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INSIGHTS

U.K. CRIMINAL PENALTIES FOR IMPROPER TAX PLANNING – COULD YOU BE EFFECTED?

NEWS ON THE FRENCH FRONT: TAX LAW CHANGES FOR CORPORATIONS AND INDIVIDUALS

INCOME TAXATION OF TRUSTS IN BELGIUM

TRUMP AND THE REPUBLICAN-LED CONGRESS SEEK OVERHAUL OF INTERNATIONAL TAX RULES

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EDITORS' NOTE

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

- **U.K. Criminal Penalties for Improper Tax Planning – Could You Be Affected?** New powers have been given to H.M.R.C. in recent legislation, and new criminal and civil penalties have been enacted as part of a massive legislative program designed to stop U.K. residents from participating in offshore tax avoidance and evasion schemes. Several criminal penalties are directed to advisory firms that facilitated tax offenses. In certain circumstances, advisory firms based outside the U.K. will be at risk of prosecution. Gary Ashford of Harbottle and Lewis L.L.P., London, and Stanley C. Ruchelman examine the new provisions.

- **News on the French Front: Tax Law Changes for Corporations and Individuals.** In France, the enactment of new tax law provisions requires a multi-faceted procedure involving many steps carried out by the government, two houses of parliament, specialized committees, a conference of both houses of parliament, and a review by the French Constitutional Court. Once the full procedure is completed, the new law may be effective retroactively. Many changes in tax law were made in 2016, including the adoption of employee withholding tax, changes to the free share regime, a reduction to the corporate tax rate, extension of exemptions to the corporate tax on the payment of dividends, and the parent-subsidiary regime. Fanny Karaman and Astrid Champion discuss these and other changes.

- **Income Taxation of Trusts in Belgium.** How are foreign trusts, Belgian beneficiaries, and Belgian settlors taxed in Belgium when Belgian law civil law generally does not recognize the existence of trusts? Depending on facts and circumstances, the so-called Cayman Tax Law will tax either the settlor or the beneficiary. Gerd D. Goyvaerts of Tiberghien, Brussels explains.

- **Trump and the Republican-Led Congress Seek Overhaul of International Tax Rules.** Elizabeth V. Zanet and Beate Erwin compare the proposals that comprise the Trump tax plan and the House Republican Tax Reform Blueprint, which will be submitted to Congress as part of a massive overhaul of U.S. tax law. Tax rates for individuals and corporations would likely be lowered, the standard deduction would be increased, and capital gains tax rates would remain at the same level. The net investment income tax would be repealed. The estate tax and generation skipping tax would be repealed. The gift tax would remain. Other provisions are discussed, also.

- **Looking to the Future: European Efforts Against Tax Evasion Take Center Stage – Where Will It Take Us?** A globalized economy has been the driving force behind cross-border tax transparency and increased dissemination of tax information in recent years. The importance of F.A.T.C.A. reporting has paled as the O.E.C.D. Common Reporting Standard has taken effect in the E.U., State Aid cases are progressing, and country-by-country reports may be publicly available. Europe and the U.S. are moving in different directions. Philip R. Hirschfeld and Stanley C. Ruchelman explain.

- **New Zealand Foreign Trust Disclosure Regime.** In April 2016, the New Zealand government convened an independent inquiry into the use of New Zealand foreign trusts. Following this inquiry, a new foreign trust disclosure regime was proposed to obtain information on ultimate beneficial ownership. Heather Howell, who heads the office of Trident Trust Group in Auckland, New Zealand, explains.

- **Foreign Charities Active in the U.S. – Public? Or Private Foundations?** Foreign nonprofit organizations have become more active in the U.S. in carrying out their charitable mandates. Such activities include performances in the U.S. by foreign artistic companies and the use by U.S. charities of technology and know-how developed by foreign charities. Fees earned by foreign charities could be subject to U.S. income or withholding taxes, but those taxes can be reduced or eliminated if specific procedures are followed. Much will depend on the status of organization as a "public charity" or a "private foundation," terms that make reference to the organization's funding sources. Nina Krauthamer and Galia Antebi explain the U.S. rules that are applicable.

- **Transfer Pricing Adjustment Does Not Reduce Dividend Received Deduction from C.F.C.** When the I.R.S. successfully maintains an adjustment to transfer pricing within an intercompany group, taxable income is increased to one participant but cash remains at the level that existed at year-end prior to the I.R.S. adjustment. To avoid a second tax adjustment, the party with excessive cash – as determined after the I.R.S. adjustment – may be treated as if it incurred an account payable, which can be repaid free of additional tax. In *Analog Devices*, the I.R.S. attempted to argue that the account payable of the C.F.C. should be treated as an actual borrowing. The effect of an actual borrowing limited the favorable tax treatment under Code §965. That provision temporarily allowed an 85% dividends received deduction for a U.S. corporation receiving a dividend from a controlled foreign corporation. The Tax Court disagreed with the I.R.S. position. Kenneth Lobo and Beate Erwin explain.

- **S.T.A.R.S. Transactions – Jury Is In, Foreign Tax Credit Disallowed.** As a litigation strategy, a large corporation that is important to a community may decide that it is better to pay the tax and demand a jury trial in U.S. District Court as part of its claim for refund, rather than to defer payment while it argues the case before the Tax Court. The basic theory is that the jury will not be sympathetic towards the I.R.S. In a recent jury trial involving Wells Fargo, it found that the strategy did not work when the issue involved a tax shelter knows as a S.T.A.R.S. (structured trust advantaged repackaged securities) transaction. Rusudan Shervashidze and Galia Antebi explain.

- **New Regulations Imminent for Triangular Reorganizations and Inbound Nonrecognition Transactions.** In Notice 2016-73, the I.R.S. announced that it intends to issue regulations preventing certain taxpayer abuses incident to triangular reorganizations involving foreign corporations. These are transactions in which a subsidiary is the acquisition vehicle and the shares used to acquire the target are shares of the parent company, hence the reference to a triangle. The Notice is another step in the saga of "Killer B" reorganizations in which U.S. corporations attempt to take cash out of foreign subsidiaries without paying significant U.S. tax. Transactions occurring in the past two years have been found to be abusive because they apply recently issued regulations in a way that was not intended at the time of publication. Fanny Karaman and Stanley C. Ruchelman explain the approach enunciated in the Notice.

- **Corporate Matters: Joint Venture Considerations.** The term "joint venture" is more a term of art than a legal concept. Joint ventures have been described by the courts as an association of two or more persons, in the nature of a partnership, to carry on a business enterprise for profit. Simon H. Prisk examines the decision points faced when drafting a joint venture agreement.

- **Updates & Tidbits.** This month, Beate Erwin, Philip R. Hirschfeld, Fanny Karaman, and Nina Krauthamer look briefly at several timely issues, including (i) the termination of foreign acceptance agent agreements used to confirm copies of passports outside the U.S. when a non-U.S. individual obtains an I.T.I.N., (ii) a court order in Canada upholding a demand for disclosure of client names and documentation relating to participation in a discredited tax shelter, (iii) E.U. steps that identify potentially blacklisted low-tax or no-tax countries, and (iv) worsening relations between the U.S. and the E.U. stemming from widening differences in tax policies.

We hope you enjoy this issue.

- The Editors

U.K. CRIMINAL PENALTIES FOR IMPROPER TAX PLANNING – COULD YOU BE AFFECTED?

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Tags
Compliance
Offshore Accounts
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BACKGROUND

New powers for H.M.R.C. to ferret out and punish tax evaders have been introduced in the U.K. and more have been proposed for introduction in the coming months. Together, they are expected to have a significant impact on financial institutions and professional advisers based outside the U.K. with employees or associates operating in the U.K. market.

CRIMINAL FINANCES BILL 2017

The recently published Criminal Finances Bill 2017 proposes two new corporate criminal tax offences that affect advisers to taxpayers. These are offense for (i) the failure to prevent facilitation of U.K. tax evasion offences and (ii) the failure to prevent facilitation of foreign tax evasion offences. Each is discussed below.

U.K. Tax Evasion Facilitation Offence

Criminal charges will be asserted against any corporate body or partnership involved in a transaction that constitutes tax evasion. The predicate facts constituting the criminal offense are as follows:

- A client has committed an offence constituting U.K. tax evasion.
- An individual employed or associated with the adviser knowingly acted in a way to assist the person who has been found guilty of the tax evasion offence.
- The adviser does not have reasonable procedures in place to prevent employees and associates from helping the individual commit the tax evasion offence.

To determine the exposure of a corporation or a partnership to prosecution three questions must be answered.

1. *When does an individual knowingly provide assistance to a person committing tax evasion in the U.K.?*

   There are two instances in which an individual can be viewed to knowingly provide assistance to the persons committing U.K. tax evasion. The first is that the individual was knowingly concerned in the fraudulent act of tax evasion or took steps with a view to assisting in the fraudulent act of another person. The second is that the individual aided, abetted, counselled, or procured the commission of the fraudulent act of tax evasion.

2. *When is an individual employed or associated with a corporation or partnership?*

A person is associated with a corporate body if that person is an employee or agent of a corporate body or performs services for it or on its behalf. The term associate, as defined, may extend to an individual or an incorporated body. H.M.R.C. has stated that determination is made by reference to all the relevant facts and circumstances, and not merely by reference to the nature of the legal relationship between the individual and the organization. In short, an individual who acts in concert with a corporation may be associated with the corporation if both are carrying out a common enterprise. It does not matter whether the associated person or the relevant body is based in the U.K. or overseas. The U.K. offence may be committed by any corporation or partnership, no matter where incorporated or formed.

3. *Must the client be convicted of a crime in order for H.M.R.C. to prosecute a corporation of partnership?*

For the corporate offence to be committed there must first be a criminal offence. Noncompliance, falling short of fraud, will not result in the corporate offence being committed. What is fraudulent behavior for these purposes? The legislation is focused on any dishonest activity that intends to divert funds from the public revenue. In the U.K. this could be an offence under common law. There are also a range of statutory offences, such as (i) fraudulently evading Value Added Tax ("V.A.T.") or (ii) fraudulently evading income tax.

H.M.R.C. has stated that a conviction for tax evasion is not a prerequisite for bringing a prosecution against a relevant body under the legislation. Voluntary disclosures by clients, for example, could still result in a prosecution conducted by H.M.R.C. against the relevant body. This is of particular concern in the current climate. Over the last decade, in line with O.E.C.D. principles, the U.K. has offered individuals the opportunity to regularize untaxed offshore assets by making voluntary disclosures. A voluntary disclosure of tax evasion, after the new offences are enacted, could potentially trigger H.M.R.C. action against any relevant corporate body that served as an adviser and had an employee or associate that provided the relevant degree of assistance. The relevant body may consider making its own voluntary disclosure in these circumstances, unless it has an adequate defense.

<u>Foreign Tax Evasion Facilitation Offence</u>

The foreign offence, is narrower in scope. It can be committed only by a relevant body that is

- incorporated under U.K. law (*e.g.*, a limited company incorporated under U.K. law),
- incorporated outside the U.K. but carrying on a business activity from a permanent establishment within the U.K., or
- incorporated outside the U.K. but whose associated person is located within the U.K. at the time of the criminal act that facilitates the evasion of the overseas tax.

In addition to the above, the foreign offence requires dual criminality. This occurs in two instances. The first is that the overseas jurisdiction has a tax evasion offence at the client level that is comparable to an offence under U.K. tax law, so that the actions carried out by the client would constitute a crime had they taken place in the U.K. Second, the overseas jurisdiction must have an equivalent offence covering the associated person's criminal act of facilitation, so that the actions of the associated person would constitute a crime had they taken place in the U.K.

The legislation also requires personal consent of the Director of Public Prosecutions or the Director of the Serious Fraud Office before proceedings for the foreign offence are issued in England, Wales, or Northern Ireland.

Penalties

The penalties for this offence include unlimited financial penalties and ancillary orders confiscation and injunctions to prevent serious crime after the conviction. H.M.R.C. has stated that a criminal conviction will also have consequences for a relevant body, such as requirements of disclosure to professional regulators.

Deferred Prosecutions

Deferred prosecution agreements ("D.P.A.'s") were introduced in the U.K. in February 2014 and are in place for fraud, bribery, and other economic crimes. A D.P.A. is an agreement between a prosecutor and a defendant organization that is reached under the supervision of a judge. Prosecution is deferred indefinitely, as long as subsequent criminal acts are not committed. D.P.A.'s will likely be pursued for the new corporate criminal tax offences.

Defenses Against the Offences

The principal defense for a corporation or partnership is that it has put in place reasonable procedures to prevent the criminal facilitation of tax evasion by the employee or associated person. H.M.R.C. has published draft government guidance for determining whether reasonable procedures exist. Advisory bodies must undertake risk assessment when taking on a new client, and risk-based prevention procedures must be proportional to the amount at stake. A due diligence procedure must also be in place in order to evaluate new matters. Top level management must be committed to preventing facilitation by employees and associates, and company policy must be communicated to employees and associates. This includes tax fraud prevention training. Finally, there must be a program in place for monitoring and review.

Advisers with clients based outside the U.K. who attempt to establish an account at a U.K. bank have discovered that the process is time consuming and disappointing. Several months and significant fees must be paid to clerks who challenge any arrangement that is not "plain vanilla." With the new act, clients should anticipate that longer periods of time will be required and greater fees will be charged to pursue the simple task of opening a bank account in the U.K. With the new rules, U.K. banks will likely find that business will be ring-fenced to include only "mom and pop" businesses and fortune 100 corporations.

FINANCE ACT 2016

Last year, the U.K. government introduced offshore tax legislation, as part of Finance

Act 2016, related to the following offenses and penalties:

- Offences relating to offshore income, assets, and activities
- Penalties for enablers of offshore tax evasion or noncompliance
- Penalties in connection with offshore matters and offshore transfers
- Asset-based penalties for offshore inaccuracies and failures

Each of these topics is discussed in the following paragraphs.

Offences Relating to Offshore Income, Assets, and Activities

The most significant of the Finance Act 2016 provisions is a strict liability criminal offence against individuals who commit acts of offshore noncompliance, even if it is not evasion. The offence relates to offshore income, assets, or activities involving a person who (i) fails to submit a tax return, (ii) fails to notify liability, or (iii) submits an incorrect return in relation to income or capital gains tax.

The significance of this offence is the absence of a link between the offence and any underlying negligence, carelessness, or fraudulent behavior, which is a predicate fact in relation to most criminal offences. Consequently, there is no requirement for H.M.R.C. to demonstrate the cause of the behavior. Taxpayers may commit an offence by the mere fact of noncompliance involving offshore matters.

As the U.K. imposes tax on a residence basis, rather than a citizenship basis, the offense reflects a view that persons savvy enough to open an offshore account should be savvy enough to arrange for proper reporting. Nonetheless, defenses exist beyond arguing that proper compliance procedures were followed. Thus, for example, a person charged with the offence can argue that reasonable cause exists for noncompliance. Also, H.M.R.C. has introduced a £25,000 threshold for triggering the offense. Finally, H.M.R.C. has suggested that the new offence will be limited to noncompliance involving offshore jurisdictions that have not signed up for automatic exchange of information under the Common Reporting Standard ("C.R.S."). Given the U.S. view that F.A.T.C.A. reporting is equivalent to the C.R.S., it will be interesting to see how the matter will play out in relation to accounts in the U.S.

Penalties for Enablers of Offshore Tax Evasion or Noncompliance

Civil penalties have been enacted with regard to those who advise clients in relation to offshore tax matters. The civil penalty is imposed on those who enable a U.K. taxpayer to commit offshore tax evasion or noncompliance.

An offence is committed when two conditions are met in relation to the adviser's relationship with the client, and the client commits a relevant offshore tax offence or is noncompliant. First, the adviser must know or have reason to know that his or her actions could assist the client in committing offshore tax evasion or noncompliance. Second, the client must have been convicted of a tax offence or, in the case of offshore tax evasion or noncompliance, the client is liable to a relevant penalty. A relevant penalty includes any offshore civil penalty relating to offshore tax matters. This could include circumstances where an adviser is caught for actions that resulted in a client becoming liable to a civil penalty for carelessness. Presumably, H.M.R.C. will not prosecute this type of technical offense, as a conviction would almost be worse for the government than for the adviser.

