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corporate international taxation

INSIGHTS

2018 YEAR IN REVIEW

A YEAR OF GUEST FEATURES

Insights Special Edition Vol. 5 No. 11

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EDITORS' NOTE

As the year comes to a close, *Insights* looks back on the ups and downs of cross-border taxation in 2018.

The year 2018 saw major tax reforms take shape in the U.S., the Netherlands, and Switzerland. Specific legislation affecting investors was passed in France, Italy, India, Germany, Canada, and Israel (among other countries). While some provisions entice investment, others focused on combatting tax avoidance and aligning national laws with the new international norms of a post-B.E.P.S. world. Taxation of the digital economy continued to be a source of international tension – with proposals arising at the O.E.C.D. and E.U. levels and then unilateral U.K. action to round out the year. Tired of chasing taxpayers, a number of countries have turned their attention toward tax advisors, raising questions of whether they have a duty to prevent tax evasion and avoidance or to report the activity in advance.

In 2018, *Insights* featured articles by 27 guest authors from around the world.

Andrea Tavecchio and Riccardo Barone
Tavecchio Caldara & Associati

Graham Busch
Gerald Edelman, Chartered Accountants

Stefano Loconte and Linda Favi
Loconte & Partners

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Miller Thomson LLP

Danielle Wenger and Manuel Vogler
Prager Dreifuss AG

Eloise Walker
Pinsent Masons

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- **Circular Letter No. 25/E Clarifies Italy's New Carried Interest Regime.** Early last year, the Italian government announced new rules regarding favorable taxation of carried interests. Graduated tax rates and social charges would be replaced by a flat 26% tax on investment income. Towards the end of the year, guidelines were published by the Italian tax authorities providing significant clarifications on the scope, requirements, and conditions under the new tax regime. Andrea Tavecchio and Riccardo Barone of Tavecchio Caldara & Associati, Milan, examine how the new regime will work in practice.

- **Doing Business Post-Brexit: What to Expect in the United Kingdom.** The U.K. is firmly on course to leave the E.U., with a target date of March 29, 2019. After a difficult period of 18 months, agreements to address two important "divorce" issues – the exit payment and the status of Brits in the E.U. and Europeans in the U.K. on Brexit Day – have been reached, while a decision has been made to defer discussions regarding the border with Northern Ireland. Graham Busch of Gerald Edelman, Chartered Accountants, London, addresses these and other settled issues as well as those for which a decision has been kicked down the road.

- **A New Definition of Permanent Establishment in Italian Domestic Income Tax Law.** Italian domestic tax law has adopted the permanent establishment ("P.E.") concept when determining whether business profits of a nonresident are taxable in the absence of an applicable income tax treaty. Earlier this year, changes to the definition of the term broadened the scope of activity constituting a P.E. Effective January 1, 2018, (i) a digital P.E. is treated as a fixed place P.E., (ii) the scope of the specific activity exemption has been scaled back, (iii) an anti-fragmentation rule has been adopted applicable to groups of companies, and (iv) the scope of an agency P.E. has been broadened. Stefano Loconte and Linda Favi of Loconte & Partners, Milan, explain the new rules.

- **India Budget 2018-19.** The Indian government announced its plans for the 2018–2019 budget year. It is the last full budget before the 2019 Parliamentary elections and the first budget following the implementation of the landmark national G.S.T. regime. Tax is reduced to 25% for domestic companies generating income of approximately $40 million or less. The definition of the term "business connection," the equivalent of a P.E. under domestic law, is broadened to cover agents having and habitually concluding contracts and circumstances where a nonresident has a significant economic presence. A 10% tax is imposed on certain stock market gains. Incentives are given to international financial services companies in the form tax exemptions for certain gains. These and other provisions are explored by Jairaj Purandare of JPM Advisors Pvt Ltd, Mumbai, India.

- **Failure to Prevent – The Future of Adviser Obligations.** The concept of failure to prevent has grown from its roots in the U.S. Foreign Corrupt Practices Act and is making inroads into the responsibilities of tax advisers. The recent trend begs the question, do advisors have a duty to prevent the evasion or improper reduction of tax or to report the activity in advance? A team of international advisors looks at the evolution of obligations: Peter Utterström of Peter Utterström Advokat AB, Stockholm, looks at the origin of the concept. Gary Ashford of Harbottle & Lewis LLP, London, looks at recently adopted legislation in the U.K. imposing strict liability on advisers to naughty clients. Lawrence S. Feld, Attorney at Law, New York, looks at its presence in the U.S. Swiss Bank Program of the Justice Department. Dick Barmentlo of Jaegers & Soons, Amsterdam, addresses a recent case in the Netherlands that imposes civil liability on a Netherlands trust company and its employees for lost taxes suffered by the Dutch tax administration.

- **New Tax Treaty Between France and Luxembourg: French Tax Implications for Investors.** France and Luxembourg signed a new double tax treaty on income and capital in late March. Ratification by the end of the year is anticipated. The new treaty reflects the current post-B.E.P.S. environment. Among other things, the residence definition is tightened, the test for the existence of a permanent establishment is loosened, real estate funds face higher withholding tax, and a credit method is adopted to avoid double taxation. Christophe Jolk explains the implications for investors.

- **O.E.C.D. and European Commission Unveil Proposals on Taxation of the Digital Economy.** Following the release of the O.E.C.D.'s B.E.P.S. Action Plan and the E.U.'s approval of the Anti-Tax Avoidance Package, the taxation of the digital economy continues to be unfinished business in the international tax arena. New O.E.C.D. and the European Commission documents mark a milestone, especially the latter, which include two different approaches. They also highlight the difficulties in achieving a consensus, which seems desirable when implementing measures that increase the tax burden of digital activities. José Luis Gaudier of Cuatrecasas, Barcelona, delves into these approaches to taxing the digital economy.

- **Do India's Amalgamation Revisions Prevent Misuse of Accumulated Losses?** India's recent Finance Act addressed a tax planning device intended to reduce or eliminate the imposition of the Dividend Distribution Tax ("D.D.T.") that applies when a corporation exercises the right to distribute dividends to shareholders. The statue targets plans involving an amalgamation between a profitable company and a loss company and prevents the reduction of earnings when the profitable company is the acquiring company. Does this mean that earnings can be reduced when the loss company is the acquiring company? Differing views have been expressed by Indian tax advisers. CA Anjali Kukreja of R.N. Marwah & Co L.L.P., New Delhi, examines both views and explains why one view is technically preferable.

- **U.K. Requirement to Correct.** The "Requirement to Correct" ("R.T.C.") rules for offshore tax affairs in the U.K. threaten steep penalties if noncompliant taxpayers at April 5, 2017, do not take action to correct the relevant noncompliance by September 30, 2018. In a detailed look at the R.T.C. rules, Gary Ashford of Harbottle & Lewis LLP, London, explains the ins and outs of the provisions, including (i) the definition of offshore noncompliance, (ii) covered taxes, (iii) penalties, (iv) the reasonable cause defense, (v) disqualified advice that cannot be reasonable cause, (v) the method that must be followed to implement a valid correction, (vi) the statute of limitations, and (vi) recent guidance from H.M.R.C. regarding last minute notifications by noncompliant taxpayers. The final date for completing a correction is December 29, 2018.

- **Israeli Court Case First to Interpret Ten-Year Exemption.** Effective in 2007, Israel's New Immigrant Benefits rules are intended to promote immigration through the grant of substantial tax benefits: (i) a ten-year tax exemption for foreign-source income produced or accrued outside Israel or income stemming from assets located outside Israel and (ii) an exemption for all tax reporting requirements related to exempt income. Over the years, the Israeli tax authorities applied strict rules in determining (i) whether a specific item of income should be considered to be foreign source income and (ii) the portion that is properly treated as foreign in circumstances of mixed income – part foreign and part domestic. Now, eleven years after the New Immigrant Benefits rules became effective, the first case addressing these open questions has been decided, *Talmi v. Kfar Saba Tax Assessor*. Daniel Paserman and Inbar Barak-Bilu of Gorntizky & Co., Tel Aviv, report on the holding. In brief, the taxpayer won on principles but lost on the basis of his facts.

- **Coming to the U.S. After Tax Reform.** Now, more than six months after enactment of the Tax Cuts & Jobs Act, many tax advisers have achieved a level of comfort with the brave new world of Transition Tax, F.D.I.I., G.I.L.T.I., B.E.A.T., and incredibly low corporate tax rates. However, sleeper provisions in the new law can have drastic adverse tax consequences in the realm of cross-border transactions and investments: (i) the threshold for becoming a C.F.C. has been reduced significantly by several changes in U.S. tax law and (ii) the 10.5% tax rate for G.I.L.T.I. is limited to corporations so that individuals face ordinary income treatment for G.I.L.T.I. inclusions from foreign corporations that were not C.F.C.'s. prior to the new law. Jeanne Goulet of Byrum River Consulting LLC, New York, addresses these problems and suggests several planning opportunities.

- **Joint Audits: A New Tool to Combat Cross-Border Tax Evasion.** When a large corporate taxpayer receives an audit notification letter from the tax authority in its country of residence, the taxpayer typically knows what to expect: a lengthy process of documenting and defending its tax position. It also knows the process under domestic law for appealing adverse tax adjustments, and if cross-border issues are raised, it knows how to take advantage of Mutual Agreement Procedures between competent authorities under an income tax treaty. The full process can take years to resolve. Now, however, a pilot program between German and Italian tax authorities empowers a joint cross-border audit team to conduct a single joint audit of cross-border operations between the two countries. The joint audit is intended to be more effective for resolving issues of double taxation in cases involving complex facts related to (i) transfer pricing issues, (ii) residency or permanent establishment issues, and (iii) aggressive tax planning schemes. Marco Orlandi of Ludovici Piccone & Partners, Milan, examines the actual process followed in the pilot program and comments on whether the goals of the joint audit have been achieved.

- **German Anti-Treaty Shopping Rule Infringes on E.U. Law.** When do attacks on cross-border tax planning move from enough to too much? The European Court of Justice ("E.C.J.") provided an answer in connection with German tax rules limiting access to the E.U. Parent Subsidiary Directive for dividends leaving Germany. For many years, German law provided an irrebuttable presumption of fraudulent or abusive tax planning when a multinational structure failed to meet a "one size fits all" set of factual parameters. The provision was struck down by the E.C.J. last year, modified slightly in response, and struck down again in June of this year. Pia Dorfmueller of P+P Pollath explains why the German tax law was found to violate European law – it provided a response that was not proportional to the alleged wrong-doing.

- **O.E.C.D. Discussion Draft on Financial Transactions – A Listing of Sins, Little Practical Guidance.** In July, the O.E.C.D. Centre for Tax Policy and Administration released Public Discussion Draft on B.E.P.S. Actions 8-10: Financial transactions (the "Discussion Draft") addressing financial transactions (*e.g.*, loans, guarantees, cash pools, captive insurance, and hedging). Michael Peggs and Scott R. Robson of Cadesky Tax, Toronto, review the draft guidance and express disappointment. The Discussion Draft is not a thought leader, as tax authorities have successfully litigated the issues inherent in intercompany loans. Decided cases generally reflect a "not in my back yard" approach to deductions for interest expense. The Discussion Draft makes statements regarding allocation of risks in financial transactions that are inconsistent with arm's length evidence. It also promotes decisions based on 20-20 hindsight. All these lead to several unanswered questions: What is the ultimate meaning of the term "arm's length" when used in a cross-border financial transaction? Is it the terms and conditions that exist in actuality among lenders and borrowers, or is it the terms and conditions that should exist in the mindset of the tax authorities?

- **Dutch Corporate Tax Reform: Dividend Tax Remains, A.T.A.D. Arrives, and Tax Rates Drop.** Across the globe, the landscape for international tax is in a constant state of change. Nowhere is this more evident than in the Netherlands. On the third Tuesday of September, a repeal of the dividend withholding tax was announced. Within a month, it was withdrawn. Paul Kraan, a partner of Van Campen Liem in Amsterdam, discusses the remaining tax proposals presented by the Dutch government on the eve of the third Tuesday of September. These include provisions related to A.T.A.D. 1, such as G.A.A.R., an exit tax for corporations, a C.F.C. anti-abuse rule, and a cap on the deductibility of net interest expense. Also discussed is an existing unilateral exemption from withholding tax on cross-border dividend payments in (i) the context of an income tax treaty and (ii) the presence of economic substance for the direct or indirect shareholder. This exemption is likely to remain in the law.

- **Extension of German Taxation on Foreign Companies Holding German Real Estate.** In August, the German Federal government proposed draft legislation that will expand the scope of German taxation to cover the sale of shares in "real estate rich companies" by nonresident taxpayers. The draft legislation proposes that capital gains from shares in non-German companies will be subject to German taxation if more than 50% of the share value is attributable to German real estate. The legislative proposal has wide application, reaching a shareholding that exceeds a 1% threshold at any time in the five years preceding the sale. Dr. Petra Eckl, a partner at GSK Stockmann + Kollegen in Frankfurt, explains the proposal and the practical exposure that arises from its overly broad language.

- **Corporate Matters: Ichabod Crane Visits His Executive Employment Attorney.** Washington Irving's "The Legend of Sleepy Hollow" tells the story of poor Ichabod Crane, a school teacher attacked by a headless horseman.

It is a tale fitting for Halloween by a 19th Century American author famous for his stories about rural New York State, somewhere near the Tappan Zee Bridge. In this latest retelling, George Birnbaum, a New York State attorney whose practice focuses on labor law, brings a new twist to the story. Here, it comes to light that Ichabod made poor decisions regarding his employment contract, and those decisions exacerbated work-related problems flowing from the attack.

- **Alta Energy Affirms Treaty Benefits: A Canadian Case Study for Applying the M.L.I.** As part of its attack on B.E.P.S., the O.E.C.D. published its Multilateral Instrument, a device that revised more than 1,200 income tax treaties. One of the provisions of the M.L.I. targets treaty shopping by the adoption of, among other things, a principal purpose test ("P.P.T."). In simple terms, the P.P.T. disallows a treaty benefit when a principal purpose of a transaction is to obtain that benefit. Transactions in accordance with the object and purpose of the provisions of a treaty are not affected by the P.P.T. Many North American tax advisers know that the P.P.T. is based on a provision of Canadian law known as the General Anti-Avoidance Rule or G.A.A.R. A recent decision of the Tax Court of Canada addresses the application of G.A.A.R. to a cross-border tax plan set up by a U.S. financial institution designed specifically to obtain enhanced Canadian tax benefits by rechanneling a U.S. investment in Canada into a U.S. investment into Luxembourg that was then invested into Canada. The Canada Revenue Agency ("C.R.A.") attacked the Luxembourg company's entitlement to treaty benefits relying heavily on G.A.A.R. Kristy J. Balkwill and Benjamin Mann of Miller Thomson LLP, Toronto, explain the decision and its potential impact on the P.P.T. The case has been appealed by C.R.A.

- **Revised Swiss Corporate Tax Reform Will Keep Switzerland a Top Corporate Location.** Since 2015, Switzerland has struggled over the adoption of a tax system that is consistent with B.E.P.S. Many different stakeholders are involved, ranging from the Swiss Federal government to the cantons, various political parties, and the E.U. At last, a version of tax reform has been adopted by the Swiss Federal National Assembly. Known as the Federal Act on Tax Reform and A.H.V. Financing ("T.R.A.F."), it contains provisions designed to please all participants while maintaining Switzerland's global reputation as an attractive jurisdiction for multinational enterprises. Danielle Wenger and Manuel Vogler of Prager Dreifuss AG, Zurich, guide the reader through the various iterations of the reform and the provisions of the T.R.A.F.

- **The U.K. Digital Sales Tax – It Could Be You.** On November 7, 2018, the U.K. government confirmed that it will proceed with the introduction of a digital services tax ("D.S.T.") on large businesses. The tax will be charged beginning April 2020. It will apply to three key areas, which the government has concluded derive a huge value from the participation of U.K. users and are largely untaxed. Eloise Walker of Pinsent Masons, London, provides an overview of the D.S.T., cautioning that problems exist in identifying both the revenue to which the D.S.T. will apply and the hallmarks of jurisdiction that must exist in order for the tax to be imposed.

We hope you enjoy this issue.

- The Editors

CIRCULAR LETTER NO. 25/E CLARIFIES ITALY'S NEW CARRIED INTEREST REGIME

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INTRODUCTION

On April 24, 2017, the Italian government introduced a new tax regime addressing carried interests and similar arrangements that involve shares, quotas, and other financial instruments. The aim is to boost the Italian private equity and private debt sectors and make Italy more attractive to fund management companies and top executives.

The new regime has been introduced by Law Decree 24 April 2017 No. 50 (the "Decree"),[1] which provides that "qualifying" carried interest schemes are deemed financial income, rather than employment income. Article 60 of the Decree provides an irrebuttable presumption that remuneration derived from certain carried interest schemes qualifies as income from capital, or capital gain, generally subject to only a 26% substitute tax.

On October 16, 2017, the Italian tax authorities released official guidelines, Circular Letter No. 25/E (the "Circular"), that provide significant clarifications on the scope, requirements, and conditions envisaged under the new tax regime.

