.D.T. rate is 20.358% on the amount of the dividend paid, declared, or distributed. The D.D.T. computation,[11] before and after the 2014 amendment, is illustrated in the following table:

	Net Basis	**Gross Basis**
Profit After Tax	INR 100	100
*D.D.T. at 15%**	$\frac{100 \times 17.304}{100} = 17.304$	$\frac{100 \times 17.304}{85} = 20.358$
Effective D.D.T. Rate	17.304%	20.358%
Dividends Available to Stockholder	INR 82.696	INR 79.642

**Surcharge at 12% and Education Cess at 3%*

8 Section 115-O of the I.T. Act.

9 The surcharge is imposed at 7%, if the taxable income of the Indian corporation exceeds INR 10 million and 12%, if the taxable income of the Indian corporation exceeds INR 100 million.

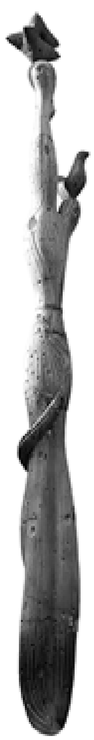
10 The education cess is chargeable at a flat rate of 3% on the D.D.T. and the applicable surcharge.

11 For the purpose of the calculations, it has been assumed that surcharge is applicable at 12%.

The introduction of the D.D.T. may have reduced certain administrative inconveniences to the Indian tax authorities, but it has resulted in a unique problem in a cross-border setting where the recipient of the dividend is a foreign investor.

The I.T. Act provides that for the purpose of computing taxable income of a nonresident to whom an Indian income tax treaty applies, the provisions of the I.T. Act shall only be applicable if the provisions are more beneficial to the taxpayer. In other words, the taxpayer may elect to be governed by either the Indian income tax treaty or the I.T. Act, whichever results in a lower income tax liability.

Generally, an Indian income tax treaty will provide for a lower withholding tax rate on dividends. Thus, absent the D.D.T., if dividends were taxable in hands of the shareholder under the I.T. Act, a foreign investor from a country with an income tax treaty with India could access certain benefits. First, a lower tax rate on dividends may be available under an Indian income tax treaty (generally 10% or 25%). Second, the foreign taxpayer may be entitled to a credit, for the Indian taxes, against a tax liability in the home country.[12]



However, since the enactment of the D.D.T., the tax on dividends is imposed on the Indian corporation, not on the shareholder. Thus, treaty rates for dividend withholding tax cannot be applied. As a result, the foreign investor suffers an income tax on dividends at a rate of 20.358%, as shown in the table above. Thus, whether or not it was the intention of the Indian government, the domestic D.D.T. provisions have an unfavorable effect of overriding the Indian income tax treaties. Moreover, the D.D.T. provisions are actually detrimental to foreign investors – not only because they are unable to benefit from a lower tax rate under a treaty, but also because, more often than not, they are unable to claim a tax credit for the D.D.T. against a tax liability in the home country.

One can argue that despite the existence of Indian income tax treaties, which provide for lower withholding tax rates on dividends, the Indian government has found a way around the treaty provisions, indirectly taxing foreign investors at a higher rate by imposing D.D.T. on Indian corporations.

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[12] Foreign investors were at par, or in beneficial tax position, when the D.D.T. was originally introduced under the I.T. Act since at that time the D.D.T. rate was only 10%, which was equal to or less than the withholding tax rates for dividends under most Indian income tax treaties.

REQUIRED TAXABLE INCLUSIONS FROM THE LOSS OF §1248 SHAREHOLDER STATUS

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Tags
C.F.C.
Code §1248
Code §1248 Amount
Code §1248 Shareholder
Nonrecognition Transaction

The status of a shareholder in a foreign corporation under Code §1248 is important in both taxable and tax-free transactions. In taxable dispositions of shares of foreign corporations, Code §1248 can cause gain to be recharacterized as dividend income. In tax-free dispositions of shares of foreign corporations (such as in tax-free reorganizations), loss of Code §1248 shareholder status can trigger a taxable inclusion under Code §367.

CODE §1248: TAXABLE DISPOSITIONS

Under Code §1248, if a U.S. person sells or exchanges stock in a foreign corporation that was a controlled foreign corporation ("C.F.C.") any time during a five-year period ending on the date of the sale or exchange, and the U.S. person owns, directly or indirectly, 10% or more of the total combined voting power of all classes of the foreign corporation's stock entitled to vote, then the gain recognized on the sale or exchange of the stock is partly or wholly recharacterized as a dividend.

Thus, for Code §1248 to apply

- the seller must be a U.S. person,[1]
- the U.S. person must own at least 10% of the foreign corporation, and
- the foreign corporation must have been a C.F.C. at some point within the past five years.[2]

The amount recharacterized as a dividend (the "Code §1248 amount") is generally equal to the shareholder's proporationate amount of the undistributed earnings generated by the foreign corporation while the shareholder owned those shares.[3]

Although the dividend recharacterization rule under Code §1248 was intended to be an anti-abuse rule, it tends to be beneficial for sellers that are C-corporations.[4] In

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1 Although Code §1248 only applies to U.S. persons selling shares in foreign corporations, in 1997 Congress enacted Code §964(e), which provides a comparable dividend recharacterization rule for C.F.C.'s selling shares in foreign corporations.

2 Typically, the foreign corporation is a C.F.C. at the time of the disposal. The five-year look-back rule is an anti-avoidance rule, intended to prevent taxpayers from circumventing the dividend recharacterization rule by selling shares of the foreign corporation in multiple stages.

3 Treas. Reg. §§1.1248-2, 1.1248-3, and 1.367(b)-2(c).

4 The recharacterization as dividends can allow the U.S. selling corporation to claim deemed paid foreign tax credits under Code §902.

addition, under current law, individuals subject to Code §1248 are generally indifferent to the recharacterization rule as long as the foreign corporation is located in a country that has an income tax treaty with the U.S.[5] The dividend recharacterization rule tends to disadvantage individuals selling shares of foreign corporations located in countries that do not have income tax treaties with the U.S.[6]

CODE §1248: TAX-FREE TRANSACTIONS

Code §1248 generally does not apply to tax-free transactions. For example, if a U.S. person owns shares in a foreign corporation that merges into another foreign corporation in a tax-free reorganization under Code §368(a)(1)(A), no gain or loss is generally recognized. Since the U.S. person holding the shares of the foreign corporation would not recognize gain, there is no gain to be recharacterized as a dividend under Code §1248.

INCLUSION REQUIRED UPON THE LOSS OF CODE §1248 SHAREHOLDER STATUS

"Although the dividend recharacterization rule under Code §1248 was intended to be an anti-abuse rule, it tends to be beneficial for sellers that are C-corporations."