The legislation also applies, as well to an adviser that turns a “blind eye” to the evasion of the client. The offence effectively extends to tax advisers, legal advisers, trustees, private bankers, and any intermediary based anywhere in the world as long as the facts involve providing services to U.S. resident clients with offshore U.K. tax matters. Risk of prosecution will depend on many factors including the reach of H.M.R.C. to obtain jurisdiction over a person outside the U.K. and the deterrence factor inherent in the defendant. Not all advisers are worth prosecuting.

If found liable, the adviser could be liable for the greater of £3,000 or 100% of the tax revenue lost by the U.K. Reductions to these penalties for unprompted disclosures are possible. In the case of an unprompted disclosure, the penalty can be reduced to £1,000 or 10% of the tax revenue lost, or in cases of prompted disclosures to £3,000 or 30% of the tax lost. Presumably, if a client paid the tax as part of an examination by H.M.R.C., the penalty based on a fixed amount will be due. However, no guidance exists to date.

Penalties in Connection with Offshore Matters and Offshore Transfers

The existing civil penalty regime for offshore matters and offshore transfers is increased. Offshore civil penalties were introduced by Finance Act 2010 that (i) increased the civil penalties under Schedule 24 of Finance Act 2007 for errors and (ii) increased the civil penalties under Schedule 41 of Finance Act 2008 for failure to notify H.M.R.C. relating to income tax and capital gains tax.

“Risk of prosecution will depend on many factors including the reach of H.M.R.C. to obtain jurisdiction over a person outside the U.K. and the deterrence factor inherent in the defendant.”

The new legislation increases the penalties when the transfer or matter relates to jurisdictions that have no commitment to exchange of information and the fostering of transparency. In a post-B.E.P.S. world, those jurisdictions are quite limited. If the jurisdiction is categorized as highly non-transparent and has not signed up to the C.R.S., the standard penalty of up to 100% of the potential lost revenue is increased from 100% to 200%. The same principles apply for offshore penalties in relation to minimum penalties for prompted and unprompted disclosures. Finance Act 2016 essentially increases those minimum penalties by 10% where the underlying behavior is deliberate.

H.M.R.C. has also stated that it will require disclosures in any case where reductions to penalties are sought. The information to be disclosed includes structures used, processes for transferring funds offshore, and the identity of all enablers who facilitated the evasion.

Amendments have also been made to the Schedule 94 of Finance Act 2009. This schedule authorizes the publication of names of those who deliberately defaulted on offshore disclosure obligations. H.M.R.C. will publish the details of those who control offshore companies and partnerships, where the person who is subject to the offshore deliberate penalty is the body itself.

Asset-Based Penalties

H.M.R.C. has introduced a new asset-based civil penalty for cases where civil offshore penalties are in point and the potential lost revenue exceeds a threshold of £25,000. The asset-based civil penalty applies where the offshore penalty relates to deliberate behavior and the tax involved is capital gains tax, inheritance tax, or asset-based income tax. The standard amount of the penalty will be limited to the lower of 10% of the value of the asset or ten times the potential lost revenue.

Again, reductions to the penalty are allowed when the person (i) discloses the inaccuracy or failure relating to the standard offshore tax penalty, (ii) provides H.M.R.C. with a reasonable valuation of the asset, or (iii) provides H.M.R.C. with information or access to records that H.M.R.C. requires for the purposes of valuing the asset. The reduction must reflect the quality of the disclosure, valuation, and information provided. The timing, nature, and extent of the disclosure are taken into account when measuring its quality. Guidance regarding the maximum amount of the penalty reduction are left to future regulations.

FINANCE BILL 2017 – REQUIREMENT TO CORRECT OFFENCE

Obligation to Correct

The Autumn Statement 2016 and Schedule 22 of Finance Bill 2017 introduce legislation addressing a Requirement to Correct Offence ("R.T.C.O."). The R.T.C.O. is a civil offense rather than a criminal offense. It will be effective from April 6, 2017, and will require persons with offshore noncompliance in relation to income tax, capital gains tax, and inheritance tax to correct all errors before September 30, 2018. The R.T.C.O. will be timed to coincide with automatic exchanges of information through the C.R.S. Any person who has not rectified past "relevant" offshore tax noncompliance by September 30, 2018, for noncompliance occurring in periods up to and including April 5, 2017, will face significant penalties.

Penalties

The penalty for not correcting the offshore noncompliance by September 30, 2018, may include the following:

- 200% of the potential lost revenue attributable to the uncorrected offshore noncompliance
- An asset-based penalty of up to 10% of the asset value
- A further 50% penalty if assets have been moved to avoid exchange of information
- Public identification of the offender

The penalty is appealable using the usual reasonable cause defense.

Correcting the Offence and Disclosure

Offshore noncompliance may be corrected in several ways, depending on whether the offence relates to (i) the failure to notify, (ii) the failure to file a tax return, or (iii) the submission of an incorrect return. Voluntary disclosure programs with favorable terms were terminated on December 31, 2015, and have been replaced by the new Worldwide Disclosure Facility, launched by H.M.R.C. in September 2016. This is one route by which historical offshore noncompliance can be rectified. However, the Worldwide Disclosure Facility provides no protection from prosecution. Where tax fraud is at issue, a disclosure under Code of Practice 9 (Contractual Disclosure Facility) may be the safer path.

DUTY TO DISCLOSE

According to the Law Society, H.M.R.C. has adopted a practice under its No Safe Havens program that requires law firms that participate in the formation of offshore companies or trusts to report on the beneficial ownership of the offshore entities. Presumably, the failure to report the information may be taken as evidence of a law firm's role in enabling offshore tax evasion or noncompliance.

CONCLUSION

In 2013, H.M.R.C. set out its Offshore Evasion Strategy building on earlier policy statements to counter offshore tax evasion and noncompliance. We have seen many developments in the intervening time, including numerous disclosure campaigns allowing holders of untaxed offshore assets to regularize U.K. tax obligations on favorable tax terms. Now, the offshore campaign is entering a new tougher phase. Individuals with untaxed offshore assets will be required to regularize their positions by September 30, 2018, by reason of the R.T.C.O. rules that will be effective from April 2017. Persons under investigation by H.M.R.C. and found to be noncompliant will face the significant penalties. H.M.R.C. intends to increase the number of criminal investigations to force home the message. If a carrot and a stick can be used to incentivize compliance, the days of the carrot are over. H.M.R.C. is now conducting a vendetta against those holding undeclared wealth offshore.

"Now, the offshore campaign is entering a new tougher phase. . . . Persons under investigation by H.M.R.C. and found to be noncompliant will face the significant penalties."

NEWS ON THE FRENCH FRONT: TAX LAW CHANGES FOR CORPORATIONS AND INDIVIDUALS

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INTRODUCTION

In France, main tax law changes are passed pursuant to an end-of-year legislative process. These yearly changes are either part of the upcoming year's finance law (the "Initial Finance Law") or the amended current year's finance law (the "Amended Finance Laws"). The Initial and Amended Finance Laws govern the country's budget allocations regarding government revenue and expenses, and thus contain tax measures. The Initial Finance Law is voted on at the end of the year prior to its year of application. Throughout the applicable year, amendments to that finance law are passed. In addition, further tax laws are also passed independently of the yearly finance laws and generally focus on one main tax provision.

The Initial Finance Law is passed in various steps. First, the government drafts a proposed Initial Finance Law, which is then submitted to the French Parliament (composed of the *Assemblée Nationale* and the *Sénat*). All proposed Initial Finance Laws are examined by the National Assembly (*Assemblée Nationale*) and are then transmitted to specialized committees in charge of advising and making changes to the draft. After this review, both houses of the French Parliament consider the new version of the proposed law over the course of several weeks and amend it until agreement is reached on the final version. After a constitutionality review by the French Constitutional Court (*Conseil Constitutionnel*), the finance law is final and expected to be published before year end. This legislative process cannot exceed seventy days.

As mentioned previously, the government is also entitled to propose Amended Finance Laws, which mainly amend the Initial Finance Law. Approved tax provisions are retroactively applicable to income and gains generated in the year in which the Initial Finance law was enacted as if the taxable event did not yet occur ("*petite rétroactivité*"). Stated differently, all income is considered to be recognized at the close of the year, not before. For corporate taxpayers, the "taxable event" is the close of their tax year. For individual taxpayers, the "taxable event" is generally the end of the calendar year.

This article seeks to summarize some of the key tax measures contained in the 2017 Initial Finance Law and the 2016 Amended Finance Law, as validated by the French Constitutional Court on December 29, 2016, and published on December 30, 2016. Among the invalidated measures were the public access to country-by-country reports and the introduction of a French diverted profits tax. The latter is briefly discussed below. Although not adopted, these measures are emblematic of the general tax environment in France and Europe.

Certain measures have been long awaited, such as the withholding tax on salaries, whereas others are emblematic of the current fight against tax evasion or the will to make France a go-to place for start-ups. However, the future of the measures is uncertain, as 2017 is an election year in France. The current government is winding down and certain presidential candidates are already claiming the need to make changes to the new provisions.

INDIVIDUAL INCOME TAX

Withholding Tax as of 2018 with 2017 Tax-Free for Certain Types of Income

Currently, French residents generally file an annual income tax return between May and June of the following year, depending on whether the filing is done on paper or online, and depending on their place of residence. They also generally pay their income tax in three yearly estimated payments. In September, they generally receive an assessment of the outstanding balance of their tax liability and have one month to effect payment.

The new law provides for monthly payment of the income tax liability. The payment will be effected through withholding by the payor or monthly payments by the taxpayer, depending on the nature of the income. Certain exceptions exist for employee-based compensation items and income from certain hedge funds, French-source income paid to nonresidents, and foreign-source income entitled to a foreign tax credit pursuant to an income tax treaty.

"The new law provides for monthly payment of the income tax liability."

These new provisions will take effect as of January 2018. Income tax due on certain items of income that have a non-exceptional nature, or that do not constitute income that is excluded from the new provisions, will be cancelled if the income is earned in 2017.

Corporations will become the withholding agents for withholding taxes to be levied on its employees' salaries. Employees will have the choice among (i) a default standard withholding tax rate, (ii) a personalized withholding tax rate, and (iii) a neutral withholding tax rate. Corporations will have to incur significant costs and spend a substantial amount of time and effort in implementing these new changes.

However, in light of the upcoming elections, it is not clear whether these provisions will remain in effect or be repealed by the new government.

Free Shares – Yet Another Regime Change

The tax regime of free shares has been reformed several times over the last years. The current favorable regime is based on a 2015 law[1] enacted to reverse the cutback of tax benefits through multiple successive reforms. The 2017 Finance Law again reverses course by depriving the free share regime of several of the beneficial aspects implemented by the 2015 legislation.

The new regime applies to free shares granted by board decisions voted after the publication of the 2017 Finance Law, which occurred on December 30, 2016. From that date forward, the portion of the acquisition gain benefitting from the favorable capital gain computation and abatement regime is capped at €300,000. Acquisition gain in excess of this amount is treated as salary for French tax purposes.

[1] Law 2015-990, August 6, 2015. For more on the regime applicable to French shares, see Fanny Karaman and Stanley Ruchelman, "French v. U.S. Share-based Compensation Plans: A Comparative Analysis," *Insights* 10 (2016).

The excess is subject to higher employment-related social charges and no longer benefits from abatements, which can be as high as 65% in most cases and 85% in certain circumstances. Thus, although still a favorable tool for small start-ups, free shares are again minimally attractive for highly compensated individuals of larger corporations.

CORPORATE INCOME TAX

Decrease in Tax Rate

Throughout the 2016 tax year, French corporate income tax was generally imposed at the rate of 33.33%. Corporations that owed more than €763,000 in corporate income tax were subject to an additional 3.3% social charge on the amount of corporate income tax in excess of €763,000. Corporations that had gross receipts below €7.63 million were subject to a reduced corporate income tax rate of 15% on taxable income up to €38,120.[2]

From January 1, 2017 until January 1, 2020, the rate of corporate income tax will be decreased in annual increments until the rate is reduced to 28%, which will be applicable to all corporations. The 3.3% additional social charge will remain in effect.[3] This will result in an effective 28.9% corporate income tax rate for large corporations. The following table summarizes the gradual decrease in corporate tax rates:

Taxable Income Brackets and Rates*

Gross Receipts

	< €7.36 Million		> €7.36 Million < €50 Million		> €50 Million < €1 Billion		> €1 Billion	
2017	€0-€38,120	15%	€0-€38,120	15%	€0-€38,120	15%	€0-€38,120	15%
	€38,120-€75,000	28%	€38,120-€500,000	28%	> €38,120	28%	> €38,120	28%
	> €75,000	33.33%	> €500,000	33.33%				
2018	€0-€75,000	28%	€0-€500,000	28%	€0-€38,120	15%	€0-€38,120	15%
	> €75,000	33.33%	> €500,000	33.33%	> €38,120	28%	> €38,120	28%
2019	33.33%		€0-€500,000	28%	28%		28%	
			> €500,000	33.33%				
2020	33.33%		€0-€500,000	28%	€0-€500,000	28%	28%	
			> €500,000	33.33%	> €500,000	33.33%		

*The 3.3% additional surcharge was not factored in and may apply.

2 Article 219 of the French Tax Code, as applicable for 2016.

3 New Article 219 of the French Tax Code.

Here again, with the upcoming elections, it is unclear whether these changes will be maintained. Certain presidential candidates favor a further decrease in rates.

3% Tax on Dividend Distributions – Exemption Extended

Currently, corporations must pay an additional 3% tax on certain distributions, including dividends.[4] Exemptions exist for dividends distributed to members of a consolidated group. However, when the distribution is made to a non-French entity, that distribution is subject to the 3% additional tax.

As of 2017, the exemption is extended to distributions made to European corporations or corporations based in countries with which France has a mutual assistance agreement in place, provided that these non-French corporations would otherwise qualify for the consolidated regime requirements had they been resident in France.[5]

Changes to the French Parent-Subsidiary Regime

Prior to the 2017 Finance Law, parent and subsidiary corporations could benefit from the participation exemption for dividends and gains pursuant to the parent-subsidiary regime where the parent corporation (i) was subject to the French corporate tax, (ii) held at least a 5% interest in a corporation making a dividend distribution, and (iii) held that interest for at least two years. If the above requirements were met, 95% of the dividends received by the parent would be deductible.[6] Shares without voting rights did not qualify their holder for the beneficial regime.[7]

From January 1, 2017 forward, the mere holding of shares without voting rights, such as preferred shares, does not disqualify the recipient corporate shareholder from the benefits of the parent-subsidiary regime.[8]

Increase of Tax on Financial Transactions

France imposes a transaction tax on certain transfers of title in publicly-traded equity securities. The tax is applicable when the issuing corporation is a French corporation that has a market capitalization in excess of €1 billion on December 1 of the year preceding the transfer of title. The tax rate has increased to 0.3% in 2017.[9] Previously, the tax rate was 0.2%.

FIGHT AGAINST TAX EVASION

French Diverted Profits Tax – Not Adopted

Article 78 of the 2017 Initial Finance Law provided for a corporate income tax on foreign entities having

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4 Article 235 *ter* ZCA of the French Tax Code.

5 New Article 235 *ter* ZCA, I, 1 of the French Tax Code.

6 2016 versions of Articles 145 and 216 of the French Tax Code.

7 Article 145, 6, c) of the French Tax Code, as applicable in 2016.

8 New Articles 145 and 216 of the French Tax Code, as resulting from Article 91 of the Amended Finance Law for 2016.

9 Article 25 of the Proposed 2017 Finance Law, amending Article 235 *ter* ZD of the French Tax Code.

- a controlled subsidiary in France;
- goods or services sold in France by a French or non-French entity, with the aim to escape or decrease the corporate income tax otherwise due; or
- a computer server in France or elsewhere, through which they sold or provided goods or services to French residents.

Only taxpayers undergoing an examination by the French tax administration could be subject to this new provision.

The French Constitutional Court deemed this proposed legislation unconstitutional. The Court recognized that Parliament can extend the scope of the corporate income tax to nonresident taxpayers. However, Parliament could not allow the French tax administration to choose the corporations that are subject to this tax by choosing the corporations that will be subject to examination.