CARRIED INTEREST: AN OVERVIEW

Private equity transactions generally require a contract between investors and the fund managers that includes provisions exposing the managers in investment-related risks.

One of these mechanisms is the "carried interest," a compensation incentive that aligns the interests of the fund managers with those of the investor group. This kind of remuneration takes the form of shares, quotas, or financial instruments with "enhanced economic rights," such as

- a shareholding more than proportional to the profits of the investment, or
- the right to convert financial instruments into a more than proportional number of ordinary shares.

This is achieved by tying remuneration to a minimum return for other investors.

QUESTION OF INCOME CLASSIFICATION

The dual role of the manager as administrator or employee and shareholder has created questions regarding the tax treatment of carried interests. If the income from

[1] Converted into Law 21 June 2017, No. 96.

enhanced equity rights is classified as financial income, the managers may benefit from the flat rate of 26%, as mentioned above. On the other hand, if that income is classified as employment income, it can be taxed at marginal rates up to 43% plus local surcharges and social contributions.

The core issue is that some types of carried interest typically are considered to be performance fees, which fall within the category of employment income if viewed as a bonus for performance. According to Article 51 of the Italian Income Tax Code ("T.U.I.R."), employment income consists of "*all sums and values of whatever nature received during the tax period, . . . , in relation to the employment relationship*." To that end, Ministerial Circular No. 326/1997 clarified that all remunerations related to an employment relationship are properly categorized as employment income "*even if they are not directly paid by the employer*," including "sums and values received in the form of equity shareholding."

One area of concern is where the rules apply to stock options. Pursuant to Italian law, income arising from the exercise of stock options (calculated as the difference between the fair market value of shares purchased and the strike price) is considered employment income. This definition posed problems for managers who benefit from:

- a "preferential" distribution of the company profits or a capital gain realized through the disposal of the company itself, or
- in the case of stock options, the payment of a strike price lower than the market value of the shares.

The similarity between the carried interest and stock options regimes led to uncertainty regarding the treatment of carried interest for income tax purposes.

In 2012, the Italian tax authorities addressed the classification of this kind of compensation in Resolution n. 103. The case concerned the assignment of a disproportionate number of shares to the company's managers compared to their cash investment in the company. The Revenue Agency stated that the non-proportional allocation of the shares to the managers had, in the analyzed case, a remunerative function for their performance. Consequently, the income arising from the share assignment – equal to the difference between the total fair value of the shares assigned to each manager and the amount paid to subscribe them – is to be considered employment income. This conclusion reflected the following rationale:

- The impossibility for the managers to transfer their shares to third parties until a specific holding period
- The connection between the share assignment and the work provided by the managers

Nonetheless, the Revenue Agency clarified that any income such as dividends and/or capital gains attributable to managers as a result of the ownership of the shares acquired through the non-proportional assignment maintains the character of "financial income" as "*the participation to the profits is not subject to the existence of the employment relationship, since the beneficiary could maintain the shares even if the work relationship is terminated*."

Consequently, the classification of the income received from the shareholding under

Article 44, para. 1, let. e of T.U.I.R. (*i.e.*, dividends from shareholding) does not depend on whether a work relationship exists between the recipient of the profits and the distributing company.

The fact that the characterization as "financial income" does not depend on the existence of an employment relationship raises the same questions regarding the loss of enhanced economic rights due to departure clauses.

NEW RULES ON CARRIED INTEREST

Given the uncertainty of this situation and a desire to attract high-skilled individuals and capital to Italy, the Italian government introduced a new provision laying down the conditions under which carried interest is to be considered financial income and not employment income.

With Art. 60 of the Decree, the Italian government introduced new rules that address proceeds derived from direct or indirect participation in companies, entities, or collective investment undertakings that are represented by shares, quotas units, or other financial instruments granting enhanced economic rights ("eligible instruments").

Under the new regime, if certain conditions are met,

- income and gain derived from direct or indirect participations in companies, other entities, or collective investment undertakings ("C.I.U.'s") established in Italy, or in a jurisdiction allowing for adequate exchange of information with Italy (*i.e.*, "white list jurisdictions"),
- will be deemed to constitute investment income (generally taxed at 26%), rather than income from personal services (taxed at progressive rates up to 43% plus surcharges)
- when received by employees and directors ("Managers") of such companies, investment undertakings ("relevant funds or companies"), or other persons controlling or managing such companies (*e.g.*, employees and directors of the management company of an investment fund).

Those eligible for the incentive include managers and employees of advisory companies, investment companies, and target companies. In this regard, it should be noted that advisory companies are included within "eligible persons" since they have a key role in investment strategies, although they have no investment decision ability and therefore no direct responsibility. On the other hand, excluded persons consist of professionals such as lawyers acting as consultants.

The application of the special regime is subject to three conditions:

- *1% Investment Threshold.* The actual investment made by all managers requires an effective disbursement greater than or equal to 1% of the total investments of the relevant fund or company.
- *Repayment Subordination.* The proceeds from shares, quotas, or financial instruments are only payable once all the fund investors or company shareholders have received an amount equal to the invested capital plus a minimum yield (*viz.*, a hurdle rate) set out by the fund regulations or by law.

- *Holding Period.* The relevant shares, units, and financial instruments must be held for at least five years or, if earlier, until the date of a change of control of the relevant company or entity, or a change of the management company of the collective investment undertaking.

Before analyzing the above conditions, it should be highlighted that the new regime concerns only proceeds derived from the holding of financial instruments with special economic rights. It does not apply to income derived from the financial instrument assignment. Indeed, upon assignment (*i.e.*, subscription or acquisition) of any eligible instruments, the excess in value between the fair market value of shares, quotas, or financial instruments and the actual amount paid will be treated as a benefit in kind and taxed as employment income. Such income is taxed at progressive rates of up to 43% on taxable income exceeding €75,000.

"The new regime applies to carried interests if all the other fund investors or shareholders other than the holders of the carry have received an amount equal to the invested capital hurdle."

1% Investment Threshold

The Circular clarifies two points with regard to funds.

First, the Managers' 1% total investment is represented by the effective capital invested, which also takes into consideration financial instruments other than those with enhanced economic rights and securities (with or without enhanced economic rights) ascribed to Managers as fringe benefits and taxed in their hands as employment or self-employment income. Considering that the Decree makes reference to direct or indirect participations in eligible instruments, where financial instruments with special economic rights are held through a dedicated company or trust or subscribed by a management company in which the holders of the carry participate, the indirect participation will be counted for the purposes of the 1% threshold.

Second, the overall investment made by the relevant fund is determined with reference to the amounts the fund has effectively received from investors (*viz.*, drawdowns), including management fees, and net of any third-party debt. In other words, the carry holders' disbursement must be proportional to the capital actually invested by the other investors, rather than to the amounts employed to acquire the underlying investments, which usually include substantial financing.

The Circular also clarifies that the 1% threshold must be verified at the end of the subscription period. Once the 1% threshold is exceeded, further transfers of the same securities with special economic rights to a person other than an employee or director (*e.g.*, by means of succession) will not trigger any consequence for the remaining carry holders even if the overall interest falls below 1%. The same conclusion can be achieved in a case where the manager terminates his or her employment relationship. Clearly this is not effective where an abuse of law exists, such as would be the case where all steps are part of a prearranged plan.

The Circular also provides useful comments on the application of the Decree when the eligible instruments are issued by a company instead of a collective investment vehicle. With regard to companies, the minimum threshold requirement must be commensurate with the company's net equity, to be calculated at fair market value determined through a specific appraisal. Furthermore, to meet the 1% investment condition, the Managers' investment must be adjusted to account for any further investment in the company by other investors.

The Circular also specifies that the foregoing condition is not met if the financial instruments are acquired by the Mangers through loans granted by the employer or third parties under favorable conditions. Where that occurs, there is no alignment between the interests of the Managers and those of the investors. In contrast, the condition is met if the financial instruments are subscribed through loans granted at rates lower than market standards provided that the loan granted in connection to the employment relationship is treated as benefit in kind pursuant to Art. 51, para. 4 of T.U.I.R.

Repayment Subordination

The Circular clarifies that the new regime applies to carried interests if all the other fund investors or shareholders other than the holders of the carry have received an amount equal to the invested capital hurdle.

If the repayment subordination condition is met, the new regime is applicable to both reimbursements and disposals of eligible instruments.

Only the carried interest must be subordinated in order to satisfy the regime.

Holding Period

A minimum holding period of five years must be met, during which all financial instruments held by Managers comprising the 1% investment threshold must be held. Hence, the holding period requirement also applies to ordinary units or interests issued by C.I.U.'s, companies, and entities and held by all carry holders. If a securities disposal occurs before the five-year period ends, the regime will not apply.

The Circular clarifies that the five-year holding period will be determined starting from the end of the subscription period for C.I.U.'s or on the date of subscription of the capital injection for entities other than C.I.U.'s.

In the event of the death of the employees or administrators, the balance of the five-year holding period requirement must be met by the heirs. Moreover, in the case of a securities disposal that triggers a "change of control" during the five-year holding period, the carried interest regime continues to be applicable. However, in the case of a transfer of the units or interests within the five-year period, such as by a change in members of the management team, a new holding period begins from the date of the change of ownership.

The holding period condition does not mandate that the distribution of carried interest proceeds be deferred until the end of the holding period. Indeed, the carried interest can be effectively received by the Managers within the five-year holding period provided that the financial instruments are held for the minimum period required.

OTHER CLARIFICATIONS

If all the foregoing requirements are met, the income received by the Managers is treated as financial income, irrespective of any connection to employment activity provided to the company, entity, or C.I.U. (or to related or controlled entities). On the other hand, if the conditions are not met, the carried interest is not automatically treated as employment income for tax purposes.

The Circular also provides important comments on the treatment of carried interest proceeds in the case any of the conditions are not met. In particular, it clarifies that carried interest could continue to be treated as financial income provided that it is not actually used to remunerate an employment or self-employment activity carried out by the Manager and highlights facts to consider when classifying the carried interest as employment income or financial income. For such purposes, a carried interest may generally fall within the category of financial income if the following facts are present:

- Managers' interests are aligned with investors' interests
- Managers bear the actual risk of loss of the invested capital
- Managers and other investors hold the same financial instruments with special economic rights (*i.e.*, securities with special economic rights are not reserved to Managers)

In contrast, the carried interest may be classified as employment income where the following facts are present:

- Arrangements exist distinguishing between good departures, such as termination other than for cause, and bad departures, such termination for cause or early resignation, unless they are mitigated by other circumstances.
- Managers' investment risks are neutralized (*e.g.*, clauses that guarantee Managers total reimbursement of invested capital).
- Managers receive compensation below market standards.

The Circular clarifies that the possibility for the holders of the carry to retain ownership of the units or interests even after a departure may be considered sufficient proof of the financial character of the instrument, even if none of the conditions set by the Decree are met.

In any case, under such circumstances, the carry holders may submit a ruling request to the Italian Tax Authorities in order to confirm the tax treatment of their carried interest schemes.

The new provisions apply to income realized on or after April 24, 2017. Investment plans approved as of April 24, 2017, may be amended in order to benefit from the new rules.

DOING BUSINESS POST-BREXIT: WHAT TO EXPECT IN THE UNITED KINGDOM

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U.K.

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BREXIT – A BRIEF REVISIT

The U.K. is firmly on course to leave the E.U., with a target date of March 29, 2019. Several U.K. and E.U. figures are backing the idea of a "transition" period, of around two years thereafter, to facilitate smooth implementation of the final Brexit deal and minimize disruption to businesses, tourists, and the like.

The terms "soft" and "hard" Brexit are often used in the debate over the terms of the departure from the E.U. While there is no strict definition of either, they refer to the closeness of the U.K.'s relationship with the E.U. post-Brexit. At one extreme, "hard" Brexit could involve the U.K. refusing to compromise on issues like the free movement of people, even if it meant leaving the single market. At the other end of the scale, a "soft" Brexit might follow a path similar to that of Norway, which is a member of the single market and must accept the free movement of people.

Politics aside, E.U. and U.K. negotiators have taken steps in recent months toward reaching agreements in principal regarding several contentious issues.

WHERE IS THE PROCESS TODAY?

After a difficult first 18 months since the U.K.'s decision to leave, three important "divorce" issues have been settled or addressed in a deal signed in December 2017.

- How much the U.K. owes the E.U. (the "Exit Payment")?
- What happens to the Northern Ireland border?
- What happens to U.K. citizens living elsewhere in the E.U. and E.U. citizens living in the U.K.?

<u>The Exit Payment</u>

In a joint agreement between the U.K. Treasury and the E.U.'s chief Brexit negotiator Michel Barnier that was reached in December 2017, the U.K. government confirmed that it is committed to paying a "divorce bill" totaling between £35 billion and £39 billion (approximately $47 billion to $53 billion). This will cover Britain's obligations to the E.U. "outstanding at December 31, 2020."

The final amount is unlikely to be known for many years, as it depends on items such as future pensions and development projects. Government backbenchers have sought assurances that the payment will be contingent upon the agreement of a suitable outcome on future trade negotiations. However, Chancellor of the Exchequer Phillip Hammond has intimated that Britain will honor its commitment irrespective of any trade deal with the E.U. Consequently, it is anticipated that amounts due will be payable on the dates that would have applied if the U.K. remained an E.U. Member State.

Nonetheless, the U.K. government has commissioned the National Audit Office to investigate the basis of the divorce bill, with instructions to pay particular attention to the assumptions and methodologies used to calculate the amount due.

Northern Ireland

Another stumbling block has been the fate of the border between Northern Ireland, which is part of the U.K., and the independent Republic of Ireland. Post-Brexit, it will be the only land border between the U.K. and the E.U.[1] This is a point not resolved but is more aptly described as "shelved for now."

With the U.K. as a member of the E.U., both the Republic of Ireland and Northern Ireland belong to the E.U. single market and customs union. They share the same regulations and standards, allowing for a soft or invisible border between the two jurisdictions. Britain's exit from the E.U. risks a return to a hard border that will be policed, unless both sides retain their present positions in key areas including food, animal welfare, prescription drugs, and product safety.

Early drafts of the agreement between the U.K. and the E.U. called for "no divergence" from E.U. rules that support north-south cooperation. However, this was later changed to "continued alignment," a formulation that appears to allow for subtle divergences.

The new terminology raised questions about who would oversee the border and how disputes might be resolved. It was also too far a step towards a hard border for soft border proponents in the D.U.P. (the Democratic Unionist Party of Northern Ireland), who are currently propping up Theresa May's minority government. This gives the D.U.P. an effective veto on Brexit matters.

Neither the Republic nor Northern Ireland wants a hard border. Trade and other links between the two jurisdictions are extremely close.

The British government has two stated ambitions which appear contradictory – leaving the E.U. single market and customs union while having no hard border.

For now, the question of the north-south border remains tenuous. Non-U.K. businesses may, on the optimistic side, view the Republic as the easiest post-Brexit trade portal into the U.K., if indeed there is some form of a soft border. Outside the Republic of Ireland, the E.U. is likely to have a different view of how that border should look.

Citizens' Rights

The December deal guarantees reciprocal protected rights, post-Brexit, to the three million E.U. citizens currently living in the U.K. and to the more than one million U.K. nationals living in the E.U. A joint document issued by the E.U. and the U.K. states that both U.K. nationals and E.U. citizens can continue "to live, work and study as they currently do under the same conditions as under EU law." The document also

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[1] The border between Gibraltar and Spain has some of the same characteristics but Gibraltar is not part of the U.K. per se.

re-affirms free rights of movement until March 29, 2019, or the actual date on which the U.K. leaves the E.U.

Any E.U. citizen who is in the U.K. on Brexit Day will have the right to remain in the U.K., even if he or she arrives in the U.K. only one day before. Those not yet granted permanent residence in the U.K. will have their rights protected, so they can still acquire permanent residence after Brexit Day. The deal also includes re-unification rights for relatives of E.U. citizens not presently living in the U.K. These rights extend to future spouses or partners of E.U. citizens.

E.U. citizens living in the U.K. will have their rights enshrined in U.K. law and enforced by British courts. The process for giving E.U. citizens residency rights in the U.K. will fall under a new procedure known as settled status. The European Court of Justice will also have jurisdiction over these rights for eight years after Brexit Day. E.U. citizens will enjoy equal access to social security, healthcare, education, and employment. However, they could lose their residence rights if they remain outside the U.K. for five years or more.

U.K. citizens living elsewhere in the E.U. before Brexit Day will have the right to remain in their E.U. Member State of residence. They will be entitled to equal treatment regarding social security, healthcare, employment, and education. However, their freedom of movement will be limited as they will not be able to freely relocate to another E.U. Member State without first applying for a passport in their E.U. country of residence.

Certain rights of U.K. nationals after Brexit Day are currently unclear. These include the absolute rights to move to another E.U. country, work cross-border in the E.U., and receive free emergency medical treatment. Decisions on these items have been deferred to the second round of negotiations.

WHAT HAPPENS NOW?