Treas. Reg. §1.367(b)-4 is intended to preserve the Code §1248 amount in tax-free transactions. A U.S. person is a "Code §1248 shareholder"[7] with respect a foreign corporation if the U.S. person owns, directly or indirectly, at least 10% of the shares of the foreign corporation and the foreign corporation is a C.F.C. If immediately before a tax-free exchange, the U.S. person is a Code §1248 shareholder with respect to a foreign corporation and, immediately after the exchange, the U.S. person is not a Code §1248 shareholder, then the U.S. person has lost his or her Code §1248 shareholder status. In this circumstance, the exchanging shareholder must include the Code §1248 amount attributable to the exchanged stock in its income as a deemed dividend.[8]

Example 1

F.C.1 is a foreign corporation that is, directly or indirectly,[9] owned solely by foreign persons. D.C. is a domestic corporation that is unrelated to F.C.1. D.C. owns all of the outstanding stock of F.C.2, a foreign corporation. Thus, D.C. is a Code §1248 shareholder with respect to F.C.2, and F.C.2 is a C.F.C. Under Treas. Reg. §1.367(b)-2(c)(1), the Code §1248 amount attributable to the stock of F.C.2 that is held by D.C. is $20. In a reorganization described in Code §368(a)(1)(C), F.C.1 acquires all of the assets and assumes all of the liabilities of F.C.2 in exchange for F.C.1 voting stock. The F.C.1 voting stock received does not represent more than 50% of the voting power or value of F.C.1's stock. F.C.2 distributes the F.C.1 stock to D.C., and the F.C.2 stock held by D.C. is canceled.

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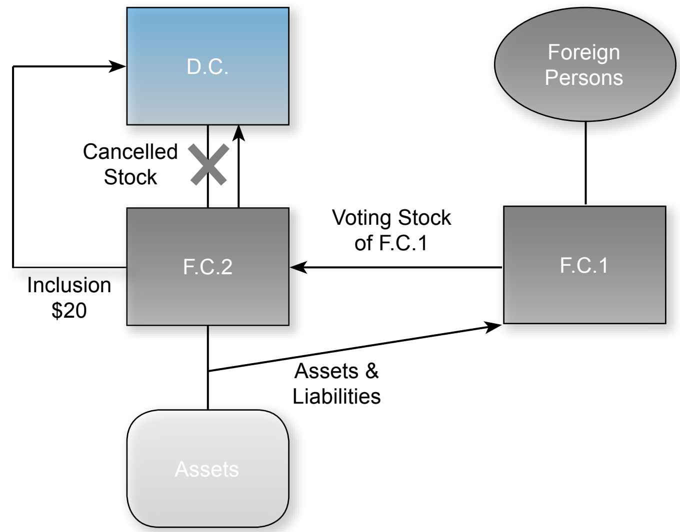
5 Under current law, capital gains and "qualified dividend income" are both taxed at the same rates. Code §1(h)(11).

6 Dividends that are not "qualified dividend income" are taxed at ordinary income tax rates.

7 Treas. Reg. §1.367(b)-2(b).

8 Treas. Reg. §1.367(b)-4.

9 Code §958.



In the foregoing example, F.C.1 is not a C.F.C immediately after the exchange. As a result, D.C. is no longer a Code §1248 sharholder and must include in income, as a deemed dividend from F.C.2, the $20 Code §1248 amount attributable to the F.C.2 stock that D.C. exchanged.

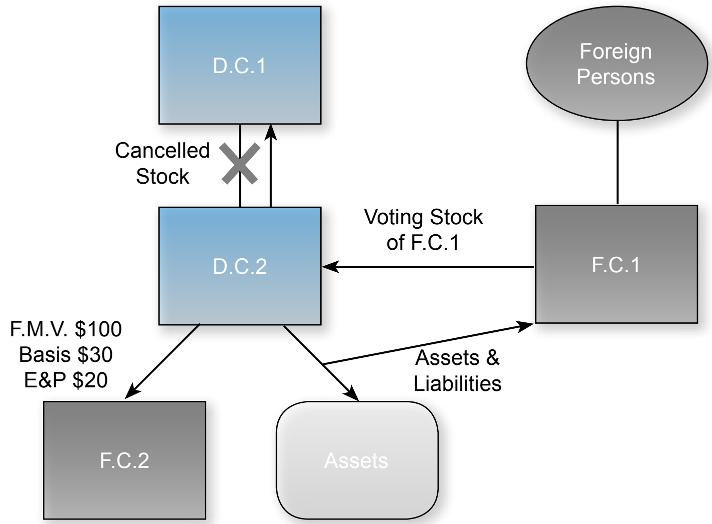
However, if D.C. were to receive voting stock of F.C.1 that represented more than 50% of the voting power of F.C.1's stock, then D.C. would remain a Code §1248 shareholder, and Treas. Reg. §1.367(b)-4(b) would not apply to require an inclusion in income of the Code §1248 amount. This would be because F.C.1 would be a C.F.C. and D.C. would maintain its Code §1248 shareholder status immediately after the exchange.

Example 2

D.C.1, a domestic corporation, owns all of the outstanding stock of D.C.2, a domestic corporation. D.C.2 owns various assets, including all of the outstanding stock of F.C.2, a foreign corporation. The stock of F.C.2 has a value of $100, and D.C.2 has a basis of $30 in the stock. The Code §1248 earnings and profits attributable to the F.C.2 stock held by D.C.2 is $20. D.C.2 does not own any stock other than the F.C.2 stock.

F.C.1 is a foreign corporation that is unrelated to D.C.1, D.C.2, and F.C.2. In a reorganization described in Code §368(a)(1)(C), F.C.1 acquires all of the assets of D.C.2 in exchange for the assumption of D.C.2's liabilities and voting stock of F.C.1 representing 20% of the outstanding voting stock of F.C.1.

D.C.2 distributes the F.C.1 stock to D.C.1 under Code §361(c)(1), and the D.C.2 stock held by D.C.1 is canceled. D.C.1 properly files a gain recognition agreement that satisfies the conditions of Treas. Reg. §§1.367(a)-3(e)(6) and 1.367(a)-8 to qualify for non-recognition treatment under Code §367(a) with respect to D.C.2's transfer of the F.C.2 stock to F.C.1. (F.C.1 is not a surrogate foreign corporation – within the meaning of Code §7874 – because D.C.1 does not hold at least 60% of the stock of F.C.1 by reason of holding stock of D.C.2).



"A U.S. person is a 'Code §1248 shareholder' with respect a foreign corporation if the U.S. person owns, directly or indirectly, at least 10% of the shares of the foreign corporation and the foreign corporation is a C.F.C."

D.C.2, the exchanging shareholder, is a U.S. person and a Code §1248 shareholder with respect to F.C.2, the foreign acquired corporation. D.C.2's inclusion of the Code §1248 amount attributable to the F.C.2 stock depends on whether, immediately after the Code §361 exchange of the F.C.2 stock for F.C.1 stock, the two foreign corporations are C.F.C.'s with respect to which D.C.2 is a Code §1248 shareholder:

- If immediately after the Code §361 exchange, F.C.1 and F.C.2 are both C.F.C.'s with respect to which D.C.2 is a Code §1248 shareholder, then D.C.2 is not required to include the Code §1248 amount attributable to the F.C.2 stock in its income, under Treas. Reg. §1.367(b)-4(b)(1)(i).