Change in Failure to Disclose Penalties

Under prior law, the failure to disclose foreign bank accounts, foreign cash surrender value of foreign life insurance policies, and foreign trusts is subject to penalties based on the amounts that are undisclosed. The rate of penalty differed among the investment vehicles:

- The penalty for failing to disclose foreign bank accounts is up to 5% of the undisclosed balance in the account.
- The penalty for failing to disclose cash surrender values of foreign life insurance policies is 5% of the undisclosed cash surrender value.
- The penalty for failing to disclose funds held by a foreign trust is 12.5% of the undisclosed amounts held by the foreign trust.[10]

Now, the penalties based on unreported accounts will be replaced by an 80% penalty applicable to the late taxes due, if any, on these undisclosed assets.[11] As with the other provisions discussed above, the new penalties may be withdrawn depending on the outcome of the presidential elections that will be held later this year.

[10] Former Articles 1736 and 1766 of the French Tax Code.

[11] Article 110 of the amended 2016 Finance Law; new Article 1729-0 A of the French Tax Code.

INCOME TAXATION OF TRUSTS IN BELGIUM

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Tags
Belgium
Income Tax
Trusts

INTRODUCTION

Trusts do not exist under Belgian civil law. However, trusts governed by foreign law are generally analyzed by applying conflict of law rules. As a result, Belgium will generally recognize trusts formed under applicable foreign laws. In Belgium, trusts can be subject to both income tax and gratuitous transfer taxes (by reason of death or *inter vivos*). This article only focuses on income tax issues.

INCOME TAX ISSUES

The Belgian income taxation of trusts is governed by the "Cayman Tax" law ("C.T.L.") enacted in 2015. The C.T.L. has introduced "pass-thru" tax treatment of income generated through foreign private wealth structures referred to in the law as "legal constructions" (and as "Type 1" entities in practice – see below). Trusts fall within this definition. The law also applies to low-taxed foundations and offshore companies (referred to as "Type 2" entities – see below) but in a different way as it does to trusts.

The C.T.L.[1] is applicable as of January 1, 2015,[2] and has been amended by a law dated December 26, 2015.[3] Prior to the C.T.L., another set of rules applied to trusts. While, no specific Belgian law dealt with the treatment of trusts, foreign trusts were analyzed based on scholarly articles and case law, including several decisions by the Federal ruling commission. The author is of the view that the C.T.L. replaces prior practice, although differing opinions exist.[4]

Pursuant to the C.T.L., income tax may be imposed on the "Founder(s)" of a trust or on "Third-Party Beneficiaries," depending on the applicable facts. Prior to this legislation, a 2013 law required Belgian-resident Founders and Belgian-resident Third-Party Beneficiaries to disclose the existence of a trust on their annual income

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1 Program Law 10 August 2015, art. 38–47, Chamber of Parliament Doc. 54 1125/001-021, Belgian Official Journal (August 18, 2015), ed. 2.

2 For a full analysis see Gerd D. Goyvaerts, "*De Kaaimantaks, Een Kritische Benadering*," T.F.R. 490-491 (2015), pp. 865–923 (article in Flemish); Valérie-Anne De Brauwere and Christelle Wils, "*Taxe Caïman, Le Crocodile aux Dents Longues*," *Wolters Kluwer* Revue Générale de Fiscalité 8 (2015), pp. 5–23 (article in French).

3 Law of 26 December 2015, B.O.G., (December 30, 2015).

4 For an extensive comment on the "old regulations" see Gerd D. Goyvaerts, "The Tax Aspects of the Use of Foreign Trusts in Belgium for Private Wealth Purposes," *The Journal of International Tax, Trust and Corporate Planning* 2011, p. 267.

tax returns.[5] This reporting allows the Belgian tax administration to gather trust-related information and assess tax on trust income, and the C.T.L. has been drafted with the same purpose in mind.

At first glance, the C.T.L. may appear to be a useful legal instrument in the fight against the fraudulent or abusive use of trusts. However, the C.T.L. does generally not take into account the complexity of internationally structured estates and the wide variety of reasons why an individual may wish to use a trust structure in another jurisdiction – be it low-tax or not. While families often seek practical solutions to civil, corporate, or common law issues, these answers cannot always be found under Belgian law. Hence, families may turn to trust indentures to achieve stability in an uncertain financial environment generated by the internationalization of family ties.

Other statements in the C.T.L. parliamentary documents reflect a general lack of knowledge regarding trusts, including the discretionary character of certain trusts. Although this misconception served as the parliamentary basis for taxing the international wealth of Belgian citizens involved with trusts, the C.T.L. is more accurately viewed as a matter of tax policy and a reflection of Federal budget considerations.

Nonetheless, the Belgian Parliament must respect international tax treaties and E.U. and European Economic Area ("E.E.A.") regulations, as well as regulations that pertain to the resolution of international conflicts of law. It remains to be seen whether the C.T.L. Tax fully conforms to these rules. Notably, the C.T.L. produces several adverse tax consequences relating to retroactive double taxation. The most important of these is that the C.T.L. does not allow for relief from double taxation where foreign taxes are paid on trust income, a significant issue when the new legislation is applied to an existing trust structure.

Trusts as Legal Constructions (Type 1 Entities)

The C.T.L. applies to trusts, yet it does so under a specific legal definition without referring to the notion of a "trust" or "trust law." Instead, the law refers to a very broad definition of a Type 1 legal arrangement that includes trusts.[6]

Since trusts are not known under Belgian tax or civil law, they have been defined as "legal relationships/arrangements" based on the general look and feel of the Anglo-Saxon trust. The term "legal relationship" is inspired by the definition of a trust as used in the Belgian Code on International Private Law ("B.I.P.L."), which contains the codification of Belgian conflict laws.

The translated Flemish text provides the following definition of "trust" (*i.e.*, a Type 1 entity):[7]

> Legal relationship(s) created by an act of the founder or by a court order, by which assets are placed under the control of a trustee in

5 Gerd D. Goyvaerts, "Belgium: A New Obligation to Declare Foreign Private Wealth Structures," *The Journal of International Tax, Trust and Corporate Planning* 2014, p. 64.

6 Article 2-§1-13° of the Belgian Income Tax Code ("B.I.T.C.").

7 Note that in the translation the word "trustee" is used, although the law refers to *beheerder* or *administrateur*. One may therefore also use the term "administrator." There is no reference whatsoever to "trust law."

order to be administered for the benefit of one or more beneficiaries or for a certain purpose. This legal relationship presents the following characteristics:

1. the property title to the assets of, or to the entitlements from, the 'legal construction' is drafted in the name of the trustee or in the name of another person on behalf of the trustee;

2. the assets of the 'legal construction' form a separate estate and are not part of the estate of the trustee;

3. the trustee has the authority and the duty, in respect of which he is accountable, to manage, administer or dispose of the goods in accordance with the provisions of the legal construction and the special duties imposed by law on the trustee.

Trust-like arrangements are within the scope of this Type 1 designation, regardless of the level of tax incurred.

"Since trusts are not known under Belgian tax or civil law, they have been defined as 'legal relationships/ arrangements' based on the general look and feel of the Anglo-Saxon trust. "

Exclusions from Pass-thru Treatment (Article 2-§1-13°/1 B.I.T.C.)

The C.T.L. provides a list of entities that are excluded from pass-thru treatment. In order to be so excluded, the listed entities must meet certain requirements. Although these exclusions may also apply to trusts, they have not been designed for trusts as such. Pension trusts or trusts designed to hold employee stock participations (defined as "settlements for the financing of legal or additional retirement payments") are generally excluded entities; however, the analysis is made on a case-by-case basis.

The Substance Exemption (Article 5/1-§3(b) B.I.T.C.)

The substance exemption provides criteria for a trust to be outside the scope of the C.T.L. This exemption was inserted to improve compatibility with E.U. and E.E.A. regulations, following the Court of Justice of the European Union's ("C.J.E.U.'s") decision in *Cadbury Schweppes Plc v. Revenue and Customs Commissioners*[8] and the E.F.T.A. Court's judgment in Olsen.[9]

Under this exemption, the Founder and/or Third-Party Beneficiary can avoid pass-thru treatment by showing that the trust meets a substance test, *i.e.*, that it is not a "wholly artificial arrangement" and that it has a "genuine economic activity" based on "objective factors[,] which are ascertainable by third parties." These factors include "offices, staff[,] and equipment which stands in relation to the mentioned genuine economic activity." It is unclear what proof will be accepted by the tax authorities. On one hand, it may be expected that a trust that merely controls a holding company would not require as many offices and staff as a company providing services in the course of an active business. On the other hand, proving when a genuine economic activity exists in a specific case will likely be a difficult undertaking.

The substance exemption is available for all trusts formed in the E.E.A. and/or

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8 *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, No. C-196/04 (2007), at ch. 30.

9 *Fred. Olsen and Others v. the Norwegian State*, No. E-3/13 and No. E-20/13 (July 9, 2014).

countries with which Belgium has concluded a double tax treaty ("D.T.T.") or Tax Information Exchange Agreement ("T.I.E.A."), including a bilateral or multilateral agreement in relation to which tax information can be exchanged on request. In light of recent developments regarding exchange of tax information, a large number of offshore trusts may theoretically claim this exemption. However, it remains to be seen to what extent invoking the substance exemption and claiming real economic activity may give rise to adverse tax consequences in the country of establishment.

To meet the substance test, substantial verifiable evidence must be provided. One should expect the highest level of scrutiny to be applied by the tax authorities. In that respect, the Belgian Parliament has indicated that the substance exemption cannot be claimed by trusts that "limit their activities solely to the management of private wealth." It is however highly questionable whether this limitation on the substance exclusion would stand up to a challenge before the E.F.T.A. Court or the C.J.E.U.

The substance exemption is not automatic and must be claimed on a Belgian tax return. As a result, claiming the exemption does not relieve the taxpayer from Belgian filing obligations, which are intended to increase transparency, and noncompliant taxpayers cannot attribute non-filing to the application of the substance exemption.

Founders

The C.T.L. provides for tax transparent treatment of the trust instrument. Thus, trust income is taxed as if directly received by the Founders, irrespective of actual distributions. Certain qualifying trust distributions may also be taxable in the hands of Third-Party Beneficiaries. This combination of both potentially taxable distributions and pass-thru taxation makes the application of the C.T.L. quite complex.

With regard to trusts, the law lists three types of Founders in Article 2-§1-14° B.I.T.C.:

- The individual who settled the trust outside the course of his or her professional activities
- The individual who, outside the course of his or her professional activities, contributed assets and "entitlements" to a trust settled by a third party (including also a declared trust)
- The "Founder by Heirship," *i.e.*, an individual who is the direct or indirect heir of one of the above-mentioned individuals (from the death of the latter onwards, unless the heir provides proof that neither they themselves nor their issue, will benefit at any time nor in any way from financial, or other, benefits granted by the trust)

The definition of Founder by Heirship is intended to be as broad as possible, encompassing several future generations of potential beneficiaries. The legislative intent here is to prevent the application of an old 1962 High Court case that excluded heirs from a comparable anti-abuse rule related to income taxes.

As an example of a (potential) heir, parliamentary documents cite a person who is to receive a benefit from a trust upon a certain condition (*e.g.*, reaching a certain age – which is common practice in many trust instruments). The example further provides that the existence of a condition will not preclude the heir from being considered a

Founder, which will lead to the transparent taxation of income received by the trust, regardless of any actual distribution. Every individual who is entitled by legal heirship to a part of the estate of the initial Founder is considered to be an heir for C.T.L. purposes. This is the case regardless of otherwise applicable intestate inheritance laws or the presence of a will or testament.

Any legal heir of the Founder can avoid being qualified a Founder by showing that he or she cannot, nor did, receive any financial or other benefit from the trust. This may be virtually impossible to prove, since one may never exclude receiving a voluntary entitlement from a trust established by ancestors, especially if it is administered by an independent discretionary trustee. However, solutions are available to prevent taxation without having received any economic benefits.

Based on the parliamentary documents, it appears that a Belgian taxpayer may avoid Founder status by irrevocably renouncing any benefit from the trust and providing a letter of the trustee stating that neither that person nor his or her heirs can ever, at any point in time, receive in any form or way any benefit from the trust. The explanatory memorandum to the law specifies that the tax authorities will in principle accept such a letter as proof. However, should it appear that such a letter does not reflect reality, the tax authorities may invoke the offence of forgery of fiscal documents against the Founder who used the letter, as well as against the legal construction that issued it. In particular, trustees of a discretionary trust should consider to what extent they are able to provide such assurances prior to the issuance of a letter.

Third-Party Beneficiaries

According to the definition under Article 2-§1-14°/1 B.I.T.C., Third-Party Beneficiaries are individuals who, at any given moment and in any given manner, effectively receive (taxable) benefits allocated by a trust. It can be argued that only an actual distribution of a benefit triggers C.T.L., along with the qualification of Third-Party Beneficiary. Hence, any reporting obligation and/or taxability depends thereon. This is relevant for beneficiaries of a trust of which the settlor is still alive. These persons will have no reporting obligations in Belgium, as long as they do not receive an effective distribution.

It is also possible that the same taxpayer can be seen as both a Founder and a Third-Party Beneficiary in the same tax year. This will mainly be the case when an entity within the scope of the C.T.L. makes a distribution to a Founder.

Pass-thru Taxation of Trust Income

The C.T.L. provides for pass-thru treatment of trust income. As a result, income from a trust is generally taxed in the hands of the Founders, and the trust is disregarded as a separate entity for Belgian income tax purposes. This means that the underlying income retains its original qualification and no effective distribution is required for taxation to occur.

Do note that this regime is not limited to merely “passive income.” One example of applicable income might be a consultancy fee received by a trustee of a trust settled by a Belgian tax resident. It is unclear how the application of pass-thru treatment will interact with the previously mentioned definitions of Founder. Indeed, individual Founders will, in general, only be individuals that established an eligible entity outside the course of their professional activities. On the other hand, mere shareholders are also seen as Founders under a distinct fourth category, which falls outside the scope of this article.

Under the C.T.L., interest received by the trust remains interest, dividends remain dividends, and capital gains remain capital gains. The first two categories of income are generally taxed at a flat 30% tax rate in Belgium (rate as from January 1, 2017). Capital gains on movable assets realized by a private individual are generally tax exempt under Belgian tax law, to the extent that they are realized within the course of the normal management of a (private) estate. Taxation of so-called miscellaneous income at 33% may occur. Parliamentary documents confirm that capital gains realized through a trust, are (in principle) deemed to qualify as capital gains realized within the course of the normal management of a (private) estate.

The investment policy undertaken by the trustees may therefore be highly relevant from a Belgian tax point of view. Indeed, to the extent the trustees invest in assets generating tax-exempt income for Belgian tax purposes, the investment policy could be beneficial, even under the C.T.L. Tax-exempt income that is attributed or distributed to a Founder or Third-Party Beneficiary may also, as a general matter (and provided certain timing requirements are met), remain tax exempt under the C.T.L.

The parliamentary documents state, "It is self-evidently [sic] that [the] Cayman Tax has to take into account the double tax treaties [D.T.T.] concluded by Belgium." For example, in cases of foreign real estate income, the D.T.T. generally attributes the right to tax to the partner state. As a result, no Belgian income tax can be levied under the C.T.L. All this is to be verified in detail, based upon the specific facts of the case at hand.

"To the extent the trustees invest in assets generating tax-exempt income for Belgian tax purposes, the investment policy could be beneficial."

Where there is a multitude of Founders, each Founder is taxed in proportion to his or her contribution to the assets held in trust. If their respective shares cannot be determined, each Founder is allocated an equal part of the assets held in trust. This may lead to disputes and difficulties in practice. It may prove difficult, for instance, when grants and settlements took place a long time ago, thus making it almost impossible to re-establish the origins of the funds.

Founders by Heirship are taxable in proportion to "their share" in the trust or, if this cannot be proven, in proportion to their part in the hereditary succession of the Founder to whom the individual is heir. Valid proof to the contrary can be provided by the heirs. This may also lead to difficulties in practice.