Unpicking 43 years of treaties and agreements covering thousands of different subjects was never going to be a straightforward task. It has not been done before on this scale, and negotiators will be making the rules as they go along. The post-Brexit trade deal is likely to be the most complex part of the negotiation because it will require the unanimous approval of more than 30 national and regional parliaments across Europe, some of whom may want to hold referendums.

It is worth citing the C.E.T.A. (Comprehensive Economic and Trade Agreement) experience here. This treaty between Canada and the E.U. took seven years to conclude and nearly fell apart with the finish line in sight when the regional parliament of the Belgian province of Wallonia demanded a concession before giving their eventual consent. In the case of C.E.T.A., two areas of local concern jeopardized the approval process. These were use of arbitration panels rather than courts and concern that the treaty could be used as a backdoor entry to the E.U. for U.S. farmers and U.S. farm goods. The former was deleted from the treaty and the latter was addressed by the adoption of stringent standards for Canadian products to prevent indirect competition from the U.S. This illustrates the tenuous and fragile nature of negotiating a trade deal agreement, as it likely will be exclusive more than inclusive in its reach.

Talks are now addressing trade between the U.K. and E.U. after Brexit. These talks are likely to focus on the terms for a “transition period” of two years or so to smooth the change in relations.

Prime Minister May says leaving the E.U. with no deal would be better than signing the U.K. up to a bad one. Without an agreement on trade, the U.K. may have to resort to operating under World Trade Organization (“W.T.O.”) rules, which could mean customs checks and tariffs on goods as well as longer border checks for travelers. This raises the question of which is more valuable: time and inconvenience costs of no deal or lost revenue arising from a bad deal.

There are questions about Britain’s current position as a global financial center, and the U.K.-Ireland border issue likely will fester.

OUTLOOK FOR U.S. BUSINESSES

The big unknown is negotiation of a trade agreement between the U.S. and the U.K. Presently, the E.U. and the U.S. have the largest bilateral trade and investment relationship and enjoy the most integrated economic relationship in the world. When the U.K. quits the E.U., it will not be part of these arrangements, and the terms of a new relationship must be hammered out with the U.S.

The key body in all of this is the W.T.O. Until Brexit Day, the U.K. is a member via its membership in the E.U. The U.K. will automatically become a member in its own right as soon as it leaves the E.U. Until a new trade deal with the E.U. is reached, trade will be conducted under W.T.O. rules after Brexit Day.

The U.K. is glancing anxiously across the Atlantic at how the U.S. will react to Brexit. President Obama, during his time in office, said the U.K. would need to go “to the back of the line” in trade discussions with the U.S. President Trump appears to have taken a contrary view. The new U.S. ambassador to the U.K., Woody Johnson, insisted the special relationship between the two countries will remain as strong as ever once Britain leaves the E.U. He has stated that the U.K. would always have a “strong and reliable trade partner” in the U.S. regardless of the outcome of Brexit and insisted the ties would not be harmed. “Our position on Brexit is clear. We want a strong and prosperous UK to remain a leader in Europe, and we want both the UK and the EU to remain strong leaders globally.” In comparison to the former president, Mr. Johnson said, “As far as the president is concerned, the United Kingdom, our most enduring ally, is always at the head of the line.” Mr. Johnson also added that the “lure” of working with Britain remains the same today as when his grandfather chose the U.K. to establish the company’s first overseas subsidiary, over 100 years ago. He added:

> Our countries are among each other’s largest inward investors. Americans and Brits hold roughly one trillion dollars of investment and employ approximately one million people in each other’s countries — jobs that have increased prosperity and opportunity in all four countries of the United Kingdom and in every American state.

The British government is confident that it will procure a trade deal with the E.U., taking the best elements of deals the E.U. has already concluded with Canada, Japan, and South Korea as examples.

QUO VADIS THE U.K. POST-BREXIT TAX REGIME?

V.A.T., Customs Duties, and Other Indirect Taxes

V.A.T. is chargeable on most goods and service supplies within the E.U. The law is fairly harmonized, although Member States have a degree of discretion over rates and collection methods. In addition, the U.K. has been granted derogations (a European term for exceptions) allowing the zero-rating of certain classes of goods. Customs duties on imports into the single market are also harmonized, and E.U. law prevents taxes being levied on the raising of capital. Indeed, a past attempt to impose a stamp duty charge on certain share issues in the U.K. was ruled contrary to E.U. law.

A departure from the E.U. will simultaneously restore the U.K.'s sovereignty over tax-setting while access to the single market will be limited. Thus, the U.K. will gain the power to overhaul its tax system but its global businesses will become subject to E.U. customs duties unless a beneficial customs arrangement is negotiated.

In one scenario, not much may change. V.A.T. forms a sizeable part of the U.K. government's tax intake and there will be little benefit in deviating significantly from the existing, E.U.-derived system, save perhaps creating further exemptions or rates for particular classes of goods. If the U.K. joins the European Free Trade Association, like Norway or Switzerland, it will benefit from a special customs procedure that suspends customs and excise duties and V.A.T. on goods that pass through the U.K. to an E.U. destination. Further tax reliefs could be negotiated via bilateral trade agreements. The U.K. tax authorities will have more freedom to apply transfer duty to certain share issues, but moves of this kind are unlikely from a practical perspective and would be seen as counter-productive to new investment.

"The U.K. will gain the power to overhaul its tax system but its global businesses will become subject to E.U. customs duties unless a beneficial customs arrangement is negotiated."

In another scenario, there will be no V.A.T.-free trading area between the U.K. and the remaining Member States. Customs duties may be imposed as goods move between the U.K. and the E.U. This would inevitably bring with it increased paperwork, delays and additional administration.

Until a trade deal is reached, the W.T.O. trade rules will apply. The likely result is higher import duty rates and increased import V.A.T. on imported goods as V.A.T. is calculated on the duty-inclusive value of imports.

Direct Taxes: Company Profits and Capital Gains

Brexit Day will mark the end of the U.K.'s obligations and rights under various E.U. laws designed to reduce the burden of direct tax for companies doing business across the single market. The Parent-Subsidiary Directive simplifies profit distributions between E.U. group companies by preventing double taxation and abolishing withholding taxes on dividend payments. The Mergers Directive simplifies the reorganization of groups based in more than one E.U. Member State, while the Interest and Royalties Directive removes withholding taxes on intra-E.U. interest and royalty payments between associated companies. All of these directives are enacted via legislation that, from the U.K. side, is likely to remain in place post-Brexit. Additionally, tax treaties have a significant crossover with some of these rules and will remain in place post-Brexit. However, as these tax rules will over time diverge from E.U. rules, taxation will inevitably become more complex and burdensome for M.N.E.'s that have group companies in both the U.K. and E.U. The U.K. will also lose its protection against discriminatory tax measures being imposed by E.U. Member States, putting it at risk of a tougher commercial environment and eroding the strategic benefit for investors of locating intermediate holding companies in the U.K. The U.K. will be free, in turn, to amend its direct tax legislation to create a more competitive environment. But substantial divergence from the E.U. system might make the U.K. less attractive to inward investors and reduce its leverage in negotiations with the E.U., so is unlikely to happen. Further, an emphasis on global trade, rather than European trade, will ease burdens to some degree.

There are proposals within the E.U. to consolidate corporate taxes further. A proposed Anti-Tax Avoidance Directive was agreed on June 21, 2016 and the E.U.'s proposed consolidated corporate tax base has reared its head again. The U.K. is generally against such further integration, so leaving the E.U. will have a potential benefit in this respect. The reality is, however, that most U.K. groups either have substantial interests in other E.U. Member States or trade with such states. E.U. measures will therefore continue to have relevance after Brexit.

The U.K.'s 19% corporation tax rate (with the government's stated intention to reduce it further in April 2020 to 17%) is the lowest among the G-20 nations. The U.K. also has a favorable holding company regime. It boasts the world's most extensive Double Tax Agreement network with dividends paid by underlying non-U.K. subsidiaries subject to, in many countries, nil or reduced withholding taxes. Dividend income received by U.K. companies is generally tax-free. And lastly, on the subject of dividends, these are paid out by a U.K. company free of any U.K. withholding tax to shareholders anywhere in the world, be they companies, trusts, foundations, or individuals. Additionally, U.K. holding companies benefit from favorable capital gains tax legislation for companies wishing to divest themselves of subsidiaries (the "Substantial Shareholding Exemption"). In most instances, this results in a zero-tax bill on the gain on disposal.

LIKELY UPSIDES

Although Brexit brings much uncertainty, there are potential positives:

- The U.K. is a member of the G-20, O.E.C.D., and W.T.O. independently from its membership in the E.U. It will thus continue to be a party to Double Tax and other agreements that have their basis in these international organizations. Indeed, a departure from the E.U. will give the U.K. more freedom over the method and pace of its implementation of the O.E.C.D.'s B.E.P.S. project, and other large-scale harmonizing initiatives.

- E.U.-wide measures can make Member States less competitive and create dual levels of accountability (*e.g.*, the proposed Anti-Tax Avoidance Directive, which includes a General Anti-Abuse Rule requiring Member States to meet certain minimum anti-abuse requirements). The U.K. has objected to proposals to harmonize corporation tax rules (the Common Consolidated Corporate Tax Base) and to introduce a new investor-state dispute resolution system (the Investment Court System), which would apply to all future E.U. agreements. If investors balk at measures of this kind, the U.K. might be viewed as an attractive host state by virtue of no longer being subject to them.

IN CONCLUSION

Much water remains to flow under the Brexit bridge. Hence, it is difficult to prognosticate life after Brexit Day. Any advice given will undoubtedly be driven by whether a hard or soft Brexit is likely to occur. The signs right now suggest that a soft Brexit is the more likely scenario, but the scenario can change overnight.

The conclusion of a favorable trade deal with the E.U. will be a major driver. Both the E.U. and the U.K. stand to gain from continuing the mutually beneficial trading environment, and there is significant interdependence that benefits both sides of the English Channel. A good example is the motor industry. Britain assembles several well-known car models, and in doing so, many parts are imported from the E.U. Will the U.K. government really seek to charge V.A.T. and duties on such parts, thereby making the cars more expensive to sell and putting a significant number of jobs at risk? Will the E.U. impose duties on the importation of such cars from the U.K. by E.U. distributors?

Equally important, will a post-Brexit world bring with it a more benign or more complex business environment in the U.K.? Will the banks desert the U.K. as a major world financial center, accompanied by the exit of many high earning executives taking their tax payments to other countries? What about Scotland, which voted in to remain in the E.U.? It is now faced with a Brexit it doesn't want, and its first minister has campaigned vigorously for Scotland's right to retain post-Brexit access to the E.U. single market. ("If a special case can be made for Northern Ireland, why not for us?")

Finally, petty local interests may intervene, attempting to stake out non-competition areas regarding certain parts of trade. Farmers, dairies, and energy are notable examples. They may also demand mandatory use of forums in home countries to resolve trade disputes.

There are so many questions and unknowns. The best advice for now, to those businesses considering the U.K. as a trading or investing partner, may well be to refrain from making any knee-jerk decisions, to keep a close watch on developments, and to act soonest thereafter. Basing a business decision on tenuous assumptions now may lead to a discovery that that the assumptions were groundless and prove to be unnecessarily expensive. On the other hand, missing the boat to relocate a business close to a market may itself be expensive if the lost opportunity cannot be regained.

While this may reflect a certain amount of fence-sitting, it may prove better in the long run than coming down irretrievably on the wrong side.

A NEW DEFINITION OF PERMANENT ESTABLISHMENT IN ITALIAN DOMESTIC INCOME TAX LAW

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B.E.P.S.
Italy
Permanent Establishment

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Effective January 1, 2018, Italy's 2018 Budget Law[1] significantly amended the domestic definition of permanent establishment ("P.E.") and implemented certain O.E.C.D. guidelines set forth under B.E.P.S. Action 1 (Addressing the Tax Challenges of the Digital Economy) and Action 7 (Preventing the Artificial Avoidance of P.E. Status). The law revised the definitions of both the "Fixed Place P.E." and the "Agency P.E.," by amending the text of Article 162 of the Italian Income Tax Code ("I.I.T.C.").

As regards the Fixed Place P.E., the main changes are (i) the introduction of a new item in the list of cases that are presumed to constitute a Fixed Place P.E., (ii) the modification of the specific activity exemption, (iii) the repeal of Art. 162 (5) of the I.I.T.C. regarding electronic equipment, and (iv) the introduction of an anti-fragmentation rule.

The Agency P.E. rules were changed in compliance with B.E.P.S. Action 7 recommendations concerning *commissionaire* arrangements.[2]

THE OLD RULES

Prior to the 2018 Budget Law, the definition of P.E. for Italian income tax purposes – contained in Article 162 of Presidential Decree no. 917 of 22 December 1986 (I.I.T.C.) – was modelled on the current O.E.C.D. Model Tax Convention definition.

Fixed Place P.E.

For the purposes of Corporate Income Tax ("I.R.E.S.") and Regional Tax on Productive Activities ("I.R.A.P."), Italian domestic tax law defined a P.E. to be a fixed place of business through which the business of a nonresident enterprise is wholly or partly carried on in Italy (a Fixed Place P.E.).[3]

Certain fixed places of business were presumed to constitute a P.E. in Italy, unless the taxpayer could provide evidence to the contrary:

- A place of management
- A branch
- An office

1 Law No. 205 of 27 December 2017.

2 See, in detail, "O.E.C.D. Issues Proposed Changes to Permanent Establishment Provisions Under Model Tax Convention," *Insights* 9 (2017).

3 Art. 162 (1) of the I.I.T.C.

- A factory
- A workshop
- A mine, an oil or gas well, a quarry or other place for the extraction of natural resources[4]

On the other hand, a fixed place of business was not deemed to be a P.E. in Italy if it was used only to perform certain preparatory or auxiliary activities. These exempt activities included the following:

- The use of an installation solely for the purpose of storage, display, or delivery of goods belonging to the enterprise
- The maintenance of a stock of goods belonging to the enterprise solely for the purpose of storage, display, or delivery
- The maintenance of a stock of goods belonging to the enterprise solely for the purpose of processing by another enterprise
- The maintenance of a fixed place of business solely for the purpose of purchasing goods or collecting information for the enterprise
- The maintenance of a fixed place of business solely for the purpose of carrying on any other preparatory or auxiliary activity for the enterprise
- The maintenance of a fixed place of business solely for any combination of the activities indicated above, provided that the overall activity of the fixed place of business, resulting from this combination, is of a preparatory or auxiliary nature[5]

In addition to the exceptions listed above, the rules provided that the maintenance of electronic processors and auxiliary equipment used for the collection and transfer of data and information for the purpose of selling goods and services did not, by itself, constitute a P.E.[6] This provision was intended to clarify that the mere ownership and use of a server or similar equipment in Italy did not constitute a P.E.

Agency P.E.

In comparison to the lists of conditions that constitute or preclude the existence of a Fixed Place P.E. in Italy, the old rules provided that a person that habitually concludes contracts in Italy in the name of a nonresident enterprise was deemed to be a P.E. of the nonresident enterprise (an Agency P.E.).[7] One exception was provided when the person's activity was limited to the purchase of goods. Another exception was provided when the person concluding contracts in Italy was a broker, general commission agent, or any other agent of an independent status. Such persons did not constitute a P.E. when they would act in the ordinary course of a business that was carried on independently in Italy.[8]

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4 *Id.*, Art. 162 (2).

5 *Id.*, Art. 162 (4).

6 *Id.*, Art. 162 (5).

7 *Id.*, Art. 162 (6).

8 *Id.*, Art. 162 (7).

THE NEW RULES

The "Digital P.E." as a Fixed Place P.E.

The 2018 Budget Law introduced a new concept of Fixed Place P.E. enacted in the context of tax measures for the digital economy. In time, the new definition may impact other businesses as well.

> ***"A fixed place of business will not constitute a P.E. if the taxpayer can prove that any and all activities – and not only their combination as under the old rule – have a preparatory or auxiliary nature."***

Under the amended text of Art. 162 (2) of the I.I.T.C., a foreign entity's significant and continuous economic presence in Italy may constitute a fixed base that could give rise to an Italian P.E. even if it does not result in a substantial physical presence.

This new P.E. definition is based on the nexus rules proposed for the digital economy by B.E.P.S. Action 1 and, in particular, on the notion of "significant economic presence," so that nonresident digital companies can trigger taxable presence in a country in ways that are not uncommon in the digital economy. These include (i) the earning of revenues from customers situated in the country, (ii) the presence of a local digital platform, (iii) the frequency of digital transactions, and (iv) the number of users.

At the same time that this new Digital P.E. concept was introduced into law, Italy introduced a Web Tax, designed to be an alternative to the income tax that applies when a foreign company does not have an Italian P.E. The Web Tax is a 3% tax on the amount realized (net of V.A.T.) for digital services supplied electronically. It will apply as of 2019 to services supplied by resident and nonresident taxpayers that carry out more than 3,000 digital transactions in a calendar year and will be levied on the recipient of the services such as Italian business taxpayers but not private individuals.