- Alternatively, if immediately after the Code §361 exchange, either F.C.1 or F.C.2 is not a C.F.C. with respect to which D.C.2 is a §1248 shareholder, then D.C.2 must include the Code §1248 amount attributable to the F.C.2 stock in its income.

In the example illustrated above, since F.C.1 continues to be 80% owned by foreign persons, neither F.C.1 nor F.C.2 will be C.F.C.'s, and D.C.2 will be required to include the Code §1248 amount with respect to its F.C.2 shares in its income.

DRAFT VALUATION RULES FOR INDIRECT TRANSFERS IN INDIA

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Tags
Draft Valuation Rules
India
Indirect Transfers
Vodafone

BACKGROUND

Section 9 of India's Income-tax Act, 1961 (the "I.T. Act") provides, *inter alia*, that capital gains arising from a transfer of a capital asset are taxed in India if the capital asset is "situated" in India. Thus, capital gains arising from a transfer of shares[1] of an Indian company are taxable in India, unless otherwise provided by a relevant tax treaty. However, prior to 2012, an issue arose on the taxability of capital gains arising upon the sale of shares of a foreign company that indirectly (*i.e.*, through intermediate entities) owns shares in an Indian company.

The landmark *Vodafone*[2] case addressed this issue. Vodafone International Holdings BV, a Dutch company, acquired a 67% stake in an Indian company, Hutchinson Essar Limited ("HEL"), by purchasing a 100% stake in the Cayman Islands company, CGP Investments (Holdings) Ltd. ("CGP") in 2007. CGP, a subsidiary of Hutchinson Telecommunications International, owned HEL's assets through a complicated network of intermediate entities. The taxpayer contended that the transaction was an offshore transaction with no nexus to India and thus did not pay tax on capital gains arising from the transaction.

The Indian tax authorities contended that capital gains from the transaction would be subject to Indian taxation, since it involved an indirect transfer of Indian assets. The matter reached the Supreme Court of India in 2012. The Supreme Court held in the taxpayer's favor and observed that the transaction is beyond India's territorial tax jurisdiction and, thus, not subject to tax in India.

RETROACTIVE OVERRIDE OF VODAFONE

Retroactive amendments were made to the I.T. Act in 2012, thereby overriding the Vodafone decision. These amendments tax capital gains arising from a transfer of a share or interest in a foreign entity that, directly or indirectly, derives its value substantially from assets located in India. Three years later, the Finance Act, 2015[3] clarified that shares or interest in a foreign company or entity (a "Foreign Entity") shall "derives its value substantially from the assets located in India" if the fair market value ("F.M.V.") of these assets

- exceeds INR 100 million, and
- represents at least 50% of the F.M.V. of the Foreign Entity's total assets.

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1 Under Indian tax law, shares are situated where the company is incorporated.

2 *Vodafone International Holdings B.V. v. Union of India & Anr.*, Civil Appeal No. 733 of 2012, Supreme Court of India, January 20, 2012.

3 Finance Act, 2015 inserted Explanation 6 into Section 9(1)(i) of the I.T. Act.

In connection to the above indirect transfer provisions, the Central Board of Direct Taxes issued draft rules[4] ("Draft Rules") on May 23, 2016, providing for the manner of determining the F.M.V. of the Indian and global assets, and the associated reporting requirements under the I.T. Act. The general public was invited to provide comments and suggestions regarding the Draft Rules until May 29, 2016.

F.M.V. OF ASSETS IN INDIA

The Draft Rules provide different methods for computing F.M.V. depending on the type of asset.

Shares of a Listed Indian Company (Without Right of Management or Control by the Foreign Company)

Where the shares are listed on a recognized stock exchange, the F.M.V. is the "observable price"[5] of the shares on the "specified date."[6] Where the shares are listed on more than one recognized stock exchange, the price of the shares is to be computed with reference to the recognized stock exchange that records the highest volume of trading in the shares during the period taken into consideration for determining the price.

Shares of a Listed Indian Company (With Any Right of Management or Control by the Foreign Entity)

F.M.V. shall be computed by market capitalization based on the observable price, plus the book value of liabilities of the Indian company on the specified date, divided by the total number of outstanding shares.

Shares of an Indian Company Not Listed on a Recognized Stock Exchange or an Interest in a Partnership Firm, Limited Liability Partnership, or Association of Persons

F.M.V. on the specified date shall be determined by a merchant banker or an accountant, in accordance with any internationally accepted pricing methodology for valuation of shares on an arm's length basis, increased by the liabilities, if any, considered in the determination.

"The Draft Rules provide different methods for computing F.M.V. depending on the type of asset."

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4 *I.e.*, Rule 11UB, Rule 11UC, and Rule 114DB, which are proposed to be inserted in the Income-tax Rules, 1962.

5 The observable price is the greater of

- the average of the weekly high and low of the closing prices of the shares quoted on the said exchange during the six months period preceding the specified date, or
- the average of the weekly high and low closing price of the shares quoted on the said exchange during the two weeks preceding the specified date.

6 Clause (d) of Explanation 6 to Section 9(1)(i) of the I.T. Act defines the specified date as

- the date on which the accounting period of the Foreign Entity ends, which precedes the date of transfer of a share or an interest; or
- the date of transfer, if the book value of the assets of the Foreign Entity on the date of transfer exceeds the book value of the assets, on the date referred to above, by 15%.

Other Assets

F.M.V. shall be the estimated price the asset would fetch if it is sold in the open market on the specified date, as determined by a merchant banker or an accountant, increased by the liabilities, if any, considered in such estimation.

F.M.V. OF ASSETS OF THE FOREIGN ENTITY

The F.M.V. of the assets of the Foreign Entity shall be computed as follows.

Transfer Between Unrelated Parties and Consideration

The F.M.V. shall be the value determined on the basis of a valuation report, as increased by the aggregate amount of liabilities, if any, that have been reduced for computing the value of the assets.

In Any Other Case

Shares of a Foreign Entity Listed on a Stock Exchange on the Specified Date

F.M.V. shall be the market capitalization based on the observable price, increased by the book value of liabilities on the specified date.

Shares of a Foreign Entity not Listed on a Stock Exchange on the Specified Date

F.M.V. of all the assets of the Foreign Entity shall be the fair market value of the Foreign Entity and its subsidiaries on a consolidated basis, as determined by a merchant banker or an accountant, as per the most appropriate internationally accepted valuation methodology as increased by the book value of liabilities of the Foreign Entity on the specified date.