Take, for instance, the case where a Belgian-resident father is the Founder of a trust. He leaves two-thirds of the estate to his son and daughter by last will and testament and transfers the other one-third of the estate more than three years prior to his death. The son and daughter are both beneficiaries of the trust. According to the trust deed and in practice, it remains wholly in the trustees' discretion to decide if and to what extent the children will or will not receive distributions of income and/or capital. In the example, the trustee decides not to make distributions within the first five years after the death of the father (Founder). In these five years, both the son and the daughter will be taxable on half of the income received by the trust, given their equal entitlement to the estate of the father. If the trustee decides after five years to distribute 90% of the total of assets only to the daughter, for whatever reason, the son will have been liable to tax on income he never received.

Parliamentary documents also give a comparable example, from which it appears that qualifying Founders remain taxable under the pass-thru tax regime, even though (i) they never received any actual distribution out of a trust and (ii) distributions were made to Third-Party Beneficiaries.

As indicated above, the parliamentary documents do mention the possibility for Founders by Heirship to demonstrate that they will never benefit from a trust, via a letter sent by the trustees. The Belgian tax administration will, in principle, accept such a letter as means of proof. Self-evidently, such a letter must reflect a genuine and irrevocable exclusion or removal from entitlement for the taxpayer and his or her heirs.

"When 'past income' is distributed to a Third-Party Beneficiary, no taxation will occur."

To the extent a Founder can demonstrate that income obtained by the trust has been effectively distributed to a Third-Party Beneficiary, who is a Belgian tax resident or tax resident of a qualifying country, this income will not be taxable in the hands of the Founder. However, such proof can only be given for income received and distributed in the income year itself.

Indeed, when "past income" is distributed to a Third-Party Beneficiary, no taxation will occur since the tax will already have been paid by the Founder.[10] No tax credit or claw back can be claimed in such cases. This is the so-called X–(X+1) rule – where "X" refers to the income year and "X+1" refers to the year in which the income has been distributed – also referred to as the "Current Income Year Principle." This principle is not described as such in the wording of the law, though the parliamentary documents apply the rule in several examples given, and the Minister of Finance has also confirmed its application in a reply to a parliamentary question. The Current Year Income Principle has also been described in a number of very recent tax rulings that were issued in November of 2016.

The following example best illustrates this principle. A father sets up a trust in 2005 for the benefit of his two children, X and Y, as well as his friend, Z. All are Belgian tax residents. The Belgian father passes away in 2012. Until 2015, the trust received €100,000 in capital gains and €100,000 in dividends. In 2015, the first year to which the C.T.L. applies, the trust received €20,000 in capital gains (tax exempt for Belgian individual income tax purposes, to the extent they are realized within the "normal management of a private estate") and €20,000 in dividends. Since X and Y can be qualified as Founders by Heirship, they are taxable under the C.T.L. on the €20,000 in the dividends. The same facts apply to 2016 and 2017. At the end of 2018, the trustees wish to make a distribution of €100,000 to Z. This distribution is financed by dividend income (€20,000) and capital gains (€20,000) received by the trust in 2018, and by income received in the past by the trust (€60,000). For 2018 (*i.e.*, tax year 2019), X and Y will most likely be able to demonstrate that Z received the €40,000 in dividends and capital gains. Hence, Z will be taxable as a Third-Party Beneficiary under the C.T.L. for the €20,000 in dividends. The capital gains remain tax exempt. In this example, the Belgian-resident children, X and Y, will have to pay tax on income they will never receive and which is finally attributed to Z.

As mentioned earlier, Belgian-resident Founders can provide valid proof to the contrary. This proof will require that the Third-Party Beneficiaries are resident in Belgium, another E.E.A. country, a country with which Belgium has a treaty containing

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[10] Article 5/1-§1 B.I.T.C.

an exchange of information provision, or a country with which Belgium has a T.I.E.A. in place. Useful to note here is that since 2009 Belgium has entered into agreements for the exchange of information with many countries, including several offshore jurisdictions. According to the parliamentary documents, the possibility of exchanging information is sufficient. An actual exchange is not necessarily required.

Specific Anti-Abuse Regulations Do Not Genuinely Apply to Trusts[11]

The C.T.L. provides for a specific anti-abuse clause aimed, in particular, at Type 2 entities (*i.e.*, low taxed foundations and offshore companies). The provision allows the Belgian tax administration to disregard transactions made by these entities when subject to pass-thru taxation.[12] This regulation is not applicable to trusts.

Parliamentary documents clearly state that the general anti-abuse clause of Article 344-§1 B.I.T.C., which applies to income taxes, remains in place and can also be of use in cases where the taxpayer "makes an appeal on several multi-layered legal structures with a view to escaping the scope of the Cayman Tax." These very broad anti-abuse provisions give the tax administration a wide range of action and may be subject to challenges from taxpayers.

C.T.L. legislation also contains a specific anti-abuse clause, which states that, as of October 9, 2014, modifications to the deed of settlement of a trust with a view to restructuring a Type 1 entity into a Type 2 entity, or vice versa, cannot be upheld against the tax administration. The parliamentary documents clarify however that restructuring an "in scope entity" into an "out of scope entity" cannot be targeted by this specific anti-abuse provision. Nonetheless, it should be borne in mind that in such a case the general anti-abuse clause of Article 344-§1 B.I.T.C. may be applied.

Ruling Request

The parliamentary documents provide that the Belgian (Federal) Ruling Commission is competent to grant advance clearance on the application of the C.T.L. Given the many uncertainties in the application of the C.T.L., seeking advanced clearance may often be the only way to achieve legal certainty for Founders or Third-Party

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11 This new anti-abuse clause is not to be confused with Article 344-§1 B.I.T.C., which contains the general anti-abuse rule as it applies to Belgian income taxes. This rule allows the Belgian tax administration to "restore" the taxable base and tax computation to achieve taxation in accordance with Parliament's objectives, as if the alleged abuse had not taken place. In order to apply this anti-abuse rule, the tax administration must provide (complex) proof of "tax abuse," based on objective circumstances. In principle, tax abuse exists when the taxpayer realizes, through a legal act or a set of legal acts, a transaction that meets either of the following criteria:

- Contrary to the law's objectives, the transaction results in the taxpayer being excluded from the scope of the Tax Code or an executing decree's application.
- The essential goal of the transaction is to obtain a tax benefit, provided under the Tax Code or an executing decree, which if granted would be contrary to the law's objectives.

The taxpayer can avoid the anti-abuse provision's application by demonstrating that the legal act(s) is justified by (sufficient) motives other than tax avoidance.

12 Article 344/1-§1 B.I.T.C.

Beneficiaries. Among the tax rulings issued by the Belgian Ruling Commission in November of 2016, at least five related to trusts.

Reporting Obligations for Founders and Third-Party Beneficiaries

The Belgian tax authorities are entitled to request that Founders or Third-Party Beneficiaries provide ample documentation on trusts. These reporting obligations have been further increased by the Law of December 26, 2015. Since the reporting obligations may have an impact on beneficiaries, trustees must also pay close attention to the requirements, which include providing adequate and timely information as well as documentation about the trust assets and the trust income. Sometimes, it will be useful to provide written statements on a person's beneficial entitlement, or the denial thereof, thus safeguarding that person from adverse tax consequences.

Even though the C.T.L. is not targeting trustees *per se*, trustees must closely monitor the obligations applicable to Belgian-resident Founders and Third-Party Beneficiaries. C.T.L. provisions require that the existence of a trust be reported in the taxpayer's annual tax return, along with the income generated by the trust assets. More precisely, the following information must be reported:

- The full name of the entity
- The legal character of the entity
- The address of the entity
- The name and address of the trustee

To the extent a trust has received income that is subject to pass-thru taxation, the Belgian taxpayer is required to report the income on his or her income tax return. However, as a practical matter, taxpayers do not always have full access to the necessary information in order to comply with these reporting requirements. Trustees should bare this obligation in mind when requested to provide information that would enable the Belgian taxpayer to file a correct income tax return. Noncompliance by a Belgian-resident Founder or Third-Party Beneficiary results in a fine of €6,250 per legal construction per tax year. Hence, trustees should verify their legal position in relation to a fine imposed on a Founder or Third-Party Beneficiary in the event of undue failure of the trustee to provide the necessary information.

No Automatic Indication of Fraudulent Behavior

Finally, the parliamentary documents clearly specify that the mere existence and reporting of an entity within the scope of the C.T.L. cannot be seen as an indication that the Founder and/or Third-Party Beneficiary has committed a tax offence in the past, nor can the first declaration of taxable income under C.T.L. legislation be seen as such. However, the tax administration's full range of investigative possibilities will remain in place, *inter alia*, in relation to the source of the funds transferred to a trust.

CONCLUSION

The tax treatment of trusts under Belgian tax laws is extremely complex. Although the principles, as proclaimed by the Belgian tax authorities, of pass-thru income taxation upon distribution may seem relatively straight forward, in practice there is a high level of uncertainty involved. Moreover, pass-thru treatment under C.T.L. regulations is not matched with the regulations that apply in relation to death duties. Therefore, when dealing with trusts in a Belgian tax environment, the utmost caution is advised.

TRUMP AND THE REPUBLICAN-LED CONGRESS SEEK OVERHAUL OF INTERNATIONAL TAX RULES

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Tax Policy
Tax Reform

January 3, 2017 marked the first meeting of the 115th U.S. Congress, which – due to the unforeseen outcome of the 2016 election – is comprised of a majority of Republicans in both the House of Representatives and the Senate. On January 20, Donald Trump took office as president. Both the newly-minted president and the Congressional Republicans have said that the U.S. tax code is in for a dramatic change, and that change may come quickly given the Republican election sweep.

President Trump's tax plan has undergone revisions since the days of his candidacy and has come to more closely resemble the House Republican Tax Reform Blueprint (the "House Blueprint") – a plan released in June 2016 by the G.O.P.-led House Ways and Means Committee, shortly before the Republican National Convention. The chairman of the House Ways and Means Committee, Kevin Brady (R-T.X.), has said that he expects to have the legislative language for the House Blueprint ready for President Trump's first 100 days in office. By some estimates, the new tax law is expected to be ready by the second half of 2017. The following is a discussion of some of the key points of each plan, with an emphasis on the proposals that would impact cross-border business activities, and how businesses might prepare for the upcoming changes.

PROPOSED PLANS FOR INDIVIDUALS

Tax Rates and Brackets

Both the Trump plan and the House Blueprint would condense the existing seven individual income tax brackets to three: 12%, 25%, and 33%. The top 33% rate would apply to married joint filers with income over $225,000 and single filers with income over $112,500.

Deductions

Another item the Trump plan and the House Blueprint have in common is an increase in the standard deduction. Under current law, the standard deduction is only $12,600 for joint filers and $6,300 for single filers. The Trump plan would increase the standard deductions for joint filers to $30,000 and single filers to $15,000. Further, the Trump plan would eliminate personal exemptions and the head-of-household filing status. The House Blueprint would increase the standard deductions to $24,000 for joint filers, $18,000 for single parents, and $12,000 for other singles.

Under the Trump plan, itemized deductions would be capped at $200,000 for joint filers and $100,000 for single filers. The House Blueprint would eliminate all itemized deductions, except for the mortgage interest deduction and the charitable contributions deduction. That the latter two tax benefits would stay in effect was recently confirmed by House Majority Leader Kevin McCarthy (R-C.A.).

Capital Gains Taxation

The Trump plan would retain the current system for taxing capital gains with a maximum rate of 20% but would tax carried interest (*i.e.*, the profits interest earned by the investment manager of a hedge fund or private equity fund) as ordinary income. Under current law, carried interest is taxed at the preferential 20% capital gains tax rate. Thus, this Trump proposal would result in a significant tax increase for investment managers. This is in line with various initiatives that have been proposed throughout the past years but have not managed to gain traction in Congress. The House Blueprint would reduce the capital gains tax rates to 6%, 12.5%, and 16.5%. The House Blueprint does not address carried interest.

Net Investment Income Tax

The 3.8% tax on net investment income, which was enacted as part of the Affordable Care Act (*i.e.*, "Obamacare"), would be repealed under the Trump plan and presumably under the House Blueprint, along with Obamacare itself. According to latest statements by President Trump, Obamacare would be replaced by a new health care plan. No details have been released so far. The Senate's budget-resolution,[1] which serves as a vehicle to dismantle Obamacare, was a first indication that G.O.P. lawmakers are determined to follow suit.

"The 3.8% tax on net investment income, which was enacted as part of the Affordable Care Act (i.e., 'Obamacare'), would be repealed under the Trump plan and presumably under the House Blueprint, along with Obamacare itself."

Estate, Generation Skipping, and Gift Taxes

Both the Trump plan and the House Blueprint would repeal the Federal estate tax and generation skipping transfer tax. However, the Trump plan calls for imposition of a tax on capital gains held until death and valued over $10 million, including gains on assets passing to family-controlled private charitable foundations. It appears that under both plans the Federal gift tax would remain in effect. The gift tax is viewed as a backstop to the income tax: it discourages individuals from shifting income-producing assets to a taxpayer in a lower tax bracket.

PROPOSED PLANS FOR BUSINESSES

Tax Rate

Under the Trump plan, the business tax rate for all businesses would drop from the current rate of 35% to 15%, whereas under the House Blueprint, the corporate income tax rate would drop to 20%. The corporate alternative minimum tax ("A.M.T.") would be eliminated under both plans. Further, under the House Blueprint, active business income from sole proprietorships and pass-through entities would be taxed at no higher than 25%, unless the income represents reasonable compensation for services, in which case it would be taxed at the usual rates for individuals (*i.e.*, up to 33%).

Tax Expenditures

Under the Trump plan, most corporate tax expenditures would be eliminated, except for the research and development credit. Manufacturers would be allowed to expense capital investments, but in so doing, they would lose the deduction for the corporate interest expense.

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[1] S. Con. Res. 3., January 12, 2017; passed by the House the following day.

Under the House Blueprint, the current system for depreciating certain investments in tangible and intangible property would be replaced with the ability to fully and immediately expense such investments. In general, "special-interest deductions" and "credits" (terms not specifically defined in the House Blueprint) would be eliminated under the House Blueprint.

Deductibility of Interest

The House Blueprint would eliminate the net interest expense but would allow the deduction of interest payments against interest income; interest payment amounts in excess of interest income would be carried forward indefinitely as a deduction against future interest income. The elimination of the net interest expense would overlap, to some extent, with the recently adopted Code §385 regulations.[2] However, unlike the primary focus of the Code §385 regulations on intra-group debt, the House Blueprint proposal is broader and would deny a deduction for net interest expense arising from interest payments to third parties. In addition, the House Blueprint would disallow the net interest expense regardless of whether the standards of the regulations are satisfied. Nonetheless, the House Blueprint proposal is narrower than the Code §385 regulations in that it would not apply to recharacterize debt as equity for all Federal income tax purposes. Moreover, the House Blueprint proposes to deny an interest deduction only for net interest expense. It is unclear to what degree the House Blueprint proposal would be coordinated with existing rules in the Code (*e.g.*, anti-earnings stripping rules).[3]

Net Operating Losses

In addition, under the House Blueprint, net operating losses ("N.O.L.'s") could be carried forward indefinitely and increased by an interest factor that compensates for inflation and a real return on capital. However, the N.O.L. deduction would be limited to 90% of the net taxable amount for the year without regard to the carryforward, and it could not be carried back.

PROPOSED PLANS FOR CROSS-BORDER ACTIVITIES

The most dramatic changes proposed by both the Trump plan and the House Blueprint would affect the tax rules governing cross-border activities.

One-Time Repatriation Tax

For starters, under both the Trump plan and the House Blueprint, corporate profits held offshore would be subject to a one-time deemed repatriation tax. Under the Trump plan, the tax rate on the deemed repatriated income would be 10%. Under the House Blueprint, the deemed repatriated income would be subject to tax a rate of 8.75% to the extent held in cash or cash equivalents, and otherwise 3.5%, with companies able to pay the resulting tax liability over an eight-year period.

U.S. multinational corporations such as Apple Inc. and Microsoft Corp. are estimated

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2 See in detail Philip Hirschfeld and Stanley Ruchelman, "The Resurrection of Code §385: Treasury Department Revises Regulations on Related-Party Debt," *Insights* 11 (2016).

3 Code §163(j).

to be holding a total of $2.6 trillion in foreign profits overseas. President Trump and the Congressional Republicans have said that the proposed tax holiday would encourage such companies to repatriate their foreign earnings and invest them into creating new jobs in the U.S. However, there is also the possibility that such companies would instead choose to use the repatriated income for stock buybacks, executive bonuses, and dividends.[4] Further, companies that had no intention of bringing foreign profits back to the U.S. would be hit with a large tax bill.