As consequence of the introduction of this new regime, Art. 162 (5) of the I.I.T.C. on servers as Fixed Place P.E.'s became redundant and was repealed.

The Specific Activity Exemption for Fixed Place P.E.'s

The list of exempting activities has been rephrased to provide that a fixed place of business will not constitute a P.E. if the taxpayer can prove that any and all activities – and not only their combination as under the old rule – have a preparatory or auxiliary nature with respect to business of the foreign entity. The amendment applies to any business activity. It may be particularly relevant for digital enterprises based abroad that maintain a stock of goods in Italy to provide prompt delivery to customers. As a consequence, the maintenance of a local warehouse and the storage of goods in the warehouse might be regarded as a core activity for digital enterprises focused on retail purchases. For these businesses, storage would not fall within the preparatory and auxiliary exemption.

The Anti-Fragmentation Rule in the Definition of Fixed Place P.E.

The 2018 Budget Law introduced the so-called anti-fragmentation rules – proposed in B.E.P.S. Action 7 – aimed at preventing foreign companies from splitting up a business into smaller units or using other related legal entities or P.E.'s to benefit from the preparatory or auxiliary exemption. In substance the new rules are designed to take into account not only the activities carried on by the same enterprise at different locations but also of the activities carried on by closely related enterprises at the same or different locations.

To this end, the new Art. 162 (5) of the I.I.T.C. now provides that the specific activity exemption shall not apply to a fixed place of business that is used or maintained by the foreign enterprise if certain conditions are met:

- The same enterprise or a closely related enterprise carries on business activities at the same location or another location in the Italian territory.
- The location(s) constitutes a P.E. for either enterprise under the provisions of Art. 162 of the I.I.T.C., or the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the enterprise(s) at the two locations, are not of a preparatory or auxiliary character.
- The business activities carried on by the two enterprises at the same place, or by the enterprise(s) at the two locations, constitute complementary functions that are part of a cohesive business operation.

Though this new provision will bring more clarity in applying P.E. identification rules, it is worth highlighting that Italian case law already applied an anti-fragmentation approach. The Italian Supreme Court Decision No. 20597 of 7 October 2011 ruled that it is irrelevant whether activities are carried out in Italy via several distinct entities, rather than by a single entity, for the purpose of ascertaining whether nonresident parent companies have a P.E. in Italy. Instead, the determination will be made by reference to facts and circumstances demonstrating whether the entities carried on business as parts of an economically integrated unitary structure that achieved an overall business purpose of the group with regard to activities in Italy.

The New Definition of Agency P.E.

Under the new Art. 162 (6) of the I.I.T.C., a P.E. is deemed to exist when a person acts in Italy on behalf of a foreign enterprise, and in so doing, habitually concludes or is involved in the conclusion of contracts that are routinely approved by the foreign company without material changes. Contracts covered by the new rule must be either (i) in the name of the enterprise, (ii) for the transfer of ownership or the right to use property owned or used by the enterprise, or (iii) for the provision of services by that enterprise.

In such cases, an Italian P.E. is deemed to exist unless the activities performed under the contract signed by the person acting in Italy on behalf of the foreign enterprise are limited to exempt activities described above. Consequently, agreements that are negotiated and signed by a person that are not binding until accepted abroad will be attributed to a P.E. and taxed in Italy as if the contract were legally binding prior to acceptance abroad.

New Art. 162 (7) of the I.I.T.C. provides an exception to the P.E. rule when the person acting in Italy on behalf of a foreign enterprise carries on its own business in Italy as an independent agent and acts for the enterprise in the ordinary course of that business. Note, however, that where a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person will not be considered to be an independent agent with respect to any such enterprise.

For the purposes of identifying an independent agent, a person is considered closely related to an enterprise if, based on all the relevant facts and circumstances, one controls the other or both are under common control of a third person or enterprise. In any event, the requisite degree of control will exist when (i) one person or enterprise directly or indirectly possesses more than 50% of the beneficial interest in the other or, in the case of a company, more than 50% of the aggregate vote and value of the issued and outstanding share capital; or (ii) another person directly or indirectly possesses more than 50% of the beneficial interests in both persons or enterprises or, in the case of a company, more than 50% of the aggregate vote and value of the share capital in both companies.

Ultimately, these changes to the Agency P.E. definition may not have a material impact on Italian business and administrative practices, since existing Italian case law contains a broad interpretation of the Agency P.E. concept. The most relevant judicial case is *Phillip Morris*,[9] where the Supreme Court affirmed, *inter alia*, the following principles:

- The participation of officers or representatives of an Italian company in phases of the negotiation or conclusion of contracts on behalf of a related company abroad constituted an Agency P.E. even if it was not granted a formal power of representation. If, under a formal grant of authority, other nonresident companies would ordinarily execute the function of the controlled Italian company, an inchoate grant of authority would be deemed to exist, resulting in an Agency P.E. in Italy. In this respect, the Court observed that the Italian company was not acting in the ordinary course of its business when providing services to related nonresident companies that were not included in its statutory business purpose and were performed without any formal mandate by the nonresident group companies.
- A national structure carrying on management of business transactions for the benefit of a nonresident company should be deemed to constitute a P.E. in Italy, even though only one area of the nonresident's business was managed by the domestic structure.
- Factors indicating the existence of a P.E. in Italy, including dependence and the authority to conclude contracts, should be assessed on the basis of the substance rather than exclusively on the basis of the mere legal form of the business transactions.
- A company situated in Italy may be deemed to be a P.E. of multiple foreign companies within the same group that pursue a common business strategy. In such instances, the nature of the activities performed in Italy will be assessed in light of the common business strategy of the group. In the view of the Court, regardless of the relationship between the Italian company and each single nonresident group company, the Italian company would be viewed to act in Italy for the benefit of the whole group. The legal and contractual relationships between the various group companies with reference to the activities performed in Italy should not be analyzed separately but should rather be considered as a whole.
- Group companies that are subject to a unified strategy aimed at maximizing

[9] Supreme Court judgments 3367, 3368, and 3369 of 7 March 2002; 431926 of 26 March 2002; 7682 and 7689 of 25 May 2002; 10925 of 22 September 2002; and 17373 of 6 December 2002.

> Italian profits for all nonresident companies involved have an Agency P.E. in Italy, and it is misleading to consider each fragment of the strategy separately. The Court referred to the wording of Paragraph 24 of the Commentary to Article 5 of the O.E.C.D. Model Income Tax Treaty, stating that a domestic structure could act as management office of the group in a way that has international ramifications.[10]

As a reaction to this interpretation, the O.E.C.D. amended the Commentary on Article 5 in 2005; however, Italian representatives at the O.E.C.D. inserted the following observation, "*Italy wishes to clarify that, with respect to paragraphs 33, 41, 41.1 and 42, its jurisprudence is not to be ignored in the interpretation of cases falling in the above paragraphs . . .*" Therefore, notwithstanding the fact that under Italian income tax law and constitutional law tax treaty provisions take precedence over Italian domestic provisions when they are more favorable to the taxpayer, Italian judicial interpretations of Agency P.E. override tax treaty provisions on a *de facto* basis.

ADVANCE RULINGS REGARDING AN ITALIAN P.E.

Because the Italian Tax Authorities quite aggressively audit the Italian operations of M.N.E.'s, it is advisable for an M.N.E. to seek advance clearance from the Italian Tax Authorities on the existence of and profit attribution to an Italian P.E. Several ruling procedures are available. Included are (i) advance tax rulings for international companies and (ii) advance tax rulings on new investments. The latter is reserved for investment projects with a significant impact on employment levels and worth at least €30 million. It would be shameful for management of an M.N.E. to invest substantial funds in Italy only to find out retroactively that a newly formed Italian subsidiary caused various group members to have a P.E. in the country.

[10] In the view of the Court, the domestic structure exercised "supervisory and coordinating functions for all the departments of the enterprise located within the region concerned."

INDIA BUDGET 2018-19

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Tags
Budget
Business Connection
Capital Gains
India
Investment Activity
Tax Policy

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INTRODUCTION

All eyes were set on the Indian Finance Minister on February 1, 2018, as he unveiled the Union Budget for 2018-19 ("Budget 2018-19"). In addition to its several important direct tax proposals, Budget 2018-19 is notable as the last full budget before the 2019 Parliamentary elections and the first budget following the implementation of the landmark Goods and Services Tax ("G.S.T.") regime. Along with proposed amendments to the tax law, Budget 2018-19 also included key economic data from the annual economic survey and policy proposals.

DIRECT TAX

The direct tax proposals discussed below are effective from financial year ("F.Y.") 2018-19 (*i.e.*, April 1, 2018, to March 31, 2019). These provisions will be introduced in the Income-Tax Act, 1961 (the "Act") and, consequently, afforded legal authority.

Tax Rates

The basic tax rate for foreign companies remains unchanged at 40%. However, for domestic companies, the corporate tax rate will be reduced to 25%, if the turnover or gross receipts of such companies in F.Y. 2016-17 does not exceed I.N.R. 2.5 billion (approximately $40 million).

In all other cases, the income tax rate remains unchanged at 30%. The education cess on income tax and the secondary and higher education cess on income tax (which amount to 3% in the aggregate) will be discontinued. A new "Health and Education" cess will be levied at 4% of income tax including surcharge, wherever applicable.

In view of these proposed amendments, the maximum tax rates for certain taxpayers for F.Y. 2018-19 are as follows:

Taxpayer	Maximum Marginal Rate (Including Surcharge and Cess)
Individual	35.88%
Partnership Firm/Limited Liability Partnership ("L.L.P.")	34.94%

[1] Tax rate is 29.12% (including surcharge and cess) if the turnover or gross receipts of the domestic company in the F.Y. 2016-17 does not exceed I.N.R. 2.5 billion.

Taxpayer	Maximum Marginal Rate (Including Surcharge and Cess)
Domestic Company	34.94% or 29.12%[1]
Foreign Company	43.68%

Accordingly, the maximum marginal tax rate for foreign companies will increase from 43.26% to 43.68%.

Under the Budget 2018-19 provisions, the Minimum Alternate Tax ("M.A.T.") will not apply to foreign companies engaged in the business of, *inter alia*, shipping, aviation, mining, or civil construction and whose income is computed on presumptive basis.[2]

This proposal will be retroactively effective from April 1, 2000.

"The Budget 2018-19 reintroduced a 10% tax (repealed in 2004) on certain long-term capital gains."

Business Connection

With a view to align the definition of "Business Connection" – the domestic equivalent of a permanent establishment under the tax treaties – with the O.E.C.D.'s B.E.P.S. recommendations, its scope will be widened to include (i) persons who habitually conclude contracts, or play the principal role in concluding contracts, for a nonresident and (ii) nonresidents having significant economic presence.

A significant economic presence would mean transactions in respect of any goods, services, or property carried out by a nonresident in India, including providing downloading of data or software in India if the aggregate payments from such transactions exceed a specific threshold which will be subsequently prescribed. Further, it would also include systematic and continuous soliciting of business activities or engaging in interaction with such number of users in India through digital means, as may be subsequently prescribed.

Significant economic presence may be triggered whether or not (i) the nonresident has a place of business in India, (ii) the nonresident renders services in India, or (iii) the agreement for such transactions or activities is executed in India. Further, income would be taxed in India only to the extent of income attributable to the above transactions or activities in India.

This proposal is enacted despite the fact that work under B.E.P.S. Action 1 is still under way and is meant to be in the nature of an enabler to facilitate negotiation for further amendments in India's tax treaties.

Long-Term Capital Gains on the Sale of Stock and Units

The Budget 2018-19 reintroduced a 10% tax (repealed in 2004) on certain long-term capital gains ("L.T.C.G.'s"). The tax will be imposed on L.T.C.G.'s exceeding I.N.R. 100,000 (approximately $1,500) arising from the transfer of (i) equity shares in a listed company, (ii) units of an equity-oriented mutual fund, or (iii) units of a business trust. The 10% tax is a concessional rate available if Securities Transaction Tax ("S.T.T.") has been paid on the acquisition and transfer of equity shares in a

[2] Under the presumptive taxation scheme, a taxpayer is allowed to declare income at a prescribed rate defined under the Act and, in turn, is exempt from maintaining books of account and also from getting the accounts audited.

company or on the transfer of units of an equity-oriented mutual fund or a business trust. Otherwise, L.T.C.G.'s will be taxed at 20%.

The requirement to pay S.T.T. does not apply when a transfer is undertaken on a recognized stock exchange located in any International Financial Services Center ("I.F.S.C.")[3] nor where consideration is received in a foreign currency.

In the case of a capital asset acquired before February 1, 2018, the cost of acquisition will be deemed to be the higher of the following:

- The actual cost of the acquisition
- The lower of the fair market value ("F.M.V.") and the full value of consideration received or accruing as a result of the transfer

The F.M.V. of a listed capital asset is the highest price quoted on the stock exchange on January 31, 2018. In the case of unlisted capital assets, the F.M.V. is the net asset value on January 31, 2018.

The benefit of indexation, in the case of residents, and foreign currency variation, in the case of nonresidents, will not be considered in computing L.T.C.G.'s. This provision will also be applicable to Foreign Institutional Investors ("F.I.I.").[4] However, relief will be available where there is a favorable tax treaty. The benefit of indexation will be allowed in the following cases:

- Equity shares not listed on a stock exchange on January 31, 2018, but listed at the time of transfer
- Equity shares listed on a stock exchange at the time of transfer but acquired as consideration for shares that were unlisted on January 31, 2018, where such transaction does not amount to a transfer

The above amendments will be effective from April 1, 2018.

Income Computation and Disclosure Standards

In 2015, the government established ten tax accounting standards – known as the Income Computation and Disclosure Standards ("I.C.D.S.") – for computing taxable income under the categories "Profits and Gains of Business or Profession" or "Income from Other Sources." However, certain I.C.D.S. provisions were rejected by the Delhi High Court in a recent ruling.

To provide requisite legislative support for these measures, the Act will be amended in the following ways:

- A deduction will be allowed for marked-to-market loss or other expected loss as computed under the I.C.D.S.

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3 An I.F.S.C. is a financial center that provides financial services to nonresidents and residents, to the extent permissible under the domestic regulations, in a currency other than the domestic currency (Indian rupee in this case) of the location where the I.F.S.C. is located.

4 An F.I.I. is an investor or an investment fund registered in a country other than the one in which it is investing. In India, all F.I.I. must register with the Securities and Exchange Board of India before investing in the country.

- A gain or loss arising from a change in foreign exchange rates will be treated as income or loss
- Profit and gain arising from a construction contract or a contract for providing services will be determined on the basis of percentage of completion method

In addition, the following accounting principles will be adopted for determining taxable income under the category "Profits and Gains of Business or Profession:"

- Inventory will be valued at actual cost or net realizable value, whichever is lower.
- The purchase and sale of goods or services and of inventory will be adjusted to include the amount of any tax, duty, cess, or fees actually paid or incurred by the taxpayer to bring the goods or services to their location on the date of valuation.
- Inventories that are securities but are not listed on a recognized stock exchange or are listed but not regularly quoted on a recognized stock exchange will be valued at actual cost.
- Inventories that are securities other than above will be valued at cost or net realizable value, whichever is lower.

Any claim for price escalation in a contract or export incentive will be deemed to be the income of the financial year in which reasonable certainty of its realization is achieved.

Furthermore, assistance in the form of a subsidy will be deemed to be the income of the financial year in which it is received, unless it is taxed in a prior year.

The above amendments will be effective from April 1, 2016.

Corporate Insolvency Resolution Process

The aggregate of unabsorbed depreciation and book loss carryforward will be deductible when computing the book profit of a company whose application for Corporate Insolvency Resolution Process ("C.I.R.P.") has been accepted by the adjudicating authority.[5] Previously, the lower of the unabsorbed deprecation or book loss was allowed as a deduction; hence, in cases where either of these amounts was zero, no deduction could be claimed.

In order to ease the restructuring and rehabilitation of companies seeking insolvency resolution, a company that takes over the business of a rehabilitating company (*i.e.*, a company undergoing insolvency proceedings under the I.B.C.) will be allowed to carry forward and set off loss of the rehabilitated company pursuant to a resolution plan under C.I.R.P. This benefit is available despite a change in shareholding exceeding 49% during the year and applies to companies whose resolution plan has been approved under the I.B.C.

Both the above amendments will be effective from April 1, 2017.

[5] The Insolvency and Bankruptcy Code ("I.B.C."), which offers C.I.R.P, was enacted in 2016 to replace existing insolvency laws with a consolidated and comprehensive piece of legislation aimed at facilitating the simple and timely winding up of insolvent businesses to maximize the value of debtor's assets.

I.F.S.C.'s

In order to develop India as a global financial center and, more specifically, to encourage investment in designated I.F.S.C.'s, transfers of the following assets on a recognized stock exchange in an I.F.S.C. by a nonresident will be exempt from both short and long-term capital gains tax:

- Global Depository Receipts
- Rupee-denominated bonds of an Indian company
- Derivatives

This benefit is available provided that the transfer takes place on a recognized stock exchange located in an I.F.S.C. and the consideration is paid in foreign currency. However, as with L.T.C.G.'s from stock and units, discussed above, L.T.C.G.'s on equity shares, units of an equity oriented mutual fund, and units of business trusts transacted on a recognized stock exchange located in I.F.S.C. will be taxed at 10%, if the gains exceed I.N.R. 100,000.