INCOME ATTRIBUTABLE TO INDIAN ASSETS

Section 9 of the I.T. Act[7] further provides that capital gains arising from the transfer of shares or an interest in a Foreign Entity shall be taxable in India only to the extent the gains are reasonably attributable to assets located in India. The Draft Rules provide for the method of computation of income reasonably attributable to assets in India, using the following formula:

A x B / C		
A	=	Income from the transfer of the share or interest in the Foreign Entity computed in accordance with provisions of the I.T. Act as if such share or interest is located in India
B	=	F.M.V. of assets located in India as on specified date from which the share or interest referred to in A derives its value substantially (to be computed as discussed above)
C	=	F.M.V. of all the assets of the company or entity as on specified date (to be computed as discussed above)

[7] Explanation 7 to Section 9(1)(i) of the I.T. Act.

The transferor of the shares or interest in the Foreign Entity is also required to furnish an audit report[8] verified by a Chartered Accountant. The report must provide the basis for apportionment in accordance with the formula above, and it must certify that the income attributable to assets located in India has been correctly computed. Failure to furnish the report will result in all the income being deemed attributable to assets located in India. Resultantly, the all capital gains arising from the transaction will be taxable in India.

REPORTING REQUIREMENTS

Section 285A of the I.T. Act, as introduced by the Finance Act, 2015, requires that the Indian entity through or in which the Foreign Entity derives substantial value must report certain information to the jurisdictional assessing officer.

The Draft Rules[9] have identify specific reporting requirements,[10] including but not limited to the following:

- Name, address, entity type, residential status, previous year, assessment year, and Permanent Account Number of the Indian entity
- Name, country of incorporation, and tax residency of the immediate, intermediate, and ultimate holding companies
- Whether the share or interest in the Foreign Entity derives its value substantially from assets located in India, which are held in or through the Indian concern
- Whether the transaction has the effect of transferring the right of management or control over the Indian entity
- Details of the transaction, including consideration
- Basis for determining the location of the share or interest being transferred
- Details of the value of Indian assets and global assets of the Foreign Entity

According to the Draft Rules, the information must be submitted within 30 days if the transfer has the effect of directly or indirectly transferring management or control of the Indian concern, and within 90 days in other cases.

Further, the Indian entity is required to maintain the information and relevant documents for a period of eight years from the end of the relevant assessment year.

CONCLUSION

The issuance of the Draft Rules is a welcome move, as they clarify various terms introduced in section 9 of the I.T. Act *vide* the Finance Act 2015. Despite the slow

8 Form 3CT.

9 Rule 114DB of the Income-tax Rules, 1962.

10 Information is to be furnished on Form 49D by the Indian entity to the jurisdictional assessing officer.

legislation process, introduction of the Draft Rules will go a long way in reducing potential litigation and simplifying compliance procedures.

Uncertainity still exists about the outcome of indirect transfers that were finalized prior to the 2015-2016 tax year – since the computation and reporting requirements inserted by the Finance Act, 2015 and the Draft Rules are only prospective, whereas the law introduced in 2012 had retroactive effect.

"Despite the slow legislation process, introduction of the Draft Rules will go a long way in reducing potential litigation and simplifying compliance procedures."

PROPOSED REPORTING REQUIREMENTS FOR FOREIGN-OWNED U.S. DISREGARDED ENTITIES

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Tags
Code §482
Code §6038A
Code §7701
Disregarded Entity
Reporting Requirements

INTRODUCTION

On May 6, the Treasury released proposed regulations under Code §§6038A and 7701,[1] which would require foreign companies doing business in the U.S. through disregarded entities ("D.R.E.'s") to supply the I.R.S. with information about the operations of these D.R.E.'s and comply with certain record-keeping requirements. Under the proposed regulations, U.S. D.R.E.'s owned by foreign persons would be treated as domestic corporations for purposes of Code §6038A, which imposes reporting, record-keeping, and compliance requirements on 25% foreign-owned domestic corporations. The change is a necessary enforcement measure that will be used to meet U.S. obligations under various tax treaties, tax information exchange agreements, and other international agreements.

The "check-the-box" regulations under Code §7701 generally allow a business entity with a single owner to be treated as a D.R.E. for most tax purposes. Among other things, this can result in the entity not having to file a U.S. tax return or obtain an employer identification number ("E.I.N."). As a result, absent the new rules, the I.R.S. may lack information about the entity. This results in a loophole in the U.S. system that may allow a foreign person to hide assets in U.S. accounts.

PROPOSED §6038A REGULATIONS

The I.R.S. is proposing to use the provisions of Code §6038A to impose reporting and recordkeeping requirements on foreign-owned D.R.E.'s. Section 6038A currently requires a domestic corporation that is a 25% foreign-owned entity to annually file Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*, if it has a "reportable transaction" with its foreign owner or other foreign related parties. In addition, a reporting U.S. corporation must maintain records (or cause another person to maintain records) that allows the I.R.S. to determine the correct treatment of transactions with related parties.

The proposed regulations would amend Treas. Reg. §301.7701-2(c) – part of the check-the-box regulations – to treat a domestic D.R.E. that is wholly owned by one foreign person as a domestic corporation that is separate from its owner for purposes of the §6038A reporting and record keeping requirements. The proposed regulations are not intended to otherwise alter the existing framework of the entity classification regulations. This would result in a D.R.E. having to file Form 5472 and maintain sufficient records to establish the accuracy of the information. The entity

[1] REG-127199-15.

would also have to obtain an E.I.N. by filing a Form SS-4 and provide information about its responsible party.

"Under the proposed regulations, U.S. D.R.E.'s owned by foreign persons would be treated as domestic corporations for purposes of Code §6038A."

In order to insure that the I.R.S. obtains all pertinent information, a new category of reportable transactions is created. This new category includes any transaction within the meaning of Treas. Reg. §1.482-1(i)(7), including any sale, assignment, lease, license, loan, advance, contribution, or other transfer of any interest in or a right to use any property or money, as well as the performance of any services for the benefit of, or on behalf of, another taxpayer. As a result, a transaction between a D.R.E. and its sole owner (or another D.R.E.) would be a transaction subject to reporting, even though it may not generally be a transaction for other purposes of the Code, such as §482.

The entity is also required to keep permanent books of account and other records under Code §6001. The exceptions to the record keeping requirements for small corporations and *de minimis* transactions will not apply to a D.R.E.

Failure to comply with these new rules can result in criminal penalties and a $10,000 civil penalty, which can be increased if the failure continues after notification by the I.R.S.

The new rules will apply to taxable years ending on or after the date that is 12 months after the date of publication of final regulations.

CONCLUSION

Transactions conducted by D.R.E.'s normally would not be considered reportable transactions for purposes of Code §6038A. The proposed regulations result in the D.R.E. having to report a wide variety of transactions and services. These rules, once finalized, will result in additional time, effort, and expense in using a D.R.E.