Destination-Based Tax System

The House Blueprint would move the U.S. from the current worldwide tax system, which generally taxes U.S. corporations on income earned anywhere in the world but permits deferral of U.S. Federal income tax on foreign active business earnings until those earnings are repatriated, to a destination-based tax system. Under a destination-based tax system, corporations would not be taxed based on where they are incorporated, like under a worldwide tax system, nor where their profits are located, like under a territorial tax system. Tax jurisdiction would follow the location of consumption (*i.e.*, where goods are sold and services are performed) rather than the location of production. According to the House Blueprint, this would be achieved in two ways: (i) by moving to a (not in a strict sense) "territorial" tax system and (ii) through border adjustments.

A destination-based system starts in the same place as a territorial tax system. Overseas profits earned by U.S. multinationals that are repatriated as dividends would be exempt from additional U.S. Federal income tax. However, unlike a territorial system, it would not encourage overseas production by U.S. multinationals because all production for U.S. consumption would be taxable, no matter where the production occurred. The House Blueprint notes that this system would eliminate the incentive to expatriate and the foreign profit "lock-out" effect under current law (*i.e.*, a disincentive to repatriate earnings due to residual U.S. taxation). Consequently, other than the one-time deemed repatriation tax, the House Blueprint would exempt foreign active business income by providing a 100% exemption for dividends received from foreign subsidiaries – similar to the participation exemption found under the E.U. Parent Subsidiary Directive and domestic tax law in many European countries. The 100% exemption rate is more generous than some prior proposals for an exemption system, which proposed a small (approximately 5%) "haircut" as a proxy for not disallowing domestically incurred expenses attributable to the exempt foreign income as, for example, is found under the German participation exemption.

According to the House Blueprint, the switch to a destination-based, territorial tax system would allow the streamlining and simplification of the Subpart F rules (*i.e.*, a complex set of rules governing the taxation of foreign income earned by U.S. corporations through foreign subsidiaries). The rules for passive foreign investment companies ("P.F.I.C.'s") would likely stay in place since they are designed to counter

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[4] A report by the nonpartisan Congressional Research Service cited studies on the repatriation provisions of the 2004 American Jobs Creation Act that found the tax holiday to be an ineffective means of increasing economic growth and some empirical evidence that repatriations were used to return money to shareholders through stock repurchase programs. See *Tax Cuts on Repatriation Earnings as Economic Stimulus: An Economic Analysis* (Congressional Research Service, 2011), p. 7.

the potential for truly passive income to be moved to low-tax jurisdictions.

A destination-based system adds one additional piece to the territorial system: "border adjustments." Through border adjustments, tax is rebated when a product is exported and imposed when a product is imported, such that sales to U.S. customers would be taxed but sales to foreign customers would be exempt. Regardless of whether the taxpayer was a foreign or U.S. corporation, costs of imported inputs would no longer be deductible from taxable income, but at the same time, export sales revenue would not be taxed. This is intended to compensate for the impact of value-added tax ("V.A.T.") rebates for exported goods in foreign tax jurisdictions using a V.A.T. system.

"Companies with significant foreign tax credits should identify ways to accelerate their use."

The House Blueprint states that border adjustments would not require the addition of a new tax but a transformed business tax system in which exports are exempt from tax and imports are taxed, within the context of a territorial tax system. Proponents of border adjustments further state that the value of the U.S. dollar will rise about 20% to 25% to cover the border adjustments. A counterargument is that an appreciated U.S. dollar could lower the demand for U.S. exports.

The House Blueprint addresses the obstacle posed by the World Trade Organization (the "W.T.O.") rules on border adjustments. Under the rules, border adjustments upon export are permitted with respect to consumption-based taxes, also known as indirect taxes. An example of a consumption-based tax is the V.A.T. system common to most European countries. However, under the rules, border adjustments upon export are not permitted with respect to income taxes, also known as direct taxes. Thus, under the current tax system, which imposes income tax on business transactions, the U.S. is not permitted to use border adjustments.

In an early version of his plan, President Trump had indicated that he would retain the worldwide system but end "deferral of taxes on corporate income earned abroad." This proposal was later dropped from the Trump plan. While it is currently unclear what Trump's exact position on the shift towards a destination-based tax system is, he did not favor the border adjustment in a recent statement. Even though, in a recent tweet, the president threatened to impose a "big border tax" on General Motors Co. for manufacturing some of its Chevrolet Cruz cars in Mexico.

THE DEMOCRATS' RESPONSE

The Democrats generally believe that the Trump plan and the House Blueprint are giveaways to businesses and wealthy individuals, and shift the tax burden to modest income earners. However, Senator Charles Schumer (D-N.Y.), has indicated a willingness to compromise on a plan that would cut corporate taxes, if proceeds from the estimated $2.6 trillion in U.S. companies' foreign profits held offshore were devoted to nationwide infrastructure improvements.

PLANNING CONSIDERATIONS FOR BUSINESSES

Use Foreign Tax Credits

Foreign tax credits for the income taxes paid to a foreign country would be less valuable if companies were able to repatriate foreign profits at a lower rate. Further, a shift to a territorial tax system may eliminate the need for foreign tax credits.

Companies with significant foreign tax credits should identify ways to accelerate their use.

Accelerate Deductions

Like foreign tax credits, deductions will generally be worth comparatively less if the corporate tax rate drops to 15% or 20%. Further, under both the Trump plan and the House Blueprint, most deductions would be eliminated. Companies would be required to revalue the deferred tax assets on their financial statements. They may also seek accounting method changes to accelerate deductions and defer income.

Installment Method

If the corporate tax rate is lowered, companies seeking to sell an asset now may choose the installment method to receive some of the payments when the lower rate is in effect.

Delay Capital Expenditures

Since the House Blueprint would allow for full and immediate expensing of machinery and equipment, companies might consider deferring capital expenditures – at least for machinery and equipment that is not immediately necessary.

Incur Debt

Though the House Blueprint would eliminate the interest expense deduction for businesses, it is expected that existing debt would be grandfathered so that taxpayers would still be able to deduct the interest expense on those loans. Accordingly, businesses should identify their near-future borrowing needs and consider incurring debt now to preserve the interest expense deduction.

Reconsider Inversion Plans

While the limitations on inversions introduced last year may not be revoked, a shift to a territorial tax system may mean that a company has less incentive to move to a lower tax jurisdiction. Companies should model the tax effects of a territorial tax system to determine the overall tax impact.

WHAT NEXT?

Although the Republicans have a slight majority in the Senate, it may not be a smooth path to pass the tax reform bills in the absence of a bipartisan agreement. Republicans may have to deal with the possibility of filibuster, an action to obstruct progress in the legislative process such as inordinately lengthy speeches, which can be overcome only by a 60-vote majority. However, a filibuster cannot block a budget reconciliation bill, and tax legislation could be included in such a bill and passed with a simple majority vote. The disadvantage of a reconciliation bill is that provisions in budget reconciliation must expire at the end of the budget window, usually a ten-year period.[5] Provisions that have no budgetary effect may not be

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5 As an example, the 2001 and 2003 Bush tax cuts were the result of reconciliation bills, and thus were expected to expire in 2010. As a result of political compromise, the tax cuts were extended for a two-year period during the presidency of Barack Obama, and most of the tax cuts were made permanent with

permitted in a reconciliation bill. Another obstacle in the Senate is the Byrd Rule, an instrument allowing senators to block a piece of legislation if it purports to significantly increase the Federal deficit beyond a ten-year period. To overcome it requires a 60-vote majority.[6]

Compared to previous legislative periods, the chance of a major tax overhaul passing both the House and the Senate is considerably higher. The president and Congress have already signaled their determination for immediate action. Thus far, the proposals are the starting points for a tax debate that leaves many open questions. Details remain to be seen once draft legislation is released.

the passage of the American Taxpayer Relief Act of 2012.

6 This is the reason the estate tax repeal enacted as part of the Bush tax cuts was subject to a ten-year sunset period.

EUROPEAN EFFORTS AGAINST TAX EVASION TAKE CENTER STAGE – WHERE ARE WE HEADED?

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Tags
Code §§1471-1474
C.R.S.
F.A.T.C.A.
Panama Papers
Reporting Requirements
Tax Evasion
Tax Havens

OVERVIEW

A globalized economy has been the driving force behind cross-border tax transparency and increased dissemination of tax information in recent years. With the enactment of the Foreign Account Tax Compliance Act ("F.A.T.C.A.") in 2010,[1] the U.S. started a movement towards global reporting requirements targeted at halting tax evasion through the use of tax havens and other means. This effort, which was directed principally at recalcitrant individuals with access to cash generated overseas, has inspired adoption by numerous countries of the Common Reporting Standard ("C.R.S.") as well as consideration of other measures targeted at expanding disclosure and transparency.

Heeding the comments of U.S. multinational groups with operations in Europe, the U.S. Treasury Department has recently moved forward with steps that would allow U.S.-based groups a means of providing country-by-country ("CbC") reporting on a voluntary basis.[2] With the term of the Obama Administration coming to an end, little is known about the future of U.S. participation in the far-reaching B.E.P.S. Action Plan of the O.E.C.D. and cooperation in the implementation of the E.U. anti-tax avoidance directive. It is expected that the next wave of attacks against global base erosion and profit shifting will be led from Europe, as stakeholders face increased pressure from the academic community and the press.

One major factor stimulating the need for change is the Panama Papers revelations by the International Consortium of Investigative Journalists ("I.C.I.J."), a global network of more than 190 investigative journalists in more than 65 countries. Eleven million, five hundred thousand documents were leaked that detailed financial and attorney-client information for more than 214,488 offshore entities created by a Panamanian law firm and various corporate service providers.[3]

Following the release, a committee was empaneled to probe the I.C.I.J. database and suggest regulatory reforms that could be adopted in Panama to prevent the facilitation of tax evasion in other countries. Joseph Stiglitz, a Nobel Prize winner in economics and committee lead for the government of Panama, and several other committee members recently resigned after the Panamanian government failed to publish the committee's report. The report was intended to be a template of regulatory measures to be adopted by jurisdictions in the offshore community.

Despite his resignation from the Panamanian committee, Mr. Stiglitz has continued to make recommendations for adoption by the offshore community. Specifically,

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1 Code §§1471-1474.

2 *E.g.*, T.D. 9773, Country-by-Country Reporting (July 18, 2016).

3 *E.g.*, "The Panama Papers," I.C.I.J.

he has gone on to recommend that noncompliant tax havens should be frozen out of the global financial system and that low-tax jurisdictions should be required to create a publicly searchable registry of companies and beneficial owners.

TAX EVASION – WHO IS TO BLAME?

Among tax authorities, politicians, professors, and journalists in Europe, a consensus is growing that money laundering and tax evasion are facilitated by outdated concepts of privacy rights for beneficial owners and the rights of investors and companies to structure direct investment in ways that are free of all tax, pejoratively called double non-taxation. Under this view, tax planning is conflated with tax evasion, and secrecy and low tax are seen as important factors that contribute to crime and terrorism. Furthermore, it is believed that high levels of global wealth concentrated in limited hands deprive stakeholders, such as governments and nongovernmental organizations ("N.G.O.'s"), of funds to carry out plans for social welfare on a global basis.

Although F.A.T.C.A. put a dent in the wall of secrecy maintained by banks, investment companies, custodial companies, and some insurance companies around the world, pressure for transparency continues to mount. According to some, the blame for the presence of tax havens goes beyond the jurisdictions that impose little or no tax. It falls on European countries that have contributed to evasion through residency rules and the territorial reporting system, which limits taxation to only domestic income and exempts foreign income. The European system encourages individuals and companies to invest money in jurisdictions with favorable tax rules. Locally-generated income is avoided.

This should be compared to the U.S. system, which imposes global tax on citizens, resident individuals, and local corporations. The U.S. has adopted the controlled foreign corporation[4] ("C.F.C") and passive foreign investment company[5] regimes to protect its worldwide tax system. However, whether the C.F.C. regime is effective as a means of protecting the tax base is not entirely clear for large multinational companies. These companies have the capacity to plan around the pitfalls of Subpart F.[6] Moreover, the U.S. system encourages the retention outside the U.S. of accumulated funds from foreign operations in order to defer U.S. tax on a permanent basis.

Recognizing that profits of foreign subsidiaries are locked up outside the U.S., proposals have been offered in the U.S. to enable foreign accumulated earnings to be repatriated on a tax-favored basis.[7] If adopted, the plan is measured as a significant revenue loser for the Federal government – but current law is not raising Federal taxes from large corporations with global operations and locked-up profits. Consequently, potential tax revenue will not be lost if the law is changed. Rather, what is being lost is more akin to a tax wish held by Congress and current administrations.

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4 Code §§951-960.

5 Code §§1291-1298.

6 Code §§951-964.

7 Kyle Pomerleau, *Details and Analysis of the 2016 House Republican Tax Reform Plan* (Tax Foundation, 2016).

In the U.S., competition among the states to attract companies has led to low state taxes in jurisdictions such as Delaware and Nevada. The European Parliament and several E.U. Member States have even gone so far as to contend that the U.S. facilitates B.E.P.S. by the absence of ownership registries at the Federal or state levels.[8] In this regard, the Financial Secrecy Index, which ranks jurisdictions according to secrecy and the scale of offshore financial activities,[9] lists Switzerland, Hong Kong, the Cayman Islands, and Panama in the top 15 list of secrecy countries. The U.S., Germany, and the U.K. are also part of that top 15 list.

ENFORCEMENT AND TRANSPARENCY EFFECTS ON EUROPE: STEPS NEEDED TO IMPROVE

Tax Competition and Transparency

Those attacking cross-border tax planning point to a series of recommendations by the Independent Commission for the Reform of International Corporate Taxation ("I.C.R.I.C.T."), a panel of N.G.O. leaders and academics, including Mr. Stiglitz. Picking up a battle cry from the E.U. Ruding Committee in 1992,[10] I.C.R.I.C.T. maintains the view that tax competition among countries is leading a race to the bottom. Preventive measures to offset the downward spiral include the following:

- A minimum corporate tax rate
- Elimination of special treatment for foreign companies such as the benefits provided by Ireland to Apple Inc.
- Elimination of tax breaks on profits and other forms of illegal State Aid

I.C.R.I.C.T. believes that taxing corporate profits is economically beneficial since it is an important source of revenue, promotes infrastructure development, and reflects a concept of social justice.[11] It notes that the Code of Conduct Group for Business Taxation has failed to prevent the harmful competition and abuses created by illegal State Aid. Encouragement towards whistleblowers and transparency of tax rulings can offset the effects.

I.C.R.I.C.T. recommends the creation of a Common Corporate Tax Base ("C.C.T.B.") for E.U. countries to resolve patent box conflicts and fix potential transfer pricing disputes. It proposes a two-step legislative approach in which the first phase would implement the C.C.T.B. The base would be mandatory for multinational companies with a turnover of €750 million (approximately $800 million at current exchange rates). The second phase would adopt a Common Consolidated Corporate Tax Base ("C.C.C.T.B.") that involves a formulary apportionment approach to tax sharing among countries.

The C.C.C.T.B. may offer a solution to eliminate transfer pricing disputes. However,

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

9 "Financial Secrecy Index," Tax Justice Network.

10 *Report of the Committee of Independent Experts on Company Taxation* (E.U. Commission, 1992).

11 *Four Ways to Tackle International Tax Competition* (I.C.R.I.C.T., 2016).

it would also require some member countries to transfer tax collected on corporate profits to the treasuries of other countries. Of course, the U.S. experience of formulary apportionment among states suggests that apportionment under a common base is not the panacea anticipated by academics. The base may be standard, more or less, but the tax authority in each jurisdiction is local.