In addition, the 9% reduced M.A.T. rate applicable to corporate entities with units in an I.F.S.C. will be extended to noncorporate entities located in an I.F.S.C.

Start-Ups

Under existing law, a start-up established between April 1, 2016, and April 1, 2019, can deduct 100% of profits earned from an "eligible business" for any three of the first seven financial years. This provision will be extended for an additional two years and will sunset on March 31, 2021. The deduction is available provided that the turnover in any of the seven financial years does not exceed I.N.R. 250 million (approximately $4 million).

The term eligible business has been expanded to include any innovation, development, or improvement of products, processes, services, or a scalable business model with a high potential of employment generation or wealth creation.

Country-by-Country Reporting

The due date to file the Country-by-Country ("C.b.C.") Report, in cases of a parent entity or Alternative Reporting Entity resident in India, will be subsequently prescribed in the Income-tax Rules. The proposed amendment follows provisions under B.E.P.S. Action 13 and will be effective from April 1, 2016.

Permanent Account Number

Taxpayers (other than individuals) and their officers (*e.g.*, managing directors of a company, partners of a partnership or L.L.P, and trustees of a trust) will be required to obtain a Permanent Account Number if they enter into specified financial transactions amounting to I.N.R. 250,000 (approximately $3,800) or more during a financial year.[6] This amendment will be applicable only to taxpayers who are residents of India (*i.e.*, nonresidents will be excluded from the scope of this provision).

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6 A Permanent Account Number is a unique ten-character alphanumeric number issued by the Indian Income-tax Department that serves as the taxpayer's proof of identification.

CONCLUSION

Budget 2018-19 has introduced many international tax provisions intended to bring India's domestic tax law in line with global standards established by the O.E.C.D.'s B.E.P.S. Project. However, the budget has also wreaked a certain amount of havoc on long-standing domestic tax law. The reintroduction of a tax on capital gains from the sale of stock, for example, caused the national stock exchange to plummet by several points due to the bearish outlook and public outcry. At the same time, the prime minister focused on the less privileged sectors of the society and proposed reforms to benefit rural communities; improve agriculture, healthcare, infrastructure, and education; and generate employment. With this budget, the government has gone one step further in improving the standard of living for the poor and bringing the country on par with international tax norms.

"The government has gone one step further in improving the standard of living for the poor and bringing the country on par with international tax norms."

FAILURE TO PREVENT – THE FUTURE OF ADVISER OBLIGATIONS

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Tags
Compliance
Failure to Prevent ("F2P")
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INTRODUCTION

Between F.A.T.C.A., C.R.S., the Panama Papers, and the Paradise Papers, taxpayer information has become increasingly transparent and available to authorities in many countries. Banks were once paradigms of confidentiality. Now, they are beholden to compliance and reporting obligations imposed by the O.E.C.D. and European Commission directives. Documents thought to be confidential are regularly hacked for "bad" reasons such as ransom and "good" reasons. The risk of embarrassing public disclosures incentivizes acceptable tax planning behavior.

The quantum of data that is in the public domain has stimulated a debate on the ethics of those who make a living advising others on tax reduction schemes. When clients commit a bad act, should tax and financial advisers be responsible? Should responsibility be eliminated if information is provided after the close of the tax year? Or do advisers have a duty to prevent the evasion or improper reduction of tax or to report the activity in advance?

This article looks at the history of liability exposure for failing to prevent a wrongful act. Starting with efforts to combat corporate bribery, it addresses the evolution of the failure-to-prevent standard of ethical behavior, highlighting recent U.K., U.S., and Dutch initiatives placing obligations on advisers.

THE EVOLUTION OF FAILURE TO PREVENT

Anti-Bribery Legislation

> The millions and – sometimes billions – in settlement and fines in anti-bribery cases is just a beginning! The rules which are implemented in anti-bribery legislation in many countries are here to stay – and are, as noted below, expanding to other areas of (corporate) compliance.

The failure-to-prevent standard of ethical behavior that now exists in many countries has its roots in U.S. Foreign Corrupt Practices Act ("F.C.P.A."). The F.C.P.A. was designed to prevent bribery of foreign government officials with the power to issue or approve contracts.

The F.C.P.A. applies to U.S. entities as well as foreign that have a legal tie to the U.S. (*e.g.*, by U.S. direct or indirect ownership), or foreign companies with publicly traded shares on a U.S. securities market. U.S. jurisdiction may also be invoked where a bribe has been facilitated by use of a U.S. bank or financial institution, the U.S. Postal Service, or a U.S. telecommunication service (including the use of U.S. servers). Companies caught by this legislation have found that turning a blind eye to bad acts and actors often leads to untold expenses and harmful public relations that drag down share value. Monetary penalties to the Department of Justice and to the Securities and Exchange Commission are to be expected as a part of a possible settlement, and the risk of individuals serving time in jail is imminent. The cases of very expensive settlements are many, and many U.S. and foreign international businesses have implemented ethical policies and procedures to prevent incompliant actions by the companies, their employees, and their agents. Equally important, ethical investor groups, including many universities and public pensions, have policies in place that limit shareholdings to corporations that meet a “good citizen” standard. Companies caught violating F.C.P.A. rules tend to be “sadder but wiser” concerning ethical behavior.

As a consequence of litigation, or an in effort to avoid it and to mitigate the consequences many international companies have introduced codes of ethics and business conduct as well as the necessary processes to implement, train and follow up such programs and policies that apply to all members of the multinational group, their employees, and their agents. Best practices have been adopted and are updated periodically as new exposure areas are identified. Employees are trained to adhere to these codes as well as to international and local legislation that attacks bribery and corruption. Monitoring systems have been implemented to track compliance. Companies have introduced due diligence procedures with business partners – customers as well as suppliers – mandating adoption of best practice policies. Today, it is impossible for many multinational companies to sell or buy products from a new or existing customers or suppliers without having performed proper due diligence as to the business practices of the counterparty to a transaction.

In most jurisdictions, the traditional view has been to look at the board of directors and hold the board responsible. The managing director is responsible only in very specific and identified cases. When bad acts are discovered, the perpetrator is described as a “rogue employee,” suggesting that the act is isolated and reflects hidden behavior. Adoption of failure-to-prevent standards will change this. The board of directors typically establishes policy, but operating management is responsible for day-to-day operations. To influence operating management, anti-bribery statutes must have an enforcement mechanism. Otherwise, the anti-bribery rules are more of a wish than a mandate.

Failure-to-prevent rules in the U.S. and the U.K. are enforced by the U.S. Department of Justice and the U.K. Serious Fraud Office, governmental agencies that have a mandate to monitor compliance and punish noncompliance. However, not all countries have such stringent tools to incentivize ethical business practices.

In Sweden, modifications were made to the anti-bribery legislation in 2012 to define a new crime: gross negligent financing of bribery. In principle, management must secure that a due diligence system exists to control counterparties to a transaction. Any agent who receives corporate funds must be vetted, and management must be able to show that all reasonable steps were taken to prevent any risk of improper use of the funds. However, the Swedish rules have been designed to be relatively weak. In comparison to other countries, Swedish law does not require the implementation of concrete steps such as training programs and monitoring after-training behavior. A high burden of proof is not placed on Swedish companies to demonstrate compliance. Consequently, Swedish companies do not face an upward battle to demonstrate compliance with ethical standards.

Data Privacy

Recently, failure-to-prevent standards have migrated to other areas of law, including finance, anti-trust, anti-money laundering, and tax. The most recent example relates to the E.U.'s General Data Privacy Regulation ("G.D.P.R."), which takes effect for corporations on May 25, 2018. The G.D.P.R. is directed to the data protection and privacy of individuals and consumers. Organizational accountability is mandated by requiring organizations to implement robust privacy governance policies and procedures that among other things require risk assessment for data collected on E.U. individuals. Data collectors will be held responsible regardless of their location and the existence of an actual data breach. The penalty for failure to comply is a fine of up to 4% of group turnover. The G.D.P.R. is similar to the anti-bribery legislation in that management is incentivized to give attention because the penalty is enormous and painful.

Gender Equality

In some countries, the failure-to-prevent standard has also been applied to combat gender discrimination. Iceland has introduced legislation calling upon companies to show the reason for pay disparities between employees who perform essentially the same work and to be responsible for damages if management failed to have in place a policy on gender equality in workforce compensation.

Tax Evasion

In the tax area we see a trend in this direction with respect to tax planning and the role of the tax adviser – most recently in the B.E.P.S Action Plan adopted by the O.E.C.D. Some actions focus on transparency, putting a burden on the taxpayer to report information and actions to the tax authorities beyond what is reported in the annual report and/or tax return. In European countries, tax advisers and their clients must report "aggressive tax planning" to give the tax authorities advance warning of abusive tax planning. Obligations are imposed on the outside tax adviser and internal management. These are recent examples of the expansion of the failure-to-prevent principle. Other examples are discussed in detail below.

U.K. FAILURE TO PREVENT TAX EVASION

U.K. attacks on abusive tax planning provide a real-life example of the expansion of the failure-to-prevent principle in the context of cross-border tax planning. The new offences for failure to prevent the facilitation of tax evasion reflect the government's frustration at the difficulty encountered in successfully prosecuting large institutions when a criminal act has been carried out by a "rogue employee." The offences are "strict liability" so that they do not require proof of the involvement of senior management.

There are two offences identified in the legislation: (i) failure to prevent U.K. tax evasion and (ii) failure to prevent tax evasion in other countries. The offences extend to corporations, limited partnerships, and other structures located in the U.K. or outside that have failed to prevent the facilitation of tax evasion. In the case of foreign tax evasion, one of the following conditions must be met for the act to be punishable in the U.K.:

- One of the advisers is incorporated or formed in the U.K.

- The adviser conducts business in the U.K.
- The conduct that constitutes foreign tax evasion facilitation takes place in the U.K.

This means that overseas advisers that visit the U.K. in connection with an advisery or financial business activity fall within the scope of the legislation.

"If the adviser fails to prevent the tax avoidance transaction from occurring, the underlying advice is not reliable."

The new offences carry the threat of unlimited fines. Fortunately, as with many other failure-to-prevent offences, entities have opportunities to protect themselves under the U.K. legislation. The key defense is that the entity has reasonable "preventative procedures" in place. H.M.R.C. issued guidance in October 2016 to help entities establish appropriate procedures. Those procedures are focused on five guiding principles:

- Risk assessment
- Proportionately of risk-based prevention procedures
- Top level commitment
- Due diligence and communication (including training)
- Monitoring and review

These are the same guiding principles used in connection with the anti-bribery statutes previously discussed. They are similar to principles that have been adopted by financial organizations required to manage anti-money laundering ("A.M.L.") risk within a large organization. While it is apparent that A.M.L. encompasses tax evasion matters, H.M.R.C. has made it clear that A.M.L. procedures, *per se*, will provide an entity with all the procedures it needs to make a complete defense against the new offences.

As mentioned above, acts of associated persons can result in liability under the offences. An associated person can be an employee or a contractor or subcontractor that can be seen to represent the entity. This risk of responsibility for the acts of others leads to the adoption of codes of ethical conduct in tax planning that are rigorously enforced. It follows that the organization must require each contractor or subcontractor to demonstrate that it has in place similar procedures that are rigorously enforced. On the other hand, it is expected that liability would not reach a corporation or partnership if it refers a client to a local adviser who then has an independent relationship with the client that leads to a prohibited act. In sum, management likely will face greater risk exposure if the company cannot prove that it has the necessary processes in place to secure proper and reasonable behavior by employees and third-party representatives that interface with taxpayers. Again, processes likely are not sufficient if they fail to include regular monitoring of behavior.

Another new development in the area of avoidance in the U.K. is the recent change to the penalties for compliance errors related to an avoidance arrangement. These changes seek to deem all behavior linked to tax avoidance arrangements as careless or deliberate for penalty purposes. These rules introduce the concept of disqualified advice, a significant and worrying development. Where a penalty is being considered and a taxpayer raises the defense of reliance on an adviser, no account is taken of advice that is disqualified. As a result, disqualified advice is treated as the absence of advice. Disqualified advice generally is the advice provided by the person who designed the plan – not one who independently evaluated the effectiveness of the plan for the taxpayer – or the person who was involved in implementing the plan based on the advice. In a sense, if the adviser fails to prevent the tax avoidance transaction from occurring, the underlying advice is not reliable. This may incentivize clients to bring malpractice actions against advisers who bring pre-packaged plans to a client or to file complaints against advisers with professional licensing bodies.

U.S. SWISS BANK PROGRAM

The United States does not criminalize the failure to prevent the facilitation or commission of a tax offense as of yet. It does, however, criminalize offshore acts that facilitate U.S. tax evasion. In addition, failure to prevent specified conduct is embodied in non-prosecution agreements and plea agreements resulting from these efforts.

The Swiss Bank Program, announced in August 2013, enabled Swiss financial institutions to avoid criminal prosecution for facilitating offshore tax evasion by U.S. taxpayers. Banks already under criminal investigations for Swiss activities were excluded from the program. However, a Swiss bank was eligible to receive a non-prosecution agreement if it fulfilled all the following conditions:

- It made a complete disclosure of cross-border activities.
- It provided detailed information on an account-by-account basis for accounts in which U.S. taxpayers had a direct or indirect interest.
- It cooperated in treaty requests for account information.
- It provided detailed information as to other banks that transferred funds into secret accounts or that accepted funds when secret accounts were closed.
- It agreed to close accounts belonging to account holders who failed to come into compliance with U.S. reporting obligations.
- It paid appropriate penalties.

There were four program categories based on the nature of the crime which determined the sort of agreement that would be available to a bank:

- Banks already under investigation were excluded from the program and generally entered a deferred prosecution agreement.
- Banks that were not yet under investigation and had reason to believe that they committed tax-related offenses sought non-prosecution agreements.
- Banks that did not believe they engaged in activities against the U.S. needed an independent examiner to verify the fact and sought non-target letters.
- Banks with a local client base, as defined under F.A.T.C.A., sought non-target letters as well.

Under the program, the U.S. government executed non-prosecution agreements with 80 Swiss banks and imposed more than $1.36 billion in penalties.

Once the Swiss Bank Program was terminated, F.A.T.C.A. became the policing measure in the U.S. Currently, F.A.T.C.A. requires U.S. persons living offshore to report their foreign financial accounts to the Financial Crimes Enforcement Network annually. Simultaneously, foreign banks now request their U.S. clients to complete forms declaring their citizenship and residency for tax purposes. This imposes a duty upon both the taxpayer to report its accounts and the financial institution to disclose its U.S. clients to ensure assets are not being concealed.

DUTCH DUTY OF CARE

Not all failure-to-prevent matters are handled by passing new law. Dutch trust companies have been targeted since the publication of the Panama Papers. Recently, the civil-law division of the Court of Amsterdam rendered an interesting judgment on a trust office's liability for the tax debts of a number of its clients.

In the case referred to as *Tradman v. Dutch Tax Administration*, clients used the trust office's advice to conceal companies that were liable to pay tax in the Netherlands. According to the Dutch Tax and Customs Administration, the trust office contributed to the fact that the tax authorities were unable to collect tax or to do so in good time. The court accepted this argument and ruled that the trust office should have borne the interests of the Tax and Customs Administration in mind when it provided assistance to its clients.

This is a remarkable judgment – in large part because a duty to the Tax and Customs Administration does not exist under Dutch law. In principle, the Tax and Customs Administration had sufficient powers under tax administrative law to safeguard its rights against the taxpayers in respect of a tax assessment. It has the power to raise an estimated assessment, which it failed to do. However, this point was not raised in the case. Instead, it seemed to rely on a concept that the trust office is an "insurer" for payment of Dutch tax by customers. Guilt by association would be a good description of the position of the Tax and Customs Administration.

The civil-law division of the Court of Amsterdam does not generally address tax matters, and certain conclusions of law do not appear to be widely accepted in tax jurisprudence. The court was correct to find that, in general, a trust office cannot be expected to weigh the interests of its client against the interests of third parties (*i.e.*, the Tax and Customs Administration). However, the court subsequently swept this consideration aside with the platitude that essentially applies to every adviser, namely that given its "social position in financial transactions and professional expertise" it should "to a certain extent" take the interests of third parties into consideration in the performance of its assignment. The court considered this to be a trust office's duty of care. Thus, if the trust office fails to perform its duty, standards of due care have been violated.

The court added to this that the directors and employees of the trust office may also be held personally liable if they can be "attributed serious blame" for the relevant trust office's actions and omissions. According to the court, this is the case if the directors and employees are personally involved in giving advice to the taxpayer. The court expressed the view that the trust office's duty of care implies that it is the trust office's task to investigate whether the service provided could be used for tax evasion.

The open issue, should the case be appealed, is whether the court's pronouncements are based on tax law that exists or simply on general views that are not found in tax practice.