PROPERTY CONTRIBUTIONS TO PARTNERSHIPS WITH RELATED FOREIGN PARTNERS

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Tags
Code §482
Code §704
Code §721
Income Allocation
Loss Allocation
Partnership
Property Contributions

INTRODUCTION

One of the tax advantages of a partnership is the ability of *any* partner to contribute "appreciated property"[1] to a partnership in a tax-free manner under Code §721(a).[2] In this case, there is a "built-in gain" for the property – equal to the excess of the property's fair market value ("F.M.V.") over its tax basis – which is not recognized under §721(a).[3] The I.R.S. has been concerned that transfers of appreciated property by a U.S. person to a partnership that has foreign partners related to the contributing partner ("related foreign partners") may be used as a way to avoid U.S. taxes.

Last year, the I.R.S. issued Notice 2015-54, which indicated that the I.R.S. intends to issue regulations that will override the §721 nonrecognition rule and treat the contribution as a taxable event unless the partnership adopts a set of requirements (the "Gain Deferral Method"), whose purpose is to insure that U.S. tax will not be avoided.

On May 23, 2016, the Section of Taxation of the American Bar Association submitted comments on the notice ("A.B.A. Report"). While generally agreeing with the approach taken in the notice, the A.B.A. Report recommends clarification on many of the mechanics of the Gain Deferral Method, including how it interacts with the Code §197 anti-churning rules and how it affects the allocation of creditable foreign taxes.

BACKGROUND

Nonrecognition Rules

Code §721(a) contains the general nonrecognition rule for transfers of property by a partner to a partnership. However, Code §721(c) gives the Treasury the power to issue regulations that override the general nonrecognition rule in the case of transfers of appreciated property to a partnership (whether foreign or domestic) if the gain, when recognized, would be includible in the gross income of a person other than a

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1 Appreciated property refers to property whose fair market value on date of transfer exceeds the property's tax basis. As a result, a taxable sale of this property will generate taxable gain.

2 By contrast, the Code §351 rules, which allow for transfers of appreciated property to a corporation, only apply if the transferors are in control of the corporation immediately after the transfer. Control requires the transferors to own 80% or more of the total combined voting power of the stock of the corporation and 80% or more of the total number of non-voting shares. Code §368(c).

3 The partnership gets a carryover basis for the contributed property. Code §723. As a result, taxation of the built-in gain is preserved and will occur when the partnership later sells the property.

U.S. person.[4] In addition, Code §367(d)(3)[5] gives the Treasury the power to use the rules of Code §367(d)(2), which applies to transfers of intangible property to foreign corporations. These rules may now be used for transfers of intangible property to certain foreign partnerships.

Special Allocation Rules

Code §704(c) deals with the transfer of appreciated property[6] to a partnership and how that affects the allocation of partnership income, gains, losses, and deductions among the partners. Special rules are necessary since the partnership gets a carry-over basis for the contributed property[7] and thus, the partnership inherits the built-in gain in the contributed property. This section requires that when the partnership later sells the contributed property, the built-in gain in the contributed property is specially allocated to the contributing partner.

For example, one partner ("A") contributes land with a F.M.V. of $100 and a tax basis of zero to the newly-formed partnership ("AB Partnership") and another partner ("B") contributes cash of $100. The Land has a built-in gain of $100. A and B are each 50% partners in AB Partnership. The partnership later sells the land for $300 and recognizes a $300 gain on the sale.[8] If §704(c) did not exist, A and B would each be allocated 50% of that gain, so that $150 of income would be allocated to each of them.

Section 704(c) changes this result. First, A is specially allocated $100 of the gain to match the built-in gain in the property. After this special allocation, there is $200 of gain left to allocate. This $200 gain is allocated 50% to A and 50% to B, so that A is allocated an additional $100 and B is allocated $100. In summary, A is allocated $200 of the gain and B is allocated $100 of the gain.

In this example, the contributed land is *not* a depreciable asset. In addition, the special allocation is only made in *one* year (*i.e.*, when the contributed property is sold). No special allocations are required for any other year.

If a *depreciable* asset is contributed to a partnership, a more complex aspect of Code §704(c) is triggered. This affects tax allocations for *every* year, starting in the first year in which the property is contributed to the partnership. The rationale behind these added rules is that the non-contributing partner is being harmed by the contribution of property with a built-in gain, since the partnership only gets a carry over basis for the property[9] and not a basis equal to its F.M.V. As a result, there will

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4 Code §§1491-1494 imposed an excise tax on certain transfers by U.S. persons of appreciated property to a foreign partnership, but these sections were repealed by the Taxpayer Relief Act of 1997 (the "1997 Act"). The 1997 Act then adopted Code §721(c), discussed above.

5 Added by the 1997 Act.

6 Section §704(c) also deals with transfers of depreciated property to a partnership that have a "built-in loss" since the tax basis exceeds the property's F.M.V. However, since this is not the focus of Notice 2015-54, this article will not address that situation.

7 Code §723.

8 Gain equals the amount realized ("A.R.") on the sale minus the tax basis of the property. Code §1001(a). In this example, the A.R. is the sale price of $300; the tax basis of the land is zero. As a result, the gain is $300.

9 Code §723.

be a shortfall in depreciation deductions allowed to the partnership[10] compared to those that would have been allowed if the basis was stepped-up to F.M.V.

In the foregoing example, if A had contributed *depreciable* property with a F.M.V. of $100 and a tax basis of zero then no depreciation would be available to the partnership to allocate between A and B. By contrast, if the basis of the contributed property would equal its F.M.V., then the partnership can depreciate the property and generate annual depreciation deductions available to B, the non-contributing partner. Absent some special allocation, there is a shortfall in depreciation deductions allocated to these partners.

To remedy this situation, the §704(c) regulations require the partnership to choose one of three methods to specially allocate income, gains, losses, and deductions among the partners each year: (i) the traditional method; (ii) the traditional method with curative allocations; and (iii) the remedial method.[11] As discussed below, Notice 2015-54 requires the remedial method be used to avoid income recognition. The following is a brief overview of these three methods and their impact on the partners.

"To specially allocate income, gains, losses, and deductions . . . Notice 2015-54 requires the remedial method be used to avoid income recognition."

The first two §704(c) methods specially allocate depreciation deductions to the *non-contributing* partners for the *contributed* property[12] or for *all* partnership property[13] up to an amount equal to the depreciation deductions they would have gotten if the partnership had a tax basis for the contributed property equal to its F.M.V.[14] However, in some cases, there may not be enough depreciation deductions to specially allocate.

The remedial method's goal is to make up the shortfall in depreciation deductions available to allocate to the non-contributing partner. The remedial method[15] creates a *deemed* amount of *added* depreciation deductions at the partnership level to specially allocate to the non-contributing partners to make them whole. The remedial method then creates a matching *deemed* amount of income to the contributing partner. This deemed income amount, which is called a correlative adjustment of income, is made outside the partnership.