In a separate report, Mr. Stiglitz and Mark Pieth proffer that the following steps are required to eliminate untoward global tax planning: [12]

- The identification of beneficial owners of accounts and companies
- Automatic exchange of tax information
- Supervision of banks and business entities
- Supervision of intermediary service providers such as the legal industry

Common Reporting Standard

On July 15, 2014, the O.E.C.D. approved the C.R.S., which calls on jurisdictions to obtain information from their financial institutions and automatically exchange that information with other jurisdictions on an annual basis. The C.R.S. sets out the financial account information to be exchanged, the financial institutions required to report, the different types of accounts and taxpayers covered, as well as the common due diligence procedures to be followed by financial institutions.[13] To that end, more than 100 jurisdictions have concluded negotiations on the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* that, *inter alia*, enables exchanges of information contemplated by the C.R.S. A signing ceremony will be held in June 2017 in Paris.[14]

The C.R.S. will result in a mass transfer of data and has inspired a bevy of privacy-related concerns. Already, public access to beneficial ownership registers has been found to violate constitutional rights to privacy in France, and similar legal challenges are anticipated in other countries. Hacker access to data regarding family wealth also poses a concern to certain Latin American clients, who have expressed fear of being targeted by kidnappers. Data protection and privacy safeguards must be implemented to prevent hacking.

European Parliament Panama Papers Investigative Committee

The European Parliament has empaneled an investigative committee to examine the role of law firms, banks, and accounting firms. In testimony given on January 24, the panel heard from academics, bankers, and members of the professions. Looking to head off regulation, one witness described an internal code of conduct for professionals; another cautioned about taking the mistaken view that the formation of an offshore company is evidence of criminal conduct. However, witnesses from academia and N.G.O.'s pointed out that the estimated $12 trillion in offshore bank

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12 Joseph Stiglitz and Mark Pieth, *Overcoming the Shadow Economy*, (Berlin, Germany: Friedrich-Ebert-Stiftung, 2016).

13 "Automatic Exchange Portal," O.E.C.D.

14 "Countries Adopt Multilateral Convention to Close Tax Treaty Loopholes and Improve Functioning of International Tax System," O.E.C.D., November 24, 2016.

accounts would be significantly reduced without the active participation of accountants and bankers.

WHERE WILL IT TAKE EUROPE AND THE U.S.?

So, what does the future hold in the next four years?

- A new administration taking office this January will likely emphasize expansion of the domestic economy accompanied by deregulation, as over-regulation is viewed to be a handmaiden of mediocre growth. U.S. participation in B.E.P.S. implementation efforts likely will not be an important part of U.S. international tax policy. Instead, international tax reform will likely move to the front of the line for consideration in 2017 by the White House, Congress, and the U.S. Treasury Department.
- Europe appears to be headed towards more regulation, more transparency, and a greater tax burden in the economy. Academics and professional experts believe that greater tax burdens will inure to the benefit of European economies. The European Commission seems to be in agreement. Tax planning will continue to be vilified.

"Recognizing that the U.S. and Europe appear to be taking divergent paths, only one outcome seems certain."

Recognizing that the U.S. and Europe appear to be taking divergent paths, only one outcome seems certain. As the U.S. withdraws from multilateral policies that overregulate business and investment, another flashpoint of tension between the U.S. and Europe will be encountered.

NEW ZEALAND FOREIGN TRUST DISCLOSURE REGIME

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Information Disclosure
New Zealand
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In April 2016, the New Zealand government convened an independent inquiry into the use of New Zealand foreign trusts. Following this inquiry, the New Zealand government proposed a new Foreign Trust Disclosure Regime ("F.T.D.R."). The new regime will run in parallel to New Zealand's adoption of the Common Reporting Standard ("C.R.S.") and will be entirely separate to any C.R.S. reporting.

The bill that will introduce the F.T.D.R. is currently going through the New Zealand parliamentary process. Parliament returns to sit on February 7, 2017 and the legislation will be considered in due course on the legislative agenda; it is expected that the bill will not be amended substantially before it is passed into law. Once the bill has been passed, regulations will be put in place which will set out the specific requirements of the regime. The draft regulations for the F.T.D.R. are currently unknown.

It is expected that the new F.T.D.R. will become effective from June 30, 2017. All existing New Zealand foreign trusts will need to comply with the legislation by that date.

Although the relevant legislation has not yet been passed and the final specific details of the new regime are unknown, we are currently able to highlight the following points about the new F.T.D.R.:

- Nothing disclosed under the F.T.D.R. may be used for C.R.S. reporting by the New Zealand government. The information gathered under the regime will be collated by the Inland Revenue Department ("I.R.D.") for the New Zealand government's records purposes only.
- The information will not be publicly available and will be protected by New Zealand's extremely strong privacy and confidentiality legislation. New Zealand government agencies have a proven track record of upholding this legislation.
- No change to the fully tax-exempt status of New Zealand foreign trusts has been proposed.
- New Zealand foreign trusts already disclose their establishment to the I.R.D., however, the information required under the F.T.D.R. is more detailed. It is proposed that the F.T.D.R. will require the following information to be filed with the I.R.D.:
    - Trust deed and particulars of settlors and, in certain cases, protectors
    - T.I.N.'s where applicable

- Beneficiaries where they have a fixed right to distributions
- Class of beneficiaries where beneficiaries are discretionary and identification of individual beneficiaries when distributions are made
- Any amendments to the above arrangements
- Annual financial statements (see below)
- An annual return

• The government will levy fees for the initial filing and the annual return filing.

• Following the introduction of the F.T.D.R., New Zealand foreign trusts will be required by law to prepare financial statements. However, consolidated financial statements will not be required. As an example, in the case of a trust holding shares in an investment company, only the shares will be shown in the statement, not the underlying assets of the investment company.

FOREIGN CHARITIES ACTIVE IN THE U.S. – PUBLIC? OR PRIVATE FOUNDATIONS?

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Tags
Nonprofit
Form W-8EXP
Public Charity
Private Foundation
Withholding

BACKGROUND

Generally, a charity[1] is exempt from U.S. tax on its income, provided that such income is not treated as unrelated business taxable income ("U.B.T.I."). This rule applies to both domestic and foreign charities and nonprofit organizations.

In recent years, foreign charities and nonprofit organizations have become more active in the U.S. in support of their missions. Such activities include performances in the U.S. by not-for-profit foreign artists and importation of foreign organizations' unique knowledge in certain fields. It is becoming increasingly common for foreign charities to earn fees that could be subject to U.S. income or withholding taxes. Federal tax can be avoided or reduced if the exempt entity can furnish the U.S. payor (*i.e.*, withholding agent) with a Form W-8EXP, Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding and Reporting.

Attached to Form W-8EXP is either a determination letter from the I.R.S. as to the foreign organization's status as a public charity or a private foundation, or an opinion of counsel. Domestic organizations generally are required to obtain an I.R.S. determination letter; foreign organizations generally are not, if substantially all of the organization's support (other than gross investment income) is from non-U.S. sources.[2] Withholding agents can rely on a submitted Form W-8EXP if the foreign organization provides a legal opinion certifying its exempt status and, further, its status as a public charity or a private foundation.

The distinction between private foundation and public charity status affects the need for special withholding in the case of a foreign private foundation. Foreign private foundations are subject to 4% excise tax on their gross investment income, generally U.S.-source interest, dividends, rents, payments with respect to securities loans, and royalties.

Generally, charities organized and registered under the charitable laws of a foreign jurisdiction would meet the U.S. standards for charitable status. What is often more difficult to determine is whether a charity is a public charity or private foundation.

PUBLIC CHARITY V. PRIVATE FOUNDATION

Code §509 provides that all organizations, domestic or foreign, described in Code §501(c)(3) are presumed to be private foundations except those organizations meeting special tests for public charity status.

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1 A charity is an organization described in §501(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code").

2 Code §508 and Code §4948(b).

Assuming a foreign organization has not obtained an exemption letter from the I.R.S., Form W-8EXP must also include an affidavit from the organization setting forth sufficient facts for the I.R.S. to determine that the organization is not a private foundation.

One test described in Code §509(a)(1) generally includes organizations that are educational institutions, churches, certain organizations related to colleges and universities, governmental units, and organizations receiving substantial support from a governmental unit or from the general public. Another test described in Code §509(a)(2) generally includes organizations that are supported by their exempt function, meaning that they derive most of their gross receipts from activity related to their exempt function.[3]

Code §509(a)(1) Test

Under the Code §509(a)(1) test the organization must receive its support from the "public." This requirement is satisfied by having 33⅓% of the "total support" received from the general public.[4] The numerator consists of the organization's public support (subject to certain limitations and exclusions), and the denominator consists of the organization's total support (also subject to some exclusions).[5]

Total support includes

- gifts, grants, and contributions (but not contributions of services, for which no deduction is allowed, nor unusual grants[6]);
- net income from unrelated business activities,
- gross investment income (*e.g.*, dividends, interest, rent, and royalties but not capital gains),
- tax revenues levied for the benefit of an organization and paid to or expended on behalf of the organization (but not the value of any exemptions from tax, *e.g.*, Federal, state, and local), and
- the value of services or facilities furnished by a governmental unit to the organization without charge.

Total support does not include amounts received from the exercise or performance

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3 For a summary and comparison of public support, total support, and limitations for each test see https://www.irs.gov/irm/part4/33239010.html and https://www.irs.gov/irm/part4/33239011.html.

4 There is an alternative "facts and circumstances" test that requires 10% of the total support to be provided by the general public. However, due to the factual nature of the test it will not be discussed in this article.

5 The support computation test must be met for the aggregate of the four taxable years preceding the year under examination. If the organization satisfies the test, it is considered to have also met the test for the current and next taxable years.

6 An "unusual grant" may be excluded from both the numerator and denominator. An unusual grant is a substantial contribution or bequest from a disinterested party that is attracted by reason of the publicly supported nature of the organization. If significant in amount, an unusual grant may make the difference between a public or private foundation determination and, thus, is ignored.

> *“The organization must not normally receive more than 33⅓% of its total support from gross investment income.”*

by the organization of its charitable, educational, or other Code §501(c)(3) purposes constituting the basis for its exemption. Any payment of money or transfer of property without adequate consideration is defined as a gift or contribution. Where payment is made in exchange for admissions, merchandise sales, services performed, or facilities furnished to the donor, payment is considered a gift or contribution only to the extent it exceeds the value of the exchange. Where property constitutes the gift or contribution, the amount includible in computing public support is the property's fair market value or rental value on the date the donor makes the gift.

Out of the total support, the organization must demonstrate that 33⅓% of its support is from the public. Public support consists of gifts, grants, and contributions from the general public (*e.g.*, individuals, corporations, and trusts), from other public charities, certain private foundations, governmental units, and membership fees that are made for purposes of the organization's support only. The amount of public support that is includible for purposes of the test is modified by limiting contributions, gifts, and grants from certain individuals, corporations, trusts, and organizations to 2% of total support, meaning that to the extent that a single donor's contribution exceeds 2% of the organization's total support, it is not considered public support. A husband and wife would be treated as one person for purposes of the 2% limitation, as well as any person or an entity related to them. The excess, and only the excess, is excluded from the numerator of the public support fraction.[7] However, the 2% limitation does not apply to support from certain governmental units and from organizations that are normally supported directly or indirectly by the public or governmental units, provided that such contribution, gift, or grant is not earmarked for the recipient organization.

<u>Code §509(a)(2) Test</u>

Under a second test, the Code §509(a)(2) test, an organization must typically derive most of its gross receipts from an activity related to its exempt function. To meet this test an organization must satisfy two tests:

- It must normally receive more than 33⅓% of its support from any combination of gifts, grants, contributions, membership fees, and gross receipts from permitted sources.
- It must not receive more than 33⅓% of its support from gross investment income and U.B.T.I.

The terms “gifts” and “contributions” in the context of this test have the same meaning as under the Code §509(a)(1) test.

The permitted sources are similar to those included in the public support of Code §509(a)(1) with the following changes:

- Public support includes membership fees (for admissions, merchandise, etc.).
- Public support includes gross receipts from a related activity (*e.g.*, admission fees, merchandise sales, services performed, furnishing facilities), except if the related activity generates receipts from one person, bureau, or similar

[7] However, the entire amount of the contribution is included in the denominator of the fraction.

governmental unit, only $5,000 or 1% (whichever is greater) of the organization's total support in any taxable year can be included. The limitation is applied on a year-to-year basis and is not cumulative.[8]

- Public support also includes rents from related activity.
- Public support does *not* include dividend or interest.[9]
- Public support does *not* include amounts from any "disqualified person."

A disqualified person generally means a substantial contributor, who is an individual, trust, estate, partnership, association, company, or corporation who contributed or bequeathed an aggregate of $5,000 (providing the $5,000 is more than 2% of the total contributions the organization received in the taxable year). Once a person becomes a substantial contributor, the individual forever remains such, even if contributions become less than 2% in following years.

According to the second prong for the Code §509(a)(2) test, the organization must not normally receive more than 33⅓% of its total support from gross investment income (*i.e.*, income from interest, dividends, rents, and royalties) and U.B.T.I. (*i.e.*, gross income from a trade or business that is not substantially related to the organization's exempt purposes).

CONCLUSION

Foreign charities, many of which are not required to obtain recognition of tax-exempt status from the I.R.S., must be mindful of the potential for U.S. tax on income earned in the U.S. It is possible for such charities to receive U.S. income without the imposition of U.S. Federal income or withholding tax if the requirements of Form W-8EXP can be satisfied. Those requirements include an opinion of counsel as to the exempt status of the charity, as well as financial information to determine whether the charity is a public charity or private foundation.

8 The entire amount, however, is included in the total support (*i.e.*, in the denominator).

9 Unlike the Code §509(a)(1) test, in this test, dividends and interest are also excluded from the total support.

TRANSFER PRICING ADJUSTMENT DOES NOT REDUCE DIVIDENDS RECEIVED DEDUCTION FROM C.F.C.

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Tags
C.F.C.
Dividends Received Deduction
Related-Party Debt
Transfer Pricing

Under a largely expired provision, a U.S. corporate shareholder of a controlled foreign corporation ("C.F.C.") could receive a one-time 85% dividends received deduction ("D.R.D.") for eligible cash dividends received from the C.F.C. However, the D.R.D. was reduced by any C.F.C. debt to any related party during the testing period. In a recent Tax Court case, the court held that there is only an increase in related-party indebtedness – and, thus, a reduction in the D.R.D. – if the indebtedness "existed" as of the close of the taxable year.

BACKGROUND

A U.S. corporation is allowed a D.R.D. for distributions received from a domestic subsidiary. The amount of the deduction varies. If a corporation owns less than 20% of the corporation paying the dividend, the D.R.D. is 70% of the dividend received. If the corporation's interest in the subsidiary ranges between 20% and 80%, the D.R.D. is 80% of the dividend received. For stakes exceeding 80%, the D.R.D. is 100% of the dividend received.[1] These deductions, complemented by the consolidated return rules, function somewhat imperfectly to tax corporate income only once until it is finally distributed to noncorporate shareholders. In general, no D.R.D. is available to U.S. corporate shareholders for dividends received from a C.F.C.

An exception previously existed under Code §965, by which a U.S. corporate shareholder could elect a one-time 85% D.R.D. for eligible cash dividends received from the C.F.C. Under this provision, the amount of the dividend was reduced by any C.F.C. indebtedness to a related party. However, indebtedness incurred in the ordinary course of business with a related party and paid within 183 days would not be subject to the reduction.[2] A taxpayer could make the election to either the taxpayer's last taxable year beginning on October 22, 2004, or the taxpayer's first taxable year starting during the one year period beginning on October 22, 2004.[3] Accordingly, although this provision has largely expired, its ramifications still transpire in the context of transfer pricing.

If an adjustment is made by the I.R.S. under transfer pricing principles, a taxpayer may need to make internal adjustments to its own accounts to reflect the original I.R.S. adjustment. Under I.R.S. procedures, internal adjustments required as a result of an I.R.S. adjustment, such as the creation of an "accounts receivable" between the related parties, does not result in income tax consequences.[4] In 2015,

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1 Code §243.

2 Code §965(b)(3); Notice 2005-64. Activities include sales, leases, licenses, or the rendition of services that a related person provides to or for a C.F.C.

3 Code §965(f).

4 Rev. Prov. 99-32, 1999-2 CB 296.

the Fifth Circuit, reversing a Tax Court holding, held that such an internal adjustment did not increase related-party indebtedness and, consequently, did not reduce the D.R.D.[5]

THE ANALOG DEVICES CASE

In *Analog*,[6] a U.S. corporation was the parent of a Dutch B.V., which was a C.F.C. The U.S. parent claimed the 85% D.R.D. on a distribution made from the subsidiary, and the U.S. parent did not report any related-party indebtedness that would reduce the amount of the D.R.D. The U.S. parent also received a 2% royalty payment from the C.F.C.