Part of the court's ruling was favorable for the taxpayer. The tax authority argued that once fraud is asserted, no defense is available to the trust company. This is consistent with the view that the trust company is an insurer of the tax which would otherwise be due. Thus, resorting to a court amounted to an additional abusive act. The court disagreed. It found that a trust office may use legal process to defend itself without being viewed as further obstructing the Tax and Customs Administration. The trust company did nothing wrong when it sought legal protection for the benefit of its other clients and for its own interest. This implies that in future cases trust companies can defend their own position.

As a final point, the case dealt only with the trust office's legal liability. It did not address damages. With regard to the extent of the loss and the extent to which the Tax and Customs Administration is to blame for that loss, as well as whether the unlawful act is causally related to the loss at all, the court deferred any decision, preferring the matter to be the subject of follow-up proceedings. Consequently, the amount for which the trust office would be liable is yet to be determined. Undoubtedly, there will be more to report as this case develops.

CONCLUSION

"Advisers may no longer be able to claim a defense based on lack of knowledge or awareness of the results of a client's activity."

Recent developments show that there has been a change in attitude regarding the adviser's role. Advisers are being held accountable for their services and the consequences of actions carried out by clients. There is a movement in government, nongovernmental organizations, and the press to shift the loyalties of advisers from strict focus on interests of the client. Instead, the movement is towards putting the public interest ahead of loyalty to the client. When this approach is carried to its ultimate conclusion, advisers may no longer be able to claim a defense based on lack of knowledge or awareness of the results of a client's activity. Simple disclaimers may no longer shield an adviser from risk. Sophisticated advisers providing aggressive but arguably justifiable plans to a client may be held civilly or criminally liable for their plans. Client confidentiality is in the cross-hairs, and it is not clear that the ultimate answer will be the same in Europe and the U.S.

NEW TAX TREATY BETWEEN FRANCE AND LUXEMBOURG: FRENCH TAX IMPLICATIONS FOR INVESTORS

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INTRODUCTION

France and Luxembourg signed a new double tax treaty on income and capital (the "New D.T.T.") on March 20, 2018. The New D.T.T. is awaiting ratification by the parliaments of both countries, which is expected to occur this year. If the target date for ratification is met, some provisions will enter into force as of January 1, 2019.

The New D.T.T. comes 60 years after the passage of the current double tax treaty on income and capital (the "Current D.T.T."), which was signed on April 1, 1958, and has been amended four times since it entered into force, in 1970, 2006, 2009, and 2014.

One significant change resulting from the New D.T.T. is the increase in the withholding tax rate on distributions made by certain French real estate investment vehicles from 5% to a potential 30%. These structures are currently heavily used by institutional real estate investors. It is likely that the real estate industry will be busy this year, searching for ways to cope with the increased tax burden.

Many of the provisions of the New D.T.T. are modeled after the O.E.C.D. Model Tax Convention (the "O.E.C.D. Model"). However, due to the trade history between France and Luxembourg, there are notable departures. Interestingly, several provisions of the New D.T.T. are directly inspired by the Multilateral Instrument ("M.L.I."), even though Luxembourg reserves the right to exclude some of these provisions in its Covered Tax Agreements, which include double tax treaties already in force and therefore encompass povisions that are now part of the New D.T.T.

RESIDENCY – ARTICLE 4 OF THE NEW D.T.T.

In accordance with the latest 2017 version of the O.E.C.D. Model, the New D.T.T. defines the term "resident" as "a person who is liable to tax."

In addition to the provisions found in the O.E.C.D. Model, the New D.T.T. addresses *sociétés de personnes* (French partnerships), *groupements de personnes* (groups of individuals), and similar entities that can be deemed resident if

- the place of effective management is situated in France,
- they are liable to tax in France, and
- the shareholders, partners, or members, are all personally subject to tax in France on their respective portions of profits.

The New D.T.T. adds that a trustee or fiduciary, as such, is not considered a resident of a contracting state even if he or she were to qualify as a resident of one of the contracting states under the general definition. This applies when and to the extent that he or she is only the apparent beneficiary of the income so that another person who cannot be deemed a resident of that particular contracting state receives the benefit.

Collective Investment Vehicles ("C.I.V.'s") established in France or Luxembourg, which are generally tax-exempt, should a priori not be treated as residents under the New D.T.T., because the liable-to-tax test cannot be met by the C.I.V. However, Paragraph 2 of the accompanying Protocol to the New D.T.T. (the "Protocol") provides that C.I.V.'s that are established in one contracting state and are comparable to domestic C.I.V.'s under the law of the other state may receive the benefit of the dividends and interest provisions (Articles 10 and 11) of the New D.T.T. These benefits apply to the fraction of C.I.V. income corresponding to the rights of persons who reside in one of the contracting states or a state that has a treaty of administrative assistance for the purpose of preventing tax evasion and avoidance with the source contracting state.

In sum, the addition of residency provisions is a major novelty of the New D.T.T., as the Current D.T.T. contains only a very short and old definition of "tax domicile" and not "residence."

PERMANENT ESTABLISHMENT – ARTICLE 5 OF THE NEW D.T.T.

The New D.T.T.'s permanent establishment definition closely follows the O.E.C.D. Model and incorporates elements contained in the Current D.T.T.

A notable departure from the Current D.T.T. relates to *commissionaire* arrangements. Under the New D.T.T., *commissionaire* arrangements may be deemed a permanent establishment when, *inter alia*, the party is acting in one "Contracting State on behalf of an enterprise and, in so doing, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise." The New D.T.T. foresees that when a person acts exclusively or almost exclusively on behalf of one or more closely-related enterprises, that person will not be allowed to use the independent-agent exemption to a permanent establishment.[1]

The New D.T.T. also incorporates Option B under Article 13(3) of the M.L.I. with respect to permanent establishment exemptions for specified activities. It provides that the maintenance of a fixed place of business solely for the purpose of carrying on activites of a "preparatory or auxiliary character" is generally not deemed to be a permanent establishment. The New D.T.T. also adds an anti-fragmentation provision for the case of activities between closely-related parties.[2]

Permanent establishments are also addressed under the business profits provision (Article 8) of the New D.T.T. This provision follows the long-standing principle that the profits of an enterprise located in one contracting state are taxable only in that contracting state, except when the enterprise carries on business in the other contracting state through a permanent establishment situated therein. This is a more

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1 These provisions are modeled after Article 12 of the M.L.I.

2 Article 13(4) of the M.L.I.

modern wording than the Current D.T.T., which states that under specific rules, business profits are only taxable in the country in which the permanent establishment is situated.

DIVIDENDS – ARTICLE 10 OF THE NEW D.T.T.

New Withholding Taxes

Although the principle that provides "the right to tax a dividend belongs to the country of the recipient of the dividend" remains, both the New D.T.T. and the Current D.T.T. grant a general withholding tax rate of 15% to the source country.

The domestic French withholding tax rate is 12.8% for dividends distributed to individuals and 30% for those distributed to companies (subject to exceptions). In the latter case, for financial years beginning on or after January 1, 2020, the withholding tax rate will equal the normal corporate income tax rate. The marginal corporate tax rate is due to be reduced gradually, from the current rate of 33 1/3% to: 31.0% as of 2019, 28.0% as of 2020, 26.5% as of 2021, and 25.0% as of 2022.

Under the Current D.T.T., there is a preferential withholding tax rate of 5% on dividends. This rate generally applies where the beneficial owner holds a substantial participation of at least 25% of the capital of a distributing company. The New D.T.T. improves upon this preferential regime. Consistent with Article 8 of the M.L.I., the New D.T.T. provides a full exemption from withholding tax on dividends paid by a company of one treaty country to a company resident in the other treaty country that holds at least 5% of the capital of the distributing company throughout a 365-day period from the date of dividend payment. No account is taken of changes of ownership that directly result from a corporate reorganization, such as a merger or divisive reorganization, of the shareholder company or the company paying dividends.

French domestic law allows for a similar exemption of withholding tax. The benefit applies if, among other conditions, the Luxembourg parent holds at least a 10% shareholding in the French subsidiary or at least a 5% shareholding if it cannot impute the French withholding tax.

Distributions from Real Estate Investment Vehicles

A novelty of the New D.T.T. and its practical repercussions for Franco-Luxembourg business relations is the addition of a new provision concerning distributions from real estate investment vehicles.

Under the new provision, when the majority of tax-exempt dividends derived from real estate income or gains are paid out on a yearly basis by an investment vehicle in one contracting state to a resident of the other contracting state, they are taxable in that other state. However, the dividends can be taxed in the source country, but the withholding tax rate is dependent on the following:

- If the beneficial owner either directly or indirectly holds less than 10% of the distributing vehicle then a 15% withholding tax rate under the treaty can be applied.

- If the beneficial owner either directly or indirectly holds 10% or more of the distributing vehicle, the dividends are taxed up to the domestic withholding tax rate, rather than at a beneficial treaty rate.

This treatment is a significant change to the current market practice. Several French real estate investment structures are organized to allow a Luxembourg vehicle to hold an interest in French (i) *organismes de placement collectif en immobilier* (undertakings for collective investments in real estate or "O.P.C.I.'s") structured as *sociétés de placement à prépondérance immobilière à capital variable* (real estate investment companies with variable capital or "S.P.P.I.C.A.V.'s") or (ii) s*ociétés d'investissement immobilier cotées* (real estate investment trusts or "S.I.I.C.'s"), the latter being listed investment vehicles. Both the S.P.P.I.C.A.V.'s and S.I.I.C.'s are exempt from corporate income tax in France unless otherwise specified.

"Royalty payments are taxable in the country where the recipient is a resident, and the source country may apply a general withholding tax rate of 5%."

As a result, French real estate investment vehicles distributing dividends to Luxembourg vehicles with a 10% or greater interest could be subject to French withholding tax of up to 30% – as opposed to the 5% treaty rate under the Current D.T.T. for dividends distributed to a 25% or greater owner, which, under certain conditions, were not subject to tax in Luxembourg. This is dicussed in the commentary on Article 22, below.

Fortunately, French domestic law may provide a saving grace in this respect. The withholding tax rate may be reduced to 15% if distributions are made from S.P.P.I.C.A.V.'s and S.I.I.C.'s to certain Luxembourg C.I.V.'s. However, for S.I.I.C.'s, a 20% domestic levy could also apply when, subject to certain conditions, distributions are made to a 10% or greater tax-exempt investor that is not an individual.

In addition, because a S.I.I.C. is not necessarily categorized legally as an O.P.C.I. (*i.e.*, a form of C.I.V.), the question arises as to whether a tax-exempt S.I.I.C. can receive the benefit of Article 10 of the New D.T.T. in accordance with Paragraph 2 of the Protocol. This can be compared to the current treaty between France and the United States, which expressly grants treaty-resident status to both S.I.I.C.'s and S.P.P.I.C.A.V.'s. Further commentary is needed to better assess the question.

INTEREST AND ROYALTIES – ARTICLES 11 AND 12 OF THE NEW D.T.T.

The New D.T.T. stipulates that interest is taxable in the country where the recipient is a resident and will no longer allow the imposition of withholding tax on interest income. This is preferable to the treatment under the Current D.T.T., which calls for a general treaty withholding tax rate of 10%. This change has little impact from a French perspective, as interest payments are in principle not subject to withholding taxes when paid to Luxembourg residents.

Under the New D.T.T., royalty payments are taxable in the country where the recipient is a resident, and the source country may apply a general withholding tax rate of 5%. This is a new condition when compared to the Current D.T.T., which does not provide the source country with a general treaty withholding rate.

Generally, French domestic law applies a withholding tax on royalties equal to the corporate income tax rate, currently 33 1/3%, which is set to be reduced gradually to 25% by 2022. Under certain conditions, an exemption may apply, such as when the Luxembourg recipient is a 25% or greater shareholder.

CAPITAL GAINS – ARTICLE 13 OF THE NEW D.T.T.

The capital gains article of the New D.T.T. is similar to the O.E.C.D. Model in that capital gains are generally taxed by the country where the person disposing of the assets is a resident. In contrast, the Current D.T.T. does not have a standalone capital gains clause. This section provides commentary on the most important capital gains taxable in the source country under the New D.T.T.

Capital Gains Derived from Interests in Real Estate

The New D.T.T. stipulates that a gain derived from the alienation of immovable property is taxable in the country where it is situated. This is similar to the treatment under the Current D.T.T.

The New D.T.T. further provides that gains derived by a resident of a contracting state from the alienation of shares or other participations in a company, trust, or other institution or entity, may be taxed in the other contracting state if, at any time during the preceding 365 days, these shares or comparable interests directly or indirectly derived more than 50% of their value from immovable property in that other contracting state. Immovable property used to carry on one's own trade activities is excluded. In this respect, the New D.T.T. merely modifies the Current D.T.T. by extending its scope to include a 365-days look-back period.

In general, the French withholding tax rate levied on occasional capital gains realized upon the sale of real estate can be either 19% or the applicable corporate income tax rate, subject to specific conditions. Occasional gains on the disposition of shares in a S.P.P.I.C.A.V. or S.I.I.C. are subject to French domestic withholding taxes if the nonresident investor has a shareholding of at least 10%. Additional social security charges and taxes may apply depending on the situation. For habitual gains, withholding tax is the corporate income tax. As a reminder, the corporate income tax rate will be gradually reduced from 33 1/3% to 25.0% by 2022.

Substantial Participation Clause for Individuals

The New D.T.T. provides that capital gains realized by an individual resident in one contracting state on the sale of shares of an entity that is a resident of the other contracting state are taxable in that other contracting state if he or she directly or indirectly holds, either alone or with related persons, at least 25% of the rights to the profits of such entity. This rule applies only if the individual was a resident of the other contracting state in which the entity is a resident of at any time during the five years preceding the disposition of the participation. Such a rule is not included in the Current D.T.T. and goes beyond the scope of the capital gains clause found in the O.E.C.D. Model.

In general and excluding gains derived from real estate interests and any French exit tax implications, the French withholding tax could be 12.8% for individuals in such situations.

TAXATION OF CAPITAL – ARTICLE 21 OF THE NEW D.T.T.

The New D.T.T. follows the O.E.C.D. Model in that capital owned by a resident of a contracting state and situated in the other contracting state is taxed in that other state. The Current D.T.T. also has a similar result.

This provision would allow France to subject Luxembourg residents to the new

French tax on real estate wealth known as the *impôt sur la fortune immobilière* ("I.F.I."). The aforementioned provision of the New D.T.T. seems to exclude indirect holdings through companies when not deemed constituting real estate under French law. However, further commentary is needed to confirm this position.

ELIMINATION OF TAXATION – ARTICLE 22 OF THE NEW D.T.T.

For French Tax Residents

The New D.T.T. employs a tax credit method, where the Current D.T.T. relied on the exemption with progression method with a few exemptions (*i.e.*, for partnership income, dividends, and interest). Consequently, the New D.T.T. provides that:

- Income or capital that is taxable in Luxembourg remains taxable in France, and double taxation is eliminated via a tax credit equal to the amount of tax paid in Luxembourg, but which cannot exceed the amount of French tax owed.
- Income or capital that is only taxable in Luxembourg remains taxable in France, and double taxation is eliminated via a tax credit equal to the amount of French tax owed. However, if the French tax resident is not effectively subject to tax in Luxembourg, he or she cannot be granted the benefit of the French tax credit.

For Luxembourg Tax Residents

Under the New D.T.T., Luxembourg keeps a general application of the exemption with progression method when the income or capital is taxable in France, provided the amount is neither tax exempt in France nor subject to withholding tax under the treaty.

For dividends, royalties, and income from artistes and athletes, a tax credit is granted for the amount of French tax paid. This amount is limited to the Luxembourg tax owed. This is a change from the Current D.T.T., which does not tax French-source dividends if the Luxembourg company holds at least 25% of the share capital of a French company.

LIMITATION ON TREATY BENEFITS – ARTICLE 28 OF THE NEW D.T.T. AND PARAGRAPH 7 OF THE PROTOCOL

The New D.T.T. contains new limitation on benefits provisions in accordance with Article 7(1) of the M.L.I. Under the limitation, the benefits of the New D.T.T. will not be granted with respect to an item of income or capital if it is reasonable to conclude, considering all relevant facts and circumstances, that obtaining the benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in the creation of that benefit. This limitation stands unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the New D.T.T.

In addition, Paragraph 7 of the Protocol provides that the following French tax code (Code générale des impôts or "CGI") provisions will not be barred by the provisions of the New D.T.T.: (i) Article 115 quinquies (Branch Tax), (ii) Article 123 *bis* (Individual Tax Residents With Holdings in Certain Offshore Investments), (iii) Article 155 A (Remunerations Paid Abroad), (iv) Article 209 B (C.F.C. Rules), (v) Article 212 (Intragroup Interest Deduction Rules), (vi) Article 238 A (Limitations on Deductions for Payments Made to Low Tax Jurisdictions), (vii) Article 238-0 A (Noncooperative States or Territories).

ENTRY INTO FORCE – ARTICLE 30 OF THE NEW D.T.T.

The New D.T.T. will enter into force once both countries complete the ratification process and notify each other of its completion.