The remedial method comes closest to the result that would happen if the partnership had acquired the property in a taxable transaction and had a tax basis for the contributed property equal to its F.M.V. The remedial method may not be the best choice for the contributing partner since, as noted above, it results in creation of correlative adjustments of income to the contributing partner outside the partnership. The other two §704(c) methods do not create any correlative adjustments of income outside the partnership; they only re-allocate depreciation deductions claimed by the partnership. A more detailed discussion of these §704(c) rules is not included here, but is available elsewhere.[16]

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[10] Depreciation is based on the basis of the property. Code §§167, 168.

[11] Treas. Reg. §§1.704-3(b), (c) & (d).

[12] In the case of the traditional method.

[13] In the case of the traditional method with curative allocations.

[14] Any excess depreciation deductions can then be allocated in the normal way that allocations are made under the partnership agreement.

[15] Treas. Reg. §1.704-3(d).

[16] Philip Hirschfeld, "Partnership Property Contributions: The Good, The Bad and The Ugly," BNA Real Estate Journal (2016).

NOTICE 2015-54

In Notice 2015-54, the I.R.S. stated it will adopt regulations under Code §721 to address a transfer of appreciated property by a U.S. person to a "§721(c) Partnership."[17] A §721(c) Partnership is any partnership in which

- a U.S. person transfers appreciated property ("§721(c) Property");
- a related foreign person is a direct or indirect partner in that partnership; and
- the U.S. transferor and one or more related persons own more than 50% of the interests in the partnership's capital, profits, deductions, or losses.[18]

The I.R.S. said such transfers will not be eligible for Code §721's nonrecognition rule, unless the partnership adopts use of the Gain Deferral Method.[19] The most important part of the Gain Deferral Method is the requirement that the partnership adopt use of the §704(c) remedial method for making allocations of income, gains, losses, and deductions among the partners.[20]

The Gain Deferral Method also requires that

- the partnership make allocations of §704(b) income, gains, losses, and deductions with respect to the contributed built-in gain property in the same proportion;
- certain new reporting requirements are satisfied;
- the U.S. transferor recognizes the remaining built-in gain on the contributed property upon certain events that cause acceleration of the gain; and
- the Gain Deferral Method is adopted for all built-in gain property subsequently contributed to the partnership by the U.S. transferor (and all related U.S. transferors) until the earlier of
    - the date that no built-in gain remains with respect to any built-in gain property to which the Gain Deferral Method applies or
    - the date that is 60 months after the date of the initial contribution of §721(c) Property to which the Gain Deferral Method first applied.[21]

In addition, the Notice describes certain additional guidance that will be developed, by analogy with Treas. Reg. §1.482-7T.[22]

A.B.A. REACTION

While acknowledging that the Treasury action in publishing Notice 2015-54 is

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17 Notice 2015-65, §4.

18 *Id.*, §4.01(5).

19 *Id.*, §4.02.

20 *Id.*, §4.03(1).

21 *Id.*, §4.03.

22 *Id.*, §5.01.

"generally appropriate,"[23] the A.B.A. Report commented on the need for further guidance to improve implementation of these rules.

The A.B.A. Report noted that the use of the remedial method raises a number of issues that are not addressed in the Notice, but which should be addressed in future guidance to provide clarity on the method's required application.[24]

"The A.B.A. Report noted that the use of the remedial method raises a number of issues that are not addressed in the Notice."

First, concern was expressed on how the remedial method interacts with the anti-churning rules of Code §197. Code §197 was adopted in 1993 to eliminate controversy between the I.R.S. and taxpayers over whether the purchase price for goodwill, or other intangible assets, can be depreciated or amortized over time. Code §197(a) permits a taxpayer who purchases goodwill or certain other intangible property to amortize the cost of such property over a 15-year period. In order to stop taxpayers from engaging in transactions that convert pre-1993 intangibles that are not eligible for amortization deductions into §197 assets eligible for amortization, Code §197(f)(9) contains an anti-churning rule. The A.B.A. Report requested that if the anti-churning rule applies, then no adjustments should be made under the remedial method.[25]

Second, concern was expressed as to whether the remedial method should apply to "reverse §704(c) gain" arising from revaluation events of the §721(c) Partnership. Reverse §704(c) gain arises in the following situation. When a partnership admits a new partner, the partnership may elect to revalue its assets, and increase (or "book up") or decrease (or "book down") the capital accounts of the old partners to reflect this new value.[26] A book up or book down creates a difference between the capital accounts of the partners and their shares of the inside basis of the partnership's assets. In that case, the regulations require that the partnership adopt special allocation methods that mirror those of Code §704(c), which are called reverse §704(c) allocations.[27] The A.B.A. Report said it is "unclear under the Notice" if the remedial method must be used for reverse §704(c) gain. The A.B.A. Report recommended that it not apply since application was not needed to accomplish the Treasury's goal and it would be an "administrative burden."[28]

Finally, the A.B.A. Report questioned whether allocations of remedial income and deductions under the remedial method should create separate categories under the §704(b) regulations governing a partnership's allocation of creditable foreign tax expenditures ("C.F.T.E.'s"). A partnership can allocate its paid or accrued foreign taxes (or C.F.T.E.'s) to the partners. The partners may then be able to use these foreign taxes to reduce the taxes owed. Code §704(b) requires that allocations of income, gains, losses, or deductions must have substantial economic effect ("S.E.E."). If S.E.E. is lacking, then the I.R.S. can reallocate such items among the partners based on the partners' interests in the partnership ("P.I.P.'s"). Allocations of tax credits (such as C.F.T.E.'s) cannot have S.E.E. since they do not affect the capital accounts of the partners. The §704(b) regulations contain a safe harbor for

[23] A.B.A. Report, Executive Summary.

[24] *Id.*, II(A)(1).

[25] *Id.*, II(A)(1)(a).

[26] Treas. Reg. §1.704-1(b)(2)(iv)(f). Other events noted in regulations can also trigger a revaluation.

[27] Treas. Reg. §1.704-1(b)(4)(i).

[28] A.B.A. Report, II(A)(1)(b).

determining if allocations of C.F.T.E.'s are in accordance with P.I.P.[29] This safe harbor requires creating separate C.F.T.E. categories to reflect income from different activities of the partnership.