In a transfer pricing audit, the I.R.S. adjusted the 2% royalty payment and increased it to 6%. The U.S. parent and the C.F.C. established accounts receivable and deemed the accounts receivable created as of the last day of the tax year to which they related. However, the I.R.S. then held that the creation of the accounts receivable amounted to "related-party indebtedness" and thus reduced the D.R.D. for the C.F.C. dividend.

"A C.F.C. is only subject to an increase in related-party indebtedness if the debt existed as of the close of the election year."

The Tax Court rejected with the I.R.S. position, holding that the accounts receivable were not related-party indebtedness. The court further held that a C.F.C. is only subject to an increase in related-party indebtedness if the debt existed as of the close of the election year. Since the U.S. parent's testing period closed before the accounts receivable was created, the debt could not have existed as of the close of the year, and therefore, the full D.R.D. could be taken.

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5 *BMC Software, Inc. v. Commr.*, (CA 5 3/13/2015) 115 AFTR 2d 2015-1092.

6 *Analog Devices Inc. & Subsidiaries*, (2016), 147 TC No. 15.

S.T.A.R.S. TRANSACTIONS – JURY IS IN, FOREIGN TAX CREDIT DISALLOWED

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Tags
Double Dip Foreign Tax Credit
Economic Substance Doctrine
Sham Transaction Doctrine
S.T.A.R.S. Transaction
Tax Shelter

Over the past decade, several U.S. banks have engaged in complex Structured Trust Advantaged Repackaged Securities ("S.T.A.R.S.") transactions promoted by U.K. banks, predominantly Barclays Bank, PLC ("Barclays"). Under these agreements, U.S. banks voluntarily subject certain income-producing assets to U.K. taxation by creating a trust that is deemed to be a U.K. tax resident. Foreign tax credits are then claimed in the U.S. to offset payments made abroad. Treasury regulations under Code §901, proposed in 2007 and finalized in 2011, prohibit S.T.A.R.S. transactions – but not retroactively. Cases involving S.T.A.R.S. transactions that took place prior to the implementation of the regulations have been examined by both the I.R.S. and the courts.

So far, four cases involving S.T.A.R.S. transactions have been published. In all final decisions, the courts held that the very purpose of the S.T.A.R.S. transactions was to generate a foreign tax credit and take advantage of U.S. deductions. Thus, the transactions failed to meet the economic substance requirement for a foreign tax credit to be allowed.

Two notable recent cases involve Wells Fargo & Company ("Wells Fargo") and Santander Holding U.S.A. Inc. ("Santander"). In *Santander*,[1] the District Court in Massachusetts ruled for the taxpayer, allowing the tax bill to be offset by the foreign taxes paid. This was the only S.T.A.R.S. case where a taxpayer prevailed on that issue and a court pushed back a bit against the economic substance doctrine. However, upon appeal to the U.S. Court of Appeals for the First Circuit, the taxpayer lost and the court ruled in favor of the I.R.S., reaffirming and uniting the courts' position that S.T.A.R.S. transactions lack economic substance.

BACKGROUND

S.T.A.R.S. transactions were first explained in our July 2015 edition[2] in which we also covered *Salem Financial, Inc. v. United States*.[3] In *Salem*, the court upheld the I.R.S.'s position on disallowing foreign tax credits resulting from S.T.A.R.S. transaction but allowed the taxpayer to deduct interest expense on borrowings that formed part of the transaction.

The complicated structure and the cash flow in a S.T.A.R.S. transaction is best illustrated by tracing the movement of $100 of trust income. In the following example,

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1 *Santander Holding USA, Inc. v. United States*, 144 F. Supp. 3d 239 (D. Mass. 2015).

2 Stanley C. Ruchelman and Christine Long, "S.T.A.R.S. Transactions – Interest Deduction Allowed but Foreign Tax Credit Disallowed," *Insights* 6 (2015).

3 *Salem Financial, Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 2015).

taken from the recent *Wells Fargo* case, both Barclays and a U.S. bank held interests in the trust.

For every $100 in income received by the trust, the U.S. bank would pay approximately $22 in U.K. taxes and then claim a $22 foreign tax credit in the U.S. Barclays would be allocated the trust income and thus report the $100 as income on its U.K. tax return. Barclays would pay 30% in taxes on that $100 income but would also be entitled to a $22 tax credit for the tax that the trust had already paid to the U.K. Thus, effectively, Barclays would pay $8 in U.K. taxes on each $100 of income generated by the trust. Barclays would then "reinvest" the $78 back into the trust in return for additional units that had no value. Because the additional units had no value, Barclays would be able to deduct the $78 as "loss" on its U.K. tax return. Given a 30% tax rate, Barclays would achieve a tax savings of $23.40 on a $78 deduction. In addition, every month Barclays would make a "Bx payment" to the U.S. bank. The monthly Bx payment would amount to $10.45 on each $100 of trust income, thereby reducing the income subject to 30% tax and resulting in an additional $3.14 in tax savings. Thus, Barclays' effective tax rate on a S.T.A.R.S. transaction would be zero and, in fact, would result in a tax benefit of $8.09 for each $100 in trust income – $23.40 in tax savings resulting from the loss deduction, minus $8 in taxes paid to the U.K., minus the $10.45 Bx payment, plus the additional $3.14 in tax savings resulting from the deduction of the Bx payment.[4] The U.K. treasury would collect a net $3.46 in taxes – $22 from the U.S. bank, plus $8 from Barclays, minus the $23.40 and $3.14 in Barclays' tax savings. Lastly, while the U.S. bank would pay $22 in taxes to the U.K., it would also cut its U.S. tax bill by $22 through claiming a foreign tax credit.[5]

THE WELLS FARGO CASE

The U.S. District Court for the District of Minnesota addressed the same issues that had been examined in two previous cases[6] and drew its own reasoning based upon the previously-published opinions. The District Court submitted two issues to a fact-finding jury based on the bank's request. The issues presented to the jury were (i) whether the Bx payment was pre-tax income or a tax benefit, and (ii) whether the S.T.A.R.S. trust and the loan were sham transactions. The jury issued a verdict on November 17, 2016.

The Sham Transaction Doctrine

Under the sham transaction doctrine, a court must disregard a transaction that a taxpayer enters into without a valid business purpose in order to claim tax benefits not contemplated by a reasonable application of the language and purpose of the Code or the regulations.[7] A sham transaction must be disregarded even when the transaction otherwise complies with the literal terms of the relevant statutes and regulations that allow the tax benefits.[8]

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[4] *Wells Fargo & Company v. United States*, No. 0:09-cv-02764 (2016).

[5] *Id.*

[6] *Bank of N.Y. Mellon Corp. v Commr.*, 801 F.3d 104 (2nd Cir. 2015); see also *Salem Financial, Inc. v. United States*, *supra* note 2.

[7] *WFC Holdings Corp. v. United States*, 728 F.3d 736, 742 (8th Cir. 2013).

[8] *Id.*

In determining whether a particular transaction is a "sham," the Eighth Circuit has traditionally applied the two-prong test set forth in *Rice Toyota World, Inc.*[9] Under that test, a transaction is a sham and should be disregarded for tax purposes if

- it lacks economic substance because no real potential for profit exists apart from tax benefits, and
- it is not motivated by any economic purpose outside of tax considerations.[10]

The first prong of this test is objective and requires that a transaction has "economic substance," while the second prong is subjective and seeks to determine whether the taxpayer has a "business purpose."

In Wells Fargo, in order to decide whether the transaction was a sham, the jury had to determine whether the loan transaction and the trust transaction were parts of one singular transaction or two unrelated transactions. Wells Fargo argued that there was only one transaction, while the I.R.S. argued that these were two separate transactions that were artificially linked to lower Wells Fargo's U.S. tax liability. The jury agreed with the I.R.S. and found that these were two separate transactions, and thus may be treated differently. The jury also found that while the loan transaction had no purpose outside of tax considerations, it did have a "reasonable possibility of pre-tax profits." However, with respect to the trust transactions, the jury found that the structure failed on both prongs of the test, having no non-tax business purpose as well as no "reasonable possibility of pre-tax profit."

"Historically, the First Circuit has been particularly wary of inquiring into the subjective motivations of taxpayers."

THE SANTANDER CASE

Shortly after the *Wells Fargo* decision was published, the Court of Appeals for the First Circuit found that the S.T.A.R.S. transaction in the *Santander* case lacked a legitimate business purpose and that the transaction had no objective economic benefit other than generating a foreign tax credit. With that, the Court of Appeals reversed the decision of the lower court, which had held for the taxpayer and found that the taxpayer had properly claimed both the foreign tax credits and the interest deductions generated by the S.T.A.R.S. transaction. No other lower court decision discussing S.T.A.R.S. transactions had ruled for the taxpayer on its foreign tax credit claim.

The Economic Substance Doctrine

Reversing the District Court's decision to allow tax benefits resulting from a S.T.A.R.S. transaction, the First Circuit ruled that the economic substance doctrine – a judicially-developed doctrine that began with *Gregory v. Helvering*[11] – prevails over a formalistic meeting of the requirements of the law. In *Helvering*, the Supreme Court looked beyond the fact that the transaction technically complied with the statutory requirement and found that it lacked economic substance. Historically, the First Circuit has been particularly wary of inquiring into the subjective motivations of taxpayers, saying "unless Congress makes it abundantly clear, we do not think tax consequences should be dependent upon the discovery of a purpose,

[9] *Rice's Toyota World, Inc. v. Commr.*, 752 F.2d 89, 91-92 (4th Cir. 1985).

[10] *WFC Holdings Corp. v. United States*, *supra* note 6, at 742-743.

[11] *Gregory v. Helvering*, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596 (1935).

or a state of mind, whether it be elaborate or simple."[12] However, in this appeal the court found that the S.T.A.R.S. transaction itself did not have a reasonable prospect of creating a profit without considering the foreign tax credits, and thus it was not a transaction to which Congress had intended to apply the benefit of the foreign tax credit.

In *Santander*, the court did not see the need to address the government's characterization of the Bx payment as a rebate rather than as income and relied on the reasoning in the *Salem* case when it found that the trust structure was put in place solely for tax avoidance reasons and that the structure lacked a *bona fide* business purpose.[13]

The court further stated that the S.T.A.R.S. transaction was profitless because each $1 of profit came with $2 of expense. To return briefly to the $100 hypothetical, even if Santander received a Bx payment of $11 from Barclays (half of the $22 paid by Santander to the U.K. at its 22% tax rate), the trust still lacked a reasonable potential (or any potential) of generating a profit because the $11 Bx payment accompanied an expense of $22 in U.K. tax. In other words, every $1 the trust earned through Bx payments cost $2 in transaction costs from subjecting the trust to U.K. tax. When the primary transaction costs – the U.K. taxes – are factored into the pre-tax profitability calculation, the S.T.A.R.S. transaction is plainly profitless. Santander's "profit" came from the foreign tax credits it claimed for the U.K. taxes combined with a Bx payment calculated as half its U.K. tax liability.[14]

Accordingly, the court concluded that the S.T.A.R.S. transaction had no business objective and no non-tax economic benefit, and that Congress, in creating the foreign tax credit regime, did not intend that it would cover this type of foreign-tax-credit-generator transaction. Exposure to U.K. taxation for the purposes of generating U.S. foreign tax credits was the S.T.A.R.S. transaction's whole function.[15]

CONCLUSION

The Court of Appeals' decision in *Santander* and the jury's decision in *Wells Fargo* both largely agreed with and relied upon the court's decision in *Salem*[16] to allow interest deductions on the loan part of the transaction and reject claims that the S.T.A.R.S. transactions had economic substance, thus disallowing the tax offset provided by the credit for foreign income tax.

When dealing with the economic substance test, the Eighth Circuit applies the two-prong test. However, the court has not yet addressed whether the two-prong test operates conjunctively or disjunctively. While the disjunctive test would be favorable to the taxpayer and may motivate Wells Fargo to appeal the case, it still seems doubtful that the Eighth Circuit would rule for the taxpayer. The government's win in the *Santander* case displayed unanimity among the circuits. All circuits agree that the S.T.A.R.S. transactions lacked economic substance and were not legitimate

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12 *Santander Holding USA, Inc. v. United States*, 2016 U.S. App. (1st Cir. Mass.).

13 *Id.*

14 *Id.*

15 *Id.*

16 *Salem Financial, Inc. v. United States*, *supra* note 2.

business transactions that would entitle the taxpayers to the benefit of foreign tax credits. In two cases involving S.T.A.R.S. transactions,[17] a writ of certiorari was filed with the Supreme Court, arguing that the appeal courts' decisions conflict with earlier cases from the early 2000's. The Supreme Court has thus far denied the consideration of this issue, and in light of government's recent winning streak and the courts unanimity, it is difficult to see a reason for the Supreme Court to do so.

[17] *Id.*; see also *Bank of New York Mellon Corp. v. Commr.*, *supra* note 5.

NEW REGULATIONS IMMINENT FOR TRIANGULAR REORGANIZATIONS AND INBOUND NONRECOGNITION TRANSACTIONS

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Tags
Nonrecognition Transaction
Tax Avoidance
Triangular Reorganization

INTRODUCTION

On December 2, 2016, the Internal Revenue Service ("I.R.S.") published Notice 2016-73, announcing that intends to issue regulations preventing certain taxpayer abuses incident to triangular reorganizations involving foreign corporations. These are transactions in which a subsidiary is the acquisition vehicle, and the shares used to acquire the target are shares of the parent company, hence the reference to a triangle.

The notice is designed to address triangular "Killer B" transactions, which use the interplay of the outbound Code §367(a) regulations and the non-outbound Code §367(b) regulations to facilitate tax-free repatriation of property from controlled foreign corporations. A U.S. corporation receives shares of a foreign target at a stepped-up basis without a significant amount of income being generated. The I.R.S. believes that taxpayers are engaging in transactions designed to repatriate earnings and basis of foreign corporations, while avoiding U.S. Federal income tax.

The forthcoming final regulations will modify

- the rules applicable to property used to acquire parent stock or securities in certain triangular reorganizations involving one or more foreign corporations,
- the consequences to persons receiving parent stock or securities in the targeted types of triangular reorganizations, and
- the amount of the income inclusion that will be required in certain inbound nonrecognition transactions.

The notice provides several examples.

CONTEXT

Code §367(a)(1) applies rules regarding the recognition of gain incident to outbound transfers of property in a rollover transaction. It provides that if, in connection with any rollover exchange described in Code §332 (liquidations), Code §351 (corporate formations), Code §354 (exchanges of stock in a reorganization), Code §356 (certain reorganizations involving boot), or Code §361 (reorganizations in which property is transferred for stock), a U.S. person transfers property to a foreign corporation, the foreign corporation will not be considered to be a corporation, and therefore, gain must be recognized. Code §§367(a)(2), (3), and (6) provide exceptions to the foregoing general rule and, *inter alia*, grant regulatory authority to the I.R.S. to provide additional exceptions and limitations.

Code §367(b)(1) applies rules regarding the required income inclusion by persons considered to be "U.S. Shareholders" for purposes of Subpart F, in connection with certain rollover transactions involving controlled foreign corporations. It provides that in the case of any rollover exchange described in Code §§332, 351, 354, 356, or 361, where no outbound transfer of property by a U.S. person takes place, a foreign corporation is considered to be a corporation, except to the extent provided in regulations that are necessary or appropriate to prevent the avoidance of U.S. Federal income tax. Thus, that no gain is recognized on the transaction that would give rise to tax under Subpart F for a U.S. Shareholder. Code §367(b)(2) provides that the regulations cover, *inter alia*, the sale or exchange of stock or securities in a foreign corporation by a U.S. person, the circumstances under which gain is recognized or deferred, the amounts that are included in gross income as a dividend, the adjustments that are made to earnings and profits, and the adjustments that are made to the basis of stock or securities.

"Triangular reorganizations . . . are transactions in which a subsidiary is the acquisition vehicle, and the shares used to acquire the target are shares of the parent company, hence the reference to a triangle."