For France, the provisions of the New D.T.T. will apply as follows:

- For income taxes levied through withholding taxes, the provisions apply to taxable amounts after the calendar year in which the New D.T.T. enters into force.
- For income taxes not levied through withholding taxes, the provisions apply to all the income of a calendar year or fiscal year that start after the calendar year in which the New D.T.T. enters into force.
- For the other taxes, the provisions apply to taxable events that occur after the calendar year in which the New D.T.T. enters into force.

"Some provisions of the New D.T.T. could apply as early as January 1, 2019."

For Luxembourg, the provisions of the New D.T.T. apply as follows:

- For withholding taxes, the provisions apply to income attributed on or after the January 1 immediately following the calendar year in which the New D.T.T. enters into force.
- For the other taxes, the provisions apply to any tax due for an entire taxable year starting on or after the January 1 immediately following the calendar year in which the New D.T.T. enters into force.

Should the ratification process be completed in 2018, which is likely, some provisions of the New D.T.T. could apply as early as January 1, 2019.

CONCLUSION

Several issues exist for businesses and the financial services sector:

- The New D.T.T. provides no transitional relief allowing the business and financial sectors time to revise structures.
- The new dividend treatment of French real estate vehicles increases the tax cost of current real estate investment structures.

As a result, the Luxembourg financial services sector will need to act quickly to revise structures commonly used to invest in French real estate.

O.E.C.D. AND EUROPEAN COMMISSION UNVEIL PROPOSALS ON TAXATION OF THE DIGITAL ECONOMY

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Tags
Digital Economy
European Commission
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BRIEF SYNOPSIS

Following the release of the O.E.C.D.'s B.E.P.S. Action Plan and the European Union's approval of the Anti-Tax Avoidance Package, the taxation of the digital economy continues to be unfinished business in the international tax arena. New O.E.C.D. and the European Commission ("E.C.") documents mark a milestone (especially the latter, which include two different approaches). They also highlight the difficulties in achieving a consensus, which seems desirable when implementing measures that increase the tax burden of digital activities.

INTRODUCTION

After several years of work, the O.E.C.D.'s[1] Tax Challenges Derived from Digitalization – Interim Report, 2018 ("Interim Report") was published on March 16 and approved on March 20 by the G-20 after a meeting in Buenos Aires.[2] The E.C. released several documents on March 21: two proposals for a Council Directive (the "Directive Proposals"), a recommendation for the Members States, and a communication for the Council and the European Parliament.[3]

None of these documents has direct implications for taxpayers, although they establish the course for future developments.

The main aspects that should be taken into account may be summarized as follows:

- Both the O.E.C.D.'s Interim Report and the E.C.'s documents start from the same basic premise: The digitalization of the economy and the limitations of the current rules to allow for taxation of value where it is created (a crucial, unquestioned principle) lead to an unlevel playing field and a risk for states' tax revenues. Consequently, the criteria for allocating taxing rights among

1 Through the Inclusive Framework and the Task Force on the Digital Economy, a dependent body of the Committee on Fiscal Affairs of the O.E.C.D., working groups where both members and non-members of the O.E.C.D. are included, which shows the widespread approach of the project.

2 The *communiqué* of the G-20 Meeting of Finance Ministers and Central Bank Governs of 2018 mentions that:

> The impacts of the digitalization of the economy on the international tax system remain key outstanding issues. We welcome the OECD interim report analyzing the impact of digitalization of the economy on the international tax system.

3 The E.C. has published an impact assessment explaining the basis of the measure. Although mandatory rules are not in this document, it includes comments and data important for understanding the E.C.'s proposals.

states, known as nexus, and the criteria for calculating tax liabilities, known as profit allocation, should be reviewed to confirm that the rules are adapted to the current situation.

- States' concerns and interests, which are in conflict at times, make an international consensus impossible to achieve. Although the consensus is desired by all the parties, some international actors have implemented unilateral measures that could generate economic inefficiencies.
- The E.C. has released both long-term and short-term solutions in order to address the tax-related challenges raised by the digital economy. In comparison, the O.E.C.D. has not managed to produce a concrete proposal, given the need for consensus. Some alternatives have been analyzed and the comments expressed are relevant.
- The E.C.'s long-term proposal creates a new nexus standard and establishes the profit split as the default profit allocation method. (This is not a commonly used method because of practical difficulties.) While the nexus approach is defined in straightforward terms in the Directive Proposal, the criteria for profit allocation requires further development to avoid situations of overtaxation or nontaxation. Assuming this measure will create consensus within the E.U., it will require an amendment of double tax conventions ("D.TC.'s") signed with non-E.U. states. This will take time.
- The digital services tax, a short-term solution proposed by the E.C. and applicable as an interim measure, has been drafted in detail, so it can be implemented if there is a consensus within the E.U. or if the Member States are willing to implement this measure as if it were approved. This tax is levied on three types of specific digital services: on line advertising, transfer of user data, and intermediation on platforms that allow interaction between users. The implementation of this measure could run into legal problems, as its compatibility with D.T.C.'s and E.U. law is questionable, as pointed out in the analysis of short-term proposals in the O.E.C.D.'s Interim Report.

THE O.E.C.D. APPROACH

Today, there is no doubt about the active involvement of the O.E.C.D. and the E.U., particularly the E.C., in reviewing international taxation standards and current challenges regarding the taxation of the digital economy. Intense activity, largely coordinated, has taken shape with the publication of the aforementioned O.E.C.D. and E.C. documents. Although only intermediate measures in the broader process of analyzing the taxation of the digital economy, each sheds light on the current situation and the trend that guides the process.

The O.E.C.D. Interim Report

It is well known that the effects of the digital economy in the field of taxation are linked to the origin and the *raison d'etre* of the O.E.C.D.'s B.E.P.S. Action Plan. As a reference, Action 1 was titled "Addressing the Tax Challenges of the Digital Economy."[4] However, this action does not include a specific recommendation to

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[4] Considering that the Interim Report is titled "Tax Challenges Derived from Digitalization," one can observe a certain change of focus in the works, if it is

that effect. Instead, it calls on states to review the progress made through the plan's other actions and to seek consensus by 2020.

The Action 1 Final Report reflects the expectation that the measures of the B.E.P.S. Project could be sufficient to substantially address the challenges raised by the digital economy.[5] Together with the lack of consensus, this seems to be one of the reasons why Action 1 does not recommend introducing concrete measures relating to the broader tax challenges of the digital economy, such as establishing a nexus relating to a significant digital presence, withholdings for digital transactions, or an equalization levy.

"Because of the absence of consensus, the O.E.C.D.'s Report does not include specific proposals."

The O.E.C.D. has presented the Interim Report as a means to describe the development of this work under the mandate that it is necessary not only to establish new regulations on the matter that can adapt to a changing environment but also to provide certainty and facilitate growth.

One of the starting points of the Interim Report confirms that, to date, implementation of the B.E.P.S. Action Plan has achieved significant progress in two areas:

- The lawmakers recognize an emerging B.E.P.S. effect, which can be verified by analyzing the new developments in domestic tax legislation inspired by the B.E.P.S. Action Plan. At a regional level, an example would be the activity of the E.U., and at a global level, it would be the adoption of the Multilateral Instrument.[6]

- Companies have modified some business models by giving prevalence to their local agents, by passing from a remote sales model to a local reseller model, or by aligning their corporate structures with the economic activity actually carried out, accomplishing the latter by reviewing transfer pricing policies and reconsidering the location of their intangible assets, graphically described as "on-shoring assets."[7]

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understood that the focus is transferred from the digital economy to a wider phenomenon such as digitalization that affects the economy as a whole, including tax administrations.

5 "As a result, it is expected that the implementation of these measures, as well as other measures developed in the BEPS Project, will substantially address the BEPS issues exacerbated by the digital economy." ("Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report," O.E.C.D./G-20 Base Erosion and Profit Shifting Project (O.E.C.D. Publishing, Paris: 2015), p 94.)

6 At this point, we highlight the low percentage of adoption to date (17%) of the modifications related to the existence of a permanent establishment ("P.E.") in the case of *commissionaire* agreements. These structures are traditionally used in the field of the digital economy. The O.E.C.D. recognizes this low acceptance in the Interim Report, although it also points out the possibility that adoption rates may increase when progress is made in the work related to attributing benefits to P.E.'s or due to their inclusion in the O.E.C.D. Model Tax Convention.

7 In practical terms, this change in the companies' business models facilitates the analysis of the nexus problem, although it brings the discussion back to profit allocation in the case of a local reseller. It is striking that the O.E.C.D. document reflects two positions: (i) Member States that recognize that this change has allowed a widening of taxable bases in their jurisdictions when moving from a remuneration based on costs to one based on sales and (ii) Member

However, Action 1 also recognizes that it is necessary to carry out follow-up work to address the broader challenges raised by the digital economy. This particularly applies to the concept of nexus, the value of data, and the characterization of digital operations. Therefore, the implementation of additional measures is necessary. Following this insight in its Interim Report, the O.E.C.D. acknowledges that the progress of the B.E.P.S. Action Plan may not be sufficient.

Because of the absence of consensus, the O.E.C.D.'s Report does not include specific proposals. This lack of consensus is not minor. It reflects the importance of needed modifications in the areas pointed out and the relevance of data and user participation in the rules regarding distribution of benefits and distribution of tax powers among states.

Countries seem to be grouped by blocks. The Interim Report identifies three blocks of jurisdictions:

- A first group of countries understands that the main challenges raised by the digitalization of the economy refer to the value of the data and the participation of the user as key elements in the process of creating value. These countries do not suggest that the principles on which international taxation is based should be modified as a consequence of the digitalization of the economy. Rather, they simply maintain that the rules must be adapted to consider the relevance of the value of the data and the participation of the user. Some E.U. countries such as Spain maintain this position.
- A second group of countries pleads for a thorough revision of the principles of international taxation relating to the concepts of nexus and the attribution of benefits. The rationale is that the digitalization of the economy is a general phenomenon that affects most digital business models. Some countries, such as the U.S., maintain that data and user participation are not relevant *per se* to the process of creating value but that they should be treated as inputs for the company.
- A third group of countries understands that significant reform in the field of international taxation is not necessary after the B.E.P.S. Action Plan. This group consists of countries that have taken advantage of the current rules to become centers for digital companies and often provide a reduced tax burden.

The classification of the different jurisdictions can be interpreted as an initial step from which the work of the O.E.C.D. can proceed.[8] The document approved by the

States that denounce that, in essence, the tax base remains essentially the same considering that the remuneration that the reseller must receive for the functions performed is not far from the remuneration that under the previous scheme should have received commissionaire. From a Spanish standpoint, the position that the tax authorities *sometimes* maintain is the differences between the compensation that corresponds to an agent, according to arm's length, and the economic result of the activity that is developed through a subsidiary or a P.E.

[8] These different positions are derived from the value chains of the states involved. The U.S. position is consistent with a state where value is created through research and development activities with high added value intangibles. However, the position of certain European states with large populations logically emphasizes the relevance of the client (*i.e.*, user). In an intermediate situation,

O.E.C.D. expects an update on the progress of the work. A new Interim Report is expected in 2019 and a Final Report is expected in 2020, in which a consensus is expected to be reached.[9]

THE E.C. APPROACH

E.U. concerns about the taxation of the digital economy first arose at the Summit of Heads of State and Government held in Tallinn in September 2017. They were proceeded by the conclusions of the E.C. and Ecofin in October and December of the same year and finally by the E.C.'s active collaboration with the O.E.C.D.

The E.U.'s vision, now represented by the E.C.,[10] centers on certain characteristics of the digital economy – lack of physical presence, importance of intangible assets, and relevance of data and user participation – for which the current tax rules are not adapted, allowing digital companies to bear a low tax burden that reduces tax collection and distorts competition. The same ideas underlie the O.E.C.D.'s work.

While there is no consensus at the O.E.C.D. level, the E.C. maintains a clear position in this area, based on the following precepts:

- A unified solution at the international level within the O.E.C.D. is desirable. However, its attainment presents certain challenges, and reaching a consensus will take time. The E.C. supports the attainment of consensus by proposing concrete solutions that can "serve as an example" at the international level.
- Measures taken in the absence of O.E.C.D. consensus should have at least an E.U. consensus and be consistent at the E.U. level. Impatience at the level of the O.E.C.D. has led to the introduction of unilateral measures, which threaten to fragment the unique digital market and distort competition.
- "It's a matter of justice" to make modifications that give an appropriate fiscal response to the challenges posed by the digitalization of the economy.
- Data and user participation are important in the digital economy. This argument underlies the E.C.'s assertion about the current discord between the place of taxation of benefits and the place of creation of value. All of the E.C. proposals reflect a consensus on the value of data and user participation in the process of creating value.
- The desirable solution to achieve fair taxation of the digital economy relies on the concept of significant digital presence. It is proposed that this concept be added to the definition of P.E., whose benefits would be attributed under

hub states have opted for a service platform model for digital businesses, which are comfortable with the classic definitions.

9 As mentioned in the *communiqué* of the G-20 Meeting, "We are committed to work together to seek a consensus-based solution by 2020, with an update in 2019."

10 We also highlight the media impact achieved by the letter signed in September 2017 by the Ministers of Finance of France, Germany, Spain, and Italy (which Austria, Bulgaria, Slovenia, Greece, Poland, and Portugal later signed) addressed to the Presidency of the E.U. in favor of introducing an equalization tax.

a functional analysis that takes into account the value of the data and the user's participation as a critical issue. This solution appears in the Proposal for a Council Directive Laying Down rules Relating to the Corporate Taxation of a Significant Digital Presence. According to the Proposal, once implemented in domestic legislations, this Directive would be effective within the E.U. and within states without D.T.C.'s in force, but not with non-E.U. countries that have signed D.T.C.'s with Member States. To facilitate the work of modifying these conventions, the E.C. has issued a Recommendation Relating to the Corporate Taxation of a Significant Digital Presence.

- As a long-term solution will take time, a new tax levied exclusively on certain digital services ("Digital Services Tax" or "D.S.T."[11]) will be introduced as an interim measure. The main feature of this tax is the relevance of the user's participation in a digital activity as a central element in creating value. It defines three types of services in which this circumstance occurs, leaving all other cases outside the scope of the D.S.T. This short-term solution is also projected in the form of the Proposal for a Council Directive on the Common System of a Digital Services Tax on Revenues Resulting from the Provision of Certain Digital Services.

The E.C. has also published a Communication to Parliament and the Council, named Time to Establish a Modern, Fair and Efficient Digital Economy Standard, as a summary of the proposed measures which are substantiated in the two Directive Proposals. The E.C.'s initial position is to process each Directive Proposal as a directive. They have been submitted for consultation to the Parliament and the Council for adoption.

The E.C. proposes the above texts "in a strict sense," meaning they should be analyzed at the E.U. level to ensure they have the modifications required and consensus for approval as directives. Given the possible lack of consensus, the focus is on the enhanced cooperation procedure, which allows a minimum of nine E.U. countries to establish advanced integration or cooperation in an area of European structures without the participation of the other E.U. countries.[12]

CONCLUSION

The digitalization of the economy is a complex issue, raising problems from both a legal and a political point of view. From a legal standpoint, it questions the fundamental rules of international taxation. Politically, the pressure from stakeholders to tax these activities is as high as the discrepancies between states about the way to do it.

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11 When using Spanish terms, some confusion could be avoided if the terminology the E.C. uses (*Impuesto sobre Servicios Digitales* – I.S.D.) is replaced with an alternative acronym (I.S.D.i.), as the former is usually used in Spain to refer to the Inheritance and Gift Tax (*Impuesto sobre Sucesiones y Donaciones* – I.S.D.).

12 At a press conference on March 21, Commissioner Moscovici was asked about the possible application of the enhanced cooperation procedure to achieve progress on the proposals. Moscovici expressed his optimism on the possibility of reaching a consensus within the E.U., so that it would not be necessary to resort to this unfavorable option.

In this situation, both the O.E.C.D. and the E.C. are attempting to generate consensus. By its nature, the O.E.C.D. seeks a quasi-global consensus, which is difficult to achieve. Additionally, it may not be easy for the E.C. to get all E.U. Member States to accept its proposals, without using the enhanced cooperation mechanism (which is not desirable).

Regarding the E.C.'s proposals, it is notable that it establishes a long-term solution together with a short-term, interim solution to avoid the serious problem of fragmenting the common market.

“The new rules proposed by the E.C. (and analyzed by the O.E.C.D.) depart so markedly from the traditional legal framework of international taxation that they require additional work from both institutions.”

The E.C.'s long-term measure will be effective only if there is consensus at the O.E.C.D. level, which does not exist today. This leads to questions of whether the proposal to rely on significant digital presence, rather than to significantly alter existing tax rules, has important political content and how this positions the E.U. in the international discussion on the taxation of the digital economy.