The A.B.A. Report indicated it was unclear how the remedial method will apply to C.F.T.E.'s. The A.B.A. Report recommended that future guidance specify that the §704(b) regulations "do not cause annual remedial allocations . . . to create separate C.F.T.E. categories when §704(b) income of the partnership is allocated to the partners in the same ratio."[30]

The A.B.A. Report recommended changes to the "Proportionate Allocation Requirement."[31] Partnerships often make a preferred or priority distribution of cash flow to partners (called a preferred return), which is equal to a certain percentage of capital invested by the partners. Once the preferred return is made, cash flow is distributed according to a set formula. For example, in a limited partnership, the partnership may first make a distribution to the limited partners in an amount equal to 5% of the partners' invested capital, and any excess cash flow is distributed 80% to the limited partners and 20% to the general partner. The A.B.A. asked that the Treasury confirm that a preferred return funded by net income does not violate the Proportionate Allocation Requirement.[32]

The A.B.A. recommended that future guidance clarify that yearly changes in the partners' allocation percentages with respect to §721(c) property are permissible and do not violate the Proportionate Allocation Requirement.[33] The A.B.A. also requested that the regulations confirm that guaranteed payments do not violate the Proportionate Allocation Requirement.[34]

With respect to the added reporting requirements, the A.B.A. recommended that "to the extent [that] duplicative information must be reported on Form 8865 and also on other new reporting form(s), an exception [should] be granted if the information is already reported by a taxpayer on Form 8865."[35]

Among other comments, the A.B.A. also commented on the rules applicable to subsequent contributions[36] and the rules that will accelerate the recognition of income by the contributing partner.[37] The A.B.A. was concerned about the impact of a technical termination of a partnership under Code §708(b)(1)(B)[38] and partnership conversions and recapitalizations,[39] which could trigger acceleration of gain in cases that the A.B.A. thought may not have been intended.

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29 Treas. Reg. §1.704-1(b)(4)(viii)(a)(1).

30 A.B.A. Report, II(A)(1)(c).

31 *Id.*, II(A)(2).

32 *Id.*, II(A)(2)(c).

33 *Id.*, II(A)(2)(a).

34 *Id.*, II(A)(2)(d).

35 *Id.*, II(A)(4).

36 *Id.*, II(A)(3).

37 *Id.*, II(B).

38 *Id.*, II(B)(2)(a). A technical termination occurs if here is a sale of 50% or more of the interest in partnership profits and capital within aa 12-month period.

39 *Id.*, II(B)(2)(b).

CONCLUSION

The A.B.A. Report offers some helpful guidance to the Treasury in adopting regulations based on Notice 2015-54. Those 42 pages of comments also illustrated that there is a great deal of complexity in these rules. As 2016 is an election year and the Treasury already has much work on its hands – addressing proposed regulations under Code §385 regarding characterization of related-party debt,[40] inversions,[41] and numerous other issues – the Treasury will be hard-pressed to review comments by the A.B.A. and others before adopting final regulations this year. The author hopes that the Treasury will have the time to address the issues raised in Notice 2015-54 in a meaningful way for both taxpayers and the I.R.S., even if it may result in delaying adoption of final regulations until next year.

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40 Philip Hirschfeld, "Related-Party Debt: Proposed Code Section 385 Regulations Raise Major New Hurdles," *Insights* 5 (2016).

41 Philip Hirschfeld, "Inversions Under Siege: New Treasury Regulations Issued," *Insights* 4 (2016).

DISALLOWANCE FOR FAILURE TO WITHHOLD ON OUTBOUND PAYMENT VIOLATES INDIA-U.S. NON-DISCRIMINATION CLAUSE

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India
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Tax Treaties

Herbalife International Private Limited (the "Taxpayer") was an Indian subsidiary of Herbalife International Inc., a U.S. corporation, engaged in the business of trading and marketing of herbal products used for weight management. During the tax year 2000-2001, the Taxpayer paid an administrative fee to Herbal International of America Inc. ("HIAI"), an affiliate U.S. corporation, in consideration for administrative services rendered by the latter.

The Taxpayer claimed this payment as deduction when computing its taxable income. The Taxpayer did not withhold tax at the time payment was made to HIAI, a nonresident, which was, nonetheless, required under the Indian Income-tax Act, 1961 (the "I.T. Act"). However, no such withholding requirement existed under the I.T. Act with respect to payments made to residents, for the year in question. The requirement of withholding tax on payments made to residents was inserted, for the first time by way of Section 40(a)(ia) of the I.T. Act, *vide* Finance Act, 2004.

The Hon'ble Court of Delhi (the "H.C.") considered the allowance of the administrative fee under Section 40(a)(i) of the I.T. Act, in light of the non-discrimination clause under Article 26 of the India-U.S. Tax Treaty (the "Treaty").

The H.C. explained that Section 40 of the I.T. Act, which requires withholding, overrides other provisions under the I.T. Act that provide for deductibility of expenditure.[1] Generally speaking, the payment of an administrative fee to HIAI would be allowable under Section 37(1) of the I.T. Act, but before this payment can be allowed, the condition regarding withholding of tax when the recipient is a nonresident must be satisfied.[2] In other words, if taxes are not withheld from the payment being made to a nonresident, then Section 40(a)(i) of the I.T. Act provides for disallowance of the expenditure for purposes of computing the taxable income of the payer.

The H.C. considered the provisions of the non-discrimination clause[3] in the Treaty to ascertain whether withholding on the payment made to HIAI (*i.e.*, payment made to a nonresident) is any different from the allowance of such payment as a deduction when it is made to a resident.

The H.C. noted that Section 40(a)(i) of the I.T. Act, as it stood during the relevant tax year,[4] did not provide for the withholding requirement where the payment was made in India to a resident. However, as far as payment to a nonresident is concerned,

1 Sections 30 to 38 of the I.T. Act.

2 Section 40(a)(i) of the I.T. Act.

3 Article 26(3) of the India-U.S. Tax Treaty.

4 *I.e.*, before insertion of sub-clause (ia) in Section 40(a) by the Finance Act, 2004.

Section 40(a)(i) of the I.T. Act, as it stood at the relevant time, mandated that if tax is not withheld at the time of payment, it will not be allowed as a deduction when computing the taxable profits of the payer.

Therefore, the H.C. observed that the lack of parity in the allowance of the payment as deduction results in discrimination against nonresidents under Article 26(3) of the Treaty. The H.C. thus held that the provisions of Section 40(a)(i) of the I.T. Act were discriminatory, being more onerous for nonresidents and, therefore, not applicable. As a result, the H.C. allowed the deduction of the expenditure for computing taxable income of the Taxpayer, despite the failure to withhold tax.

It may be noted that the rationale of the H.C. is not applicable to payments made after April 1, 2004, since the Finance Act, 2004 amended Section 40 of the I.T. Act to introduce withholding tax requirements where the recipient is a resident in India, thereby eliminating any discriminatory treatment and introducing parity in disallowance among residents and nonresidents in India.

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Action 3
Action 4
B.E.P.S.
Blacklist
Code §385
C.F.C.
Tax Avoidance

CONTROLLED FOREIGN COMPANY TERMS DIVIDE EUROPEAN UNION

Countries within the E.U. are divided over the definition and application of controlled foreign company ("C.F.C.") rules within the E.U.[1] B.E.P.S. Action 3 suggests non-binding approaches when countries draft C.F.C. rules, and the European Commission ("E.C.") has proposed C.F.C. rules where tax is based on a minimum rate. However, countries with low tax rates, such as Ireland, are opposed to the legislation, as they believe it will inhibit foreign investment.