Treas. Reg. §1.367(b)-10 applies to certain triangular reorganizations. The regulation deals with a fact pattern in which a subsidiary ("S") acquires stock or securities of its parent corporation ("P") in exchange for property (the "P acquisition"), and S exchanges the acquired P stock or securities for stock, securities, or property of a target corporation ("T"). The final regulations do not apply unless P or S or both are foreign corporations. The application of the final regulations is also subject to a priority rule, described below.

ANNOUNCED REVISIONS

When applicable to a triangular reorganization, the final regulations will require that adjustments be made that have the effect of a distribution of property from S to P under Code §301 (deemed distribution).[1] For this purpose, the amount of the deemed distribution generally is the amount of property that was transferred by S to acquire the P stock and securities in the P acquisition.[2] For purposes of making the required adjustments, the final regulations treat the deemed distribution as a separate transaction that occurs before the P acquisition or, if P does not control S at the time of the P acquisition, immediately after P acquires control of S, but before the triangular reorganization.[3] The term "property" for purposes of the final regulations has the meaning set forth in Code §317(a) (*i.e.*, money, securities, and any other property, other than stock in the corporation making the distribution), as modified to take into account certain assumed liabilities and S stock or rights used by S to acquire P stock or securities from a person other than P.[4]

PRIORITY RULES

Treas. Reg. §1.367(b)-10(a)(2)(iii) provides that the final regulations do not apply to a triangular reorganization if, in an exchange under Code §§354 or 356,

- one or more U.S. persons exchange stock or securities of T,

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1 Treas. Reg §1.367(b)-10(b)(1)

2 *Id.*

3 Treas. Reg §1.367(b)-10(b)(3).

4 Treas. Reg §1.367(b)-10(a)(3)(ii).

- the amount of gain in the T stock or securities recognized by such U.S. persons under Code §367(a)(1) is equal to or greater than the sum of the amount of the deemed distribution that would be treated by P as a dividend under Code §301(c)(1) and the amount of such deemed distribution that would be treated by P as gain from the sale or exchange of property under Code §301(c)(3) (together, "Code §367(b) Income"), and
- the final regulations would otherwise apply to the triangular reorganization (the "Code §367(a) Priority Rule").

Treas. Reg. §1.367(a)-3(a)(2)(iv) provides a similar priority rule that turns off the application of Code §367(a)(1) for an exchange under Code §§354 or 356 that occurs in connection with a triangular reorganization described in the final regulations. In order for the rule to apply, the amount of gain that otherwise would be recognized under Code §367(a)(1) (without regard to any exceptions thereto) must be less than the amount of the Code §367(b) Income recognized under the final regulations (the "Code §367(b) Priority Rule").

CONCLUSION

The regulations described in the notice apply to transactions completed on or after December 2, 2016, and to inbound transactions treated as completed before December 2, 2016, as a result of an entity classification election that is filed on or after December 2, 2016. The regulations have been widely attacked as an overly broad exercise of discretion because the purpose for the transaction, and not the transaction itself, triggers the determination that a transaction is abusive. While U.S. tax law does not have a general anti-abuse rule, it does contain an economic substance test. This test is intended to be applied when tax reduction, rather than economic benefit, is the principal result of the transaction. As drafted, Notice 2016-73 attacks many common transactions that are far from being abusive. Comments have been requested by the I.R.S. and the Treasury Department and must be received by March 2, 2017.

CORPORATE MATTERS:

JOINT VENTURE CONSIDERATIONS

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Tags
Corporate Law
Joint Venture

WHAT IS A JOINT VENTURE?

The term “joint venture” is more a term of art than a legal concept. Joint ventures have been described by the courts as an association of two or more persons, in the nature of a partnership, to carry on a business enterprise for profit. A joint venture is not required to be a legal entity. Consequently, the variety of forms through which joint ventures are conducted runs the gamut from implied contracts to more formal partnerships, limited liability companies, and corporations. The choice of form is dependent on several factors including liability and tax considerations.

The general attributes of a joint venture are as follows:

- The joint participation of two or more entities in a specific activity with a common strategy involving the pooling of some of their resources for mutual gain
- The retention by the participants of their individual identities
- Either an arrangement by contract or the formation of a legal entity that serves as the vehicle through which the joint venture is conducted

WHY FORM A JOINT VENTURE?

Joint ventures are entered into for many reasons. In the establishment of a new product, a joint venture may be a good way to share the costs and risks. For example, a company with a new product or technology may lack the resources for manufacturing or distribution. Additionally, a company looking to expand may seek out a joint venture partner with existing platforms in new geographic markets. In the entertainment industry, joint ventures are often used to marry content with distribution.

ADVANTAGES

Joint ventures offer a flexible operational structure that can be tailored to the participant’s needs. Often, limited liability companies are used as the joint venture entity because they offer a very flexible governance and capitalization platform. Limited liability companies have legal personality.

Joint ventures offer a way to achieve strategic goals with less risk to one individual party, and unlike an acquisition, a joint venture may offer significantly lower cash or equity exposure.

DISADVANTAGES

As with most business arrangements where risk is shared, in a joint venture the upsides and opportunities are shared along with the downsides and risks. Control is also generally shared, although to what extent is determined depending on the relative bargaining power of the parties.

A potentially sizeable disadvantage of forming a joint venture is the inherent agreement to restrict future activities. This, to an extent, goes with sharing the upsides, but most joint venture agreements also limit co-venturers from competing with the joint venture entity. The parties also typically agree that they will only conduct the business (as defined) through the joint venture entity, and that if any business opportunity is brought to their attention that fits within the scope of the business, the opportunity must be offered to the joint venture. Typically, the joint venture agreement will allow the entity a certain time period to decide whether to take up the opportunity and may allow the party bringing the opportunity to the joint venture the right to pursue it on a standalone basis if the co-venturer passes up the opportunity.

STRUCTURAL CONSIDERATIONS

As mentioned earlier, there are a variety of forms that can be used in the joint venture context. Separate and apart from the form are the mechanisms for control over the entity and the allocation of responsibility for day-to-day management. For example, if a limited liability company is chosen, the members will decide whether the company will be "member managed" or whether one member will be the "managing member." If a managing member is appointed, the members will then determine the extent of the powers given to that office and whether the parties will want veto power over certain decisions.

It is also important to clearly establish the purpose and scope of the venture. This will clearly delineate the activities that fall within the venture. It also may serve to avoid later conflict if a party's business objectives change over time.

Care must be taken in preparation of the joint venture documents. Joint ventures require mutual trust, and the disclosure of commercially-sensitive information may be required in order to further the aims of the joint venture. The mechanics of disclosure must be discussed early in the negotiations leading up to the relationship. The goals of the venture must also be clearly identified to avoid an unpleasant discussion should the parties discover that they have divergent goals.

Individuals within each organization must be identified as responsible for ongoing issues. At the outset of a joint venture, there is typically a great deal of interest within each organization. It is not uncommon for the interest level to decline with time, leaving the joint venture managers with unclear reporting lines. When this occurs, the entity is unable to cope quickly with unexpected occurrences.

A joint venture can be an effective way to increase growth in a business when one does not have the capability to achieve a goal or goals on a standalone basis. It is essential to find a joint co-venturer with complimentary capabilities and a similar vision. As in all business alliances, the benefits must be carefully weighed against the challenges of operating under such a business model.

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Offshore Accounts
Tax Policy
Tax Havens

FOREIGN ACCEPTANCE AGENT AGREEMENTS TERMINATED – MORE HURDLES FOR NON-U.S. PERSONS TO OBTAIN AN I.T.I.N.

When claiming a refund of over-withheld tax, purchasing or selling real property, or complying with U.S. filing requirements, a non-U.S. person is required to obtain an individual taxpayer identification number ("I.T.I.N."). Under I.R.S. regulations, an original passport or an official copy prepared by the issuing agency must be filed with the I.T.I.N. application, which is submitted on Form W-7. Prior to 2017, where neither option was feasible, a U.S. or foreign certifying acceptance agent could attest to the accuracy of the identification documents (usually passports). A recent change to these rules significantly limits the options available to non-U.S. I.T.I.N. applicants.

Effective January 1, 2017, the rules relating to foreign-based certifying acceptance agents have changed considerably.[1] Consequently, all agreements with agents located outside the U.S. have been terminated.[2] While domestic acceptance agent agreements are not affected by these new rules, the language in the standard agreement with U.S.-based certifying acceptance agents suggests that they can act only on behalf of applicants that reside in the U.S.

Under the new rules, I.T.I.N. applicants residing outside the U.S. may only submit the Form W-7 application (i) by mail or (ii) in person to an employee of the I.R.S. or a designee of the Treasury Department at a U.S. diplomatic mission or consular post. While it has been the practice for these diplomatic offices to offer document authentication services and provide certified copies of documents to I.T.I.N. applicants, services vary from country to country. Further, it should be noted that all I.R.S. employees authorized to review and accept such applications are currently located in the U.S.

At this time, no further guidance is available regarding the I.T.I.N. application process at U.S. diplomatic missions or consular posts. Thus, the new rules leave several questions open for non-U.S. applicants and their advisors:

- Will U.S. diplomatic missions or consular posts continue to certify the accuracy of documents, as was the case under the acceptance agent agreements?
- If not, must a foreign individual leave his or her passport at the diplomatic

1 Code §6109(i)(1)(B).

2 Section 203 of the Protecting Americans from Tax Hikes Act of 2015 (PATH Act), Pub. L. 114-113, div. Q, enacted on December 18, 2015, modified Code §6109.

mission or consular post if the issuing agency does not provide official copies, which is the case in some countries?

In terminating the acceptance agent agreements of organizations operating in foreign countries, the I.R.S. exercised its authority under the standard agreement with acceptance agents and Revenue Procedure 2006-10. However, it is not clear whether denying foreign persons the option to use certifying acceptance agents for filing I.T.I.N. applications is the result of an intentional policy shift or mere legislative error. A proposed correction of the new rules, introduced in two bills in April and December of 2016,[3] points in the direction of the latter. If approved, the correction would allow foreign applicants to, at least, use the services of domestic certifying acceptance agents.[4] While the I.R.S. has stated that the change in law will eliminate the need for non-U.S. certifying acceptance agents, the agency appeared reluctant to terminate foreign acceptance agent agreements in its communications to agents. Nonetheless, as the bills to correct the language of this provision were not passed by Congress, the I.R.S. had no choice but to implement the new rules.

"It is not clear whether denying foreign persons the option to use certifying acceptance agents for filing I.T.I.N. applications is the result of an intentional policy shift or mere legislative error."

These new rules combined with other newly promulgated rules on the expiration of I.T.I.N.'s that have not been used for consecutive three years (with special rules for I.T.I.N.'s issued before 2008 through 2012)[5] hinder the process for non-U.S. taxpayers to be compliant with U.S. filing and reporting requirements. It remains to be seen how this new rule will be applied in practice. Updates on guidance and administrative practice or a correction of the new provision will follow.

CANADIAN COURT UPHOLDS KPMG OFFSHORE DISCLOSURES

On November 29, 2016, the Federal Court of Canada allowed the Canadian Revenue Agency ("C.R.A.") to demand that KPMG disclose confidential information relating to clients who participated in an Isle of Man tax structure. Names of clients and documentation relating to participation in the structure must now be disclosed. The ruling follows the C.R.A.'s discovery that KPMG clients transferred assets to an offshore company incorporated in the Isle of Man. The Isle of Man corporation was not registered in the names of the clients but in the names of third parties. A report of the Standing Committee on Finance states the following on the matter:

> The offshore corporate structure developed by KPMG and located on the Isle of Man allows KPMG clients to gift sums of money to an offshore corporation that would hold or invest that money for an indeterminate period of time. According to KPMG, the structure was designed for the purposes of estate planning, asset protection or philanthropic use; KPMG indicated that a tax benefit would also be present. KPMG believed that the structure operated as follows: KPMG clients would not own shares in the offshore corporation, and

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[3] H.R. 4891, the "Technical Corrections Act of 2016."; H.R. 6439 (114th).

[4] See "Joint Committee on Taxation Technical Explanation of the Tax Technical Corrections Act of 2016."

[5] See Galia Antebi, Fanny Karaman, and Kenneth Lobo, "Updates and Other Tidbits," *Insights* 7 (2016), pp. 67-68.

> would not have legal ownership of the money gifted to the corporation; therefore, these clients would not be taxed on any interest or income resulting from the offshore corporation's investment activities. KPMG felt that this interest or income would fall under the Isle of Man's taxation system, which has a corporate tax rate of 0%. The offshore corporation could then gift the money to the KPMG clients and their families. Because gifts are generally not subject to taxation under Canadian tax law, KPMG believed that these clients and their families would receive the gifted money on a taxfree basis.[6]

KPMG requested that the order to disclose be quashed or cancelled because Rule 208 of the Code of Professional Conduct for chartered accountants in Ontario provides a general confidentiality rule between a firm and its clients. However, the court found that Section 231.2(3) of the Tax Act is clear and overrides the general confidentiality rule imposed by Rule 208 of the Code of Conduct. The mere fact that Rule 208 exists does not provide a sufficient basis to cancel or set aside an order validly issued by C.R.A. pursuant to Section 231.2(3). However, a clients' claim for attorney-client privilege can be made at the time KPMG provides the information.

POST-ELECTION VIEW FROM THE TREASURY: U.S.-E.U. RELATIONS WILL LIKELY WORSEN

The new Trump administration has been discussing major tax reform overhaul that will, if adopted, dramatically modify the U.S. international tax system in a very pro-taxpayer manner. Tax reform proposals such as adoption of a destination-based tax system and new rules to allow for repatriation of foreign earnings in a low tax manner may help U.S. taxpayers compete better in a global environment. However, the new administration will also have to deal with foreign governments and their representatives whose recent actions may forebode difficulty for the new administration in achieving multilateral tax relief.

Robert Stack is the U.S. deputy assistant treasury secretary for international tax policy in the Obama administration. In a December speech in Washington, D.C., he raised three areas of tension that will persist in 2017 under the Trump administration:

- The European Commission appears to be walking away from multilateral solutions reached by the O.E.C.D. where views of the U.S. were accepted.
- The European Commission is using the O.E.C.D. B.E.P.S. actions as a baseline to mandate global tax rates as part of a political agenda. If those with a low band of tax are forced to increase their rates, those countries with higher rates will no longer be outliers.
- The European Commission is pushing the mandatory adoption of harmonized tax rules in Europe, so that the U.S. is practically dealing with one mega tax authority that gets 22 seats around the table.

In these circumstances, the Trump administration will face a great deal of risk and

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6 Standing Committee on Finance, 42nd Parliament, 1st Session, "The Canada Revenue Agency, Tax Avoidance and Tax Evasion: Recommended Actions," October 22, 2016, p. 22.

difficulty in achieving multilateral solutions that are acceptable. As the new administration moves to reduce tax rates, it will encounter problems with the European Commission attempting to raise taxes to fund government expenditures.

E.U. IDENTIFIES BLACKLIST COUNTRIES

The European Union ("E.U.") has targeted 28 jurisdictions for increased scrutiny in 2017. The blacklisted nations, which are viewed as common tax havens, include a range of Pacific and Caribbean nations that are offshore financial centers. They include Belize, Grenada, the Cook Islands, Montserrat, Cabo Verde, Dominica, Saint Kitts, Nevis, Macao, Saint Lucia, and Samoa. Additionally, the Cayman Islands, the British Virgin Islands, Anguilla, Bahamas, Bermuda, Guernsey, the Isle of Man, and Jersey have been flagged for special screening based upon their zero tax rates. Thirteen of the nations have failed to commit to the O.E.C.D.'s framework for base erosion and profit shifting ("B.E.P.S.") reforms.

The E.U. has taken the screening process further than the O.E.C.D. and is looking specifically into jurisdictions with preferential or harmful tax regimes and zero corporate tax rates. In comparison, the O.E.C.D. targets countries that do not abide by two of the three prescribed transparency criteria, which includes a commitment to the O.E.C.D. common reporting standard for bank information, information exchange of bank information upon request, and ratification of the O.E.C.D. convention on Mutual Administrative Assistance.

In an effort to preserve fair taxation, the E.U. plans to prepare an economic substance test that will determine whether the zero rates facilitate offshore structures or arrangements aimed at attracting profits that do not reflect real economic activity.

About Us

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

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

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

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

Disclaimer

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