E.C. Proposal and Conflict

Under the E.C. proposal, a C.F.C. would be defined as follows:

- More than 50% of the company's shares, profits, or assets are controlled by a group.
- The company is based in a non-E.U. country with a statutory tax rate lower than 40% of the tax rate in the country of the parent company.
- More than 50% of the company's income comes from passive sources.[2]

The C.F.C. rules would not apply to companies listed on a public stock exchange, but it would apply to E.U. subsidiaries if the sole purpose of the subsidiary's existence was artificial.[3]

Many E.U. countries provide an exemption from tax for dividend and capital gain income realized from qualifying subsidiaries. These transactions are affected by the E.C.'s proposed "switch-over" clause.[4] Under the switch-over clause, dividend and capital gain income would be taxed if the subsidiaries were located in a jurisdiction whose tax rate was less than 40% of the rate in the parent jurisdiction.

Some countries are concerned that this would impact E.U. companies that serve as central holding companies for multinationals, as multinationals would choose to incorporate these entities elsewhere.

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1 European Commission, "Proposal for a Council Directive Laying Down Rules Against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market," January 28, 2016.

2 *Id.*, art. 8, para. 1(a)-(c).

3 *Id.*, art. 8, para. 2.

4 *Id.*, art. 6.

The Dutch Proposal

As chairman of the E.U. Council, the Netherlands has recommended various amendments in an attempt to obtain agreement on the proposed C.F.C. rules before a self-imposed September deadline. The first amendment would add a statement that the proposed minimum tax rate is not an attempt to proscribe corporate tax rates in any E.U. country. Under the second, the C.F.C. rules would only apply to "artificial entities" and not every subsidiary in a group. Finally, the Netherlands has proposed the elimination of the switch-over clause. While these amendments may obtain agreement from some countries, larger European economies, such as Germany and France, may fight the amended proposals. Thus, despite hopes that the C.F.C. rules would be implemented quickly, they seem mired in negotiation gridlock for the foreseeable future.

GROUP CREATED TO SECURE PASSAGE OF E.U. "BLACKLIST"

A previous edition of *Insights* introduced the creation of a common E.U. blacklist, by noting that "under the European Commission's proposed country-by-country ('CbC') reporting requirements, any company with business activities in a country on the blacklist would be required to disclose profits earned and taxes paid in that jurisdiction."[5] The blacklist criteria include whether a country uses the common reporting standard on bank account transparency[6] and whether a country has adopted B.E.P.S. reforms.[7]

If a country is blacklisted, it may be exposed to "defensive measures" from the entire E.U.[8] These defensive measures may include the imposition of sanctions on the blacklisted country or a greater administrative burden on companies resident there. This may de-incenti*vize* companies from establishing residency in the blacklisted country.

The E.U. blacklist is expected to be finalized by the end of 2016, and E.U. ministers must formally adopt the list once it is finalized. However, the ministers cannot agree on the definition of a tax haven, and for several E.U. countries, their respective blacklists remain empty. To overcome this problem, the E.U. has created a "code of conduct group,"[9] which will determine the blacklist criteria based on O.E.C.D. and other standards, to be named later. Based on the C.F.C. negotiations mentioned above, it is unlikely that an agreement will be forthcoming.

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5 See in detail Christine Long and Beate Erwin, "U.S. on the Blacklist – Is Delaware a Tax Haven?," *Insights 5 (2016)*.

6 European Council, "Council Conclusions on an External Taxation Strategy and Measures Against Tax Treaty Abuse," May 25, 2016. para. 8.

7 *Id.*, para. 17.

8 *Id.*, para. 4.

9 European Commission, "Questions and Answers on the Action Plan for Fair and Efficient Corporation Taxation in the E.U.," news release, June 17, 2015.

PRACTITIONERS CRITIQUE "INEFFECTIVE" PROPOSED CODE §385 REGULATIONS

The previous edition of *Insights* discussed the proposed Code §385 regulations, noting that the "Treasury considered guidance to restrict strategies that avoid U.S. tax on U.S. operations by shifting or 'stripping' U.S.-source earnings to lower-tax jurisdictions through the use of intercompany debt."[10] In general, under the proposed regulations, the I.R.S. may disallow deductions made on certain loans by determining that a transaction is actually an equity investment, rather than a tax-deductible loan. The proposed regulations not only target corporate inversions but implicate non-inversion transactions as well.

Critics such as the legislative counsel for the Joint Committee on Taxation have indicated that the proposed regulations are not a long-term solution and the bigger problem is the U.S. system of worldwide taxation, which encourages base erosion. The Senate Finance Committee is discussing a possible response to the Treasury Department's controversial rules to stop companies from stripping U.S.-source income via loans to their subsidiaries. Other critics note that the regulations are so extensive that they require Congressional input and approval. The proposed regulations are unclear as to the treatment of long-standing debt instruments and whether the I.R.S. may, with hindsight, reclassify debt as equity even though the principal has been partially paid. Practitioners are seeking clarification on these issues before the proposed regulations are enacted.

"The French authorities believe that McDonald's had been using a Luxembourg-based entity to shift profits to lower-tax jurisdictions through fees for using the company brand and other services."

FRENCH AUTHORITIES RAID U.S. COMPANIES FOR TAX EVASION

French tax authorities have raided the French offices of Google, McDonald's, and Booking.com, respectively.

The French tax authorities believe Google owes the government €1.6 billion for failure to pay French tax. The assessment is based on the government's assertion that Google's Irish subsidiary maintains a permanent establishment ("P.E.") in France.[11] The French government claims that Google's French entity is a front and that it is in fact the Irish entity that produces the substantial activity in France resulting in revenue. Google asserts there is no P.E. in France, as all contracts are concluded in Ireland and, accordingly, all French sales income is correctly reported in Ireland. France's finance minister has dismissed a possible settlement with Google. If found guilty, Google may be subject to a penalty of €10 million or half of the value of the assessed amount.

Recently, the French authorities also raided the French headquarters of McDonald's in a tax probe. The French authorities believe that McDonald's had been

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10 Philip Hirschfeld, "Related-Party Debt: Proposed Code §385 Regulations Raise Major New Hurdles," *Insights 5 (2016).*

11 "French Raid Google in Latest Probe into Tech's Tax Tactics," *The New York Times*, May 24, 2016.

using a Luxembourg-based entity, named McD Europe Franchising, to shift profits to lower-tax jurisdictions through fees for using the company brand and other services.

Finally, after a two-year investigation, French authorities are now seeking €365 million in unpaid taxes, penalties, and interest from Booking.com. Similar to the Google situation, the French authorities accuse Booking.com of maintaining a P.E. in France. Booking.com may challenge the assessment in French court.

The French government has claimed that, in 2015 alone, it collected €3.3 billion in back taxes and penalties from just five multinationals. These collection issues may become more prevalent as cash-strapped governments seek additional sources of revenue.

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