Regarding the interim solution to establish a D.S.T., there is concern that the measure that could be implemented unequally in the E.U., because of a lack of consensus between Member States. In contrast with the long-term solution, this measure is defined in clear terms (probably more characteristic of a regulation than of a directive) and its implementation, based on a tested V.A.T. mechanism, should not be complex. However, its implementation sparks certain questions: How should a tax be assessed if it is designed to grant taxing rights to a state in a situation where, under a D.T.C., that state would have been prevented from taxing the income? And to what extent can existing taxes and this new tax have a different nature, essentially on the basis of formal arguments, when the economic capacity that they both seek to tax, in light of the facts, is the same?

In conclusion, the new rules proposed by the E.C. (and analyzed by the O.E.C.D.) depart so markedly from the traditional legal framework of international taxation that they require additional work from both institutions to remove any doubts raised about their validity and ability to achieve the objective that digital activities support fair taxation. This work should take into account, in particular, possible conflicts between taxpayers and tax administrations that could arise from the introduction of measures of this nature.

DO INDIA'S AMALGAMATION REVISIONS PREVENT MISUSE OF ACCUMULATED LOSSES?

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INTRODUCTION

India's Finance Act, 2018 addressed a tax planning device intended to reduce or eliminate the imposition of the Dividend Distribution Tax ("D.D.T."), which applies when a corporation exercises the right to distribute dividends to shareholders. The D.D.T. serves as a dividend withholding tax. However, because it is imposed on the Indian company paying the dividend and not on the shareholder, favorable income tax treaty provisions are not applicable. This article compares the prior law to two possible interpretations of the amendment and examines the intent of the amendment.

INDIAN TAX LAW BEFORE THE AMENDMENT

The D.D.T. Mechanism

Section 115O of the Income-tax Act, 1961 ("Act") provides for the D.D.T. It is imposed at the rate of 15% plus applicable surcharge and cess[1] whenever a dividend is declared, distributed, or paid by a domestic company. The term "dividend" covers a deemed dividend.[2] It also includes any distribution to shareholders in a reduction of capital3 when a company possesses accumulated profits, even if capitalized. Accumulated profits[4] include all profits of the company up to the date of distribution for the purpose of section 2(22)(d) of the Act.

Strategy to Avoid D.D.T. on Payments to Shareholders in Capital Reductions

In order to avoid D.D.T., certain unlisted companies, mainly multinationals resort to the "Purchase Method"[5] of amalgamation[6] wherein a profit-making company with substantial accumulated profits is amalgamated with a company having significantly lower profits, or even losses. Fixed assets (including bank accounts and cash) of

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1 A cess is an additional income tax, leviable over and above, the basic tax rate and surcharge (if applicable). Currently, the rate of the cess is 4%.

2 Section 2(22)(e) of the Act.

3 Section 2(22)(d) of the Act.

4 Explanation 2 to section 2(22) of the Act.

5 Assets and liabilities are purchased at a mutually agreed value ("purchase price"). This is different from an amalgamation under the "Pooling of Interest Method" where there is a line-by-line addition of book values.

6 "Amalgamation" in relation to companies, means a merger of two or more companies to form one company.

the "Amalgamating Company"[7] are transferred to the "Amalgamated Company."[8] Accumulated profits of the Amalgamating Company are not recorded or accounted for in the books of the Amalgamated Company (*i.e.*, the assets lose their identity). The books of the Amalgamated Company contain its accumulated losses as well as its assets (as held prior to the amalgamation) with the addition of newly acquired cash, bank balances, or other assets.

After amalgamation, the Amalgamated Company reduces capital to write off the accumulated losses by resorting to any of the following:

- Cancelling paid-up share capital against accumulated losses
- Distributing cash to the shareholders for paying off any paid-up share capital that is in excess of the wants of the company[9]

Upon this distribution of cash on capital reduction, the company circumvents payment of D.D.T. under section 2(22)(d) of the Act, as the D.D.T. is applicable on a distribution of cash only to the extent of accumulated profits and the Amalgamated Company typically does not have any such profits.

AMENDMENT IN INDIAN FINANCE ACT, 2018

> In the case of an amalgamated company, the <u>accumulated profits</u>, whether capitalized or not, <u>or loss</u>, as the case may be, shall be <u>increased by the accumulated profits</u>, whether capitalized or not, of the amalgamating company on the date of amalgamation [emphasis added].[10]

<u>**Interpretations of the Amendment**</u>

What does the amendment mean? Two contrasting viewpoints have been expressed.

<u>*View 1*</u>

In cases where the Amalgamating Company has accumulated losses, they will not be recorded in the books of the Amalgamated Company. Only in cases where the Amalgamating Company has accumulated profits will they be added to the accumulated profits or losses of the Amalgamated Company.

<u>*View 2*</u>

Accumulated profits or accumulated losses (as the case may be) of the Amalgamating Company will be recorded in the books of the Amalgamated Company. The omission of the expression "or losses, as the case may be" in the context of the <u>Amalgamating Company</u> is not deliberate.

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7 Transferor company (which is merged inside the other company) is referred to as the Amalgamating Company.

8 Transferee company (which is formed as a result of the merger) is referred to as the Amalgamated Company.

9 Section 66 of the Companies Act 2013 allows reduction of share capital through cancellation against paid up share capital as well as cash.

10 Inserted vide Explanation 2A to section 2(22) of the Act.

Analysis of the Viewpoints

A literal reading of the exact words of the amendment would mean that in the case of an Amalgamated Company,

- accumulated profits . . . , **or losses**, as the case may be,
- "shall be increased by"
- "the accumulated profits" of the Amalgamating Company.

Exact interpretation to mean that

- the Amalgamated Company can either have accumulated profits or loss, and
- the accumulated profit or loss of the Amalgamated Company will be increased by the accumulated profits of the Amalgamating Company.

A bare reading of the plain language suggests that, only in cases where the Amalgamating Company has substantial accumulated profits, such accumulated profits would be added to the accumulated profits or losses of the Amalgamated Company.

The language clearly uses the expression "accumulated profits or losses as the case may be" for the Amalgamated Company, whereas it uses the expression "increased by accumulated profits of the amalgamating company." It is evident that the use of the word "losses" for the Amalgamated Company and its omission for the Amalgamating Company is conscious and intended.

Object of the Legislation

The language of the explanatory memorandum to Finance Bill 2018 clarifies that the intent of introducing this amendment is to prevent abusive arrangements for tax avoidance through amalgamations. The relevant extract is reproduced below:

> Instances have come to light whereby companies are resorting to abusive arrangements in order to escape liability of paying tax on distributed profits. <u>Under such arrangements, companies with large accumulated profits</u> adopt the <u>amalgamation route</u> to reduce capital and circumvent the provisions of sub-clause (d) of clause (22) of section 2 of the Act. With a view to preventing such abusive arrangements and similar other abusive arrangements, it is proposed to insert a new Explanation 2A in clause (22) of section 2 of the Act to widen the scope of the term 'accumulated profits' so as to provide that in the case of an amalgamated company, accumulated profits, whether capitalized or not, or losses as the case may be, shall be increased by the accumulated profits of the amalgamating company, whether capitalized or not, on the date of amalgamation [emphasis added].[11]

The law aims to target the misuse of amalgamation arrangements wherein the Amalgamating Company has substantial accumulated profits and the intent of the amalgamation is to distribute these profits by way of a capital reduction without paying D.D.T.

[11] Clause 3 of the Memorandum Explaining the Provisions of Finance Bill, 2018.

An inverse arrangement (*i.e.*, wherein the Amalgamating Company has substantial accumulated losses and the Amalgamated Company has substantial accumulated profits) is not intended to be covered by this amendment. This would mean that post amalgamation, by virtue of the amendment (under View 2), the Amalgamated Company may record losses (due to addition of substantial accumulated losses to the profits of the company). On applying this interpretation, we come back to square one, as the Amalgamated Company, on reduction of its capital, may now be able to circumvent the provisions of section 2(22)(d) of the Act. This interpretation renders the amendment ineffective when the Amalgamating Company has losses.

"The intent of introducing this amendment is to prevent abusive arrangements for tax avoidance through amalgamations."

Parallel Provision

The arrangement is reminiscent of section 72A of the Act introduced vide Indian Finance Act, 1977. This section relates to the carry forward and set off of accumulated loss and unabsorbed depreciation allowance in an amalgamation or demerger. Section 72A aims to prevent tax avoidance under an amalgamation arrangement where the Amalgamating Company is a loss-making company and the intent of the amalgamation is to avoid tax payment by the profit-making Amalgamated Company – as under such an arrangement, the profit-making company would be able to reduce taxes by taking advantage of the business losses and unabsorbed depreciation of the Amalgamating Company. Therefore, this section limits the tax benefit under artificial amalgamation arrangements (*i.e.*, undertaken without honest business considerations). This section also contains conditions whereby genuine business amalgamations do not suffer and companies are able to revive or expand their business.

CONCLUSION

If the Amalgamating Company is a loss-making company and the amalgamation is aimed at genuine revival of business under due commercial considerations, the interpretation under the View 1 (*i.e.*, that Amalgamated Company only gets accumulated profits and not losses of Amalgamating Company) allows the Amalgamating Company to leave behind the losses. After amalgamation, if the Amalgamated Company is a profit-making company, it would be in a better position to raise money from investors or arrange credit or loans to fund and revive its business operations. This interpretation seems to be in alignment with intent of the Indian government in preventing misuse of accumulated losses through amalgamations between loss-making and profit-making companies. At the same time, it also keeps the door open for the revival of loss-making companies through amalgamation arrangements. Furthermore, the Indian government does not aim to adversely affect genuine amalgamation arrangements taken for honest business expansion or revival purpose. The intent of the Indian government is to only block artificial arrangements. Mostly such an amendment would cover arrangements wherein two companies not engaged in the same or similar businesses join together so that available accumulated losses can be used strategically (for undue income tax benefit). This amendment is effective from April 1, 2018 (*i.e.*, the Indian financial year comprising the period from April 1, 2017 to March 31, 2018) and this will be the first year of implementation, only the time will tell whether the changes are effective. Has the Indian government achieved its goal of preventing the misuse of accumulated losses? Will this provision lead to increased litigation? Or will the affected taxpayers devise new methods of avoiding tax using amalgamation or merger arrangements?

U.K. REQUIREMENT TO CORRECT

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BACKGROUND

The "Requirement to Correct" ("R.T.C.") rules became law when the Finance (No. 2) Act 2017 received Royal Assent on November 16, 2017. The legislation required taxpayers who were noncompliant as of April 5, 2017, with regard to offshore tax affairs, to correct the relevant noncompliance by September 30, 2018. The deadline corresponds to the final date for over 100 jurisdictions who have signed up to exchange data on financial accounts information. Under the Model for Automatic Exchange of Financial Account Information in Tax Matters (Common Reporting Standard ("C.R.S.")), H.M.R.C. will have more access to personal financial information about offshore assets held than ever before.

Under the initial legislation, failure to correct by September 30, 2018, would result in a 200% penalty being applied, plus a potential penalty of 10% of the value of the associated asset. Subsequent to government consultation, H.M.R.C. has published updated guidance, which includes a much-welcomed relaxation to the penalties where (i) ahead of the September 30, 2018, deadline, H.M.R.C. has been notified that a disclosure will be made, and (ii) the disclosure is made ahead of the associated deadline for the particular disclosure route taken. The final date is December 29, 2018. Given the significant liability, not to mention the scrutiny and administration costs, it is vital to review historic U.K. tax compliance in advance of this date.

WHAT IS OFFSHORE NONCOMPLIANCE?

The definition of offshore noncompliance is far-reaching and relates to *any* compliance matter where tax is owed to H.M.R.C. as a result of tax noncompliance where there is an offshore connection.

WHAT TAXES ARE COVERED?

The R.T.C. applies to any person with potential undisclosed U.K. income tax, capital gains tax, and/or inheritance tax liabilities.

"Persons" refers to the following:

- Individuals
- Partnerships
- Trustees
- Nonresident landlord individuals/companies

WHAT ARE THE PENALTIES?

The standard penalty is 200% of the tax liability but can be reduced according to factors such as cooperation and quality of the disclosure to H.M.R.C. However, the minimum penalty is 100% of the tax liability. Where, after the deadline, H.M.R.C. opens an enquiry ahead of any disclosure, the penalty cannot be less than 150%.

Where H.M.R.C. believes that the person was aware of the tax noncompliance and failed to correct by the deadline, they can apply an additional penalty to the standard penalty and seek up to 10% of the value of the assets linked to the offshore noncompliance.

There is also potentially a further penalty of 50% if it can be shown that assets were intentionally moved to avoid, for example, an overseas bank reporting the account to H.M.R.C.

In serious cases, which involve over £25,000 in tax any tax year, H.M.R.C. may cause reputational damage by publishing the taxpayer's details on a public website.

REASONABLE EXCUSE

Penalties will be chargeable for failure to correct, unless the taxpayer can demonstrate a "reasonable excuse" existed for not meeting the obligation. The definition of a "reasonable excuse" is very narrow. The legislation makes it clear that a reasonable excuse cannot be based on tax advice received from an "interested person." Such advice will not be accepted and will instead be treated as "disqualified" advice.

If the taxpayer fails to make a correction but has a reasonable excuse for not doing so, a penalty will not be imposed, and an obligation will exist to pay the tax owed and accompanying interest.

WHAT IS CONSIDERED "DISQUALIFIED ADVICE"?

- Advice given to the taxpayer by an interested person
- Advice given to the taxpayer as a result of arrangements made between an interested person and the person giving the advice
- Advice given by an advisor who does not have appropriate expertise in the matter
- Advice which does not consider all of the person's individual circumstances
- Advice that is addressed to, or is given to, a person other than the taxpayer

WHO IS AN INTERESTED PERSON?

An interested person is someone who has participated in the "avoidance arrangement or has received consideration for implementing or facilitating entry into a tax avoidance arrangement."

An interested person includes the following:

- A body of persons both corporate or unincorporated
- Limited companies
- Accounting firms
- Limited liability partnerships

H.M.R.C. guidance on the R.T.C. provides examples of disqualified advice.

Example 1

> *Trustees of an offshore trust obtain advice from an accountancy firm on how best to distribute funds to U.K. and non-U.K. beneficiaries. The firm specializes in giving this advice. After considering the trust and the beneficiaries' circumstances, the accountant advises the trustees on how to make distributions in a way that they minimize their tax position.*
>
> *Some years later, H.M.R.C. challenges the trustees and the beneficiaries for not paying enough tax on the distributions and for failure to correct.*

As the advice was given by an interested person (a firm of accountants) and concerned "avoidance arrangements," it is treated as disqualified advice and cannot be used as a reasonable excuse.

Example 2

> *The facts are the same as in Example 1, however, in this scenario, the trustees later undertook a secondary and independent review from a person with the appropriate expertise who was not involved in facilitating the original arrangements. Provided that the trustees followed the advice given and it took into account the trustees' and beneficiaries' circumstances, then it can be relied on as a reasonable excuse if the trustees fail to make a correction.*

"The legislation requires taxpayers who, as of April 5, 2017, are noncompliant with regards to their offshore tax affairs, to correct the relevant noncompliance by September 30, 2018."

The trustees in Example 1 sought advice in good faith. However, the R.T.C. legislation clearly seeks to disregard advice given by professional advisors paid to do so, and an independent review from a peer, as in Example 2, is necessary to ensure the advice is not considered as disqualified advice.

HOW CAN CORRECTIONS BE MADE?

A correction can be made by refiling tax documents (*e.g.*, a self-assessment tax return). Consideration should be given to using the Worldwide Disclosure Facility ("W.D.F.") or the Contractual Disclosure Facility ("C.D.F."). The latter should be used in cases where the noncompliance results from deliberate behavior.

For taxpayers who are not confident that their offshore affairs are tax complaint, a review should be carried out to assess their tax position by someone whose advice will not be disqualified, and then a disclosure should be made, if appropriate.

As stated above, it is important to take the initiative and file a disclosure, or notify H.M.R.C. of the intention to file, before September 30, 2018. If a tax enquiry is already underway, the disclosure must be made within 60 days. If using the W.D.F., the disclosure should be made within 90 days. If using the C.D.F., the disclosure should be made within 60 days (i.e., the Outline Disclosure deadline).

If there are concerns that H.M.R.C. could successfully dispute a historical tax position, it may be prudent to lodge a "protective" disclosure regarding the potential noncompliance.

WHAT IS THE STATUTE OF LIMITATIONS?

Under "normal" tax rules, H.M.R.C. has the following time limits to make an assessment:

- Four years in circumstances of reasonable care
- Six years in circumstances of careless behavior
- 20 years in circumstances of deliberate behavior

For the purposes of R.T.C., however, the "normal" H.M.R.C. time limits have been extended retroactively by four years. This means that up until April 5, 2021, a person who has failed to correct can still be investigated by H.M.R.C. as follows:

- For assessments not involving careless or deliberate behavior,
- H.M.R.C. can still go back to 2013-14.
- For assessments including careless behavior, H.M.R.C. can still go back
- to 2011-12.
- For assessments involving deliberate behavior, H.M.R.C. can still go back to 1997-98.

WHAT STEPS CAN TAXPAYERS TAKE?

Given the scale of R.T.C. penalties, doing nothing is no longer a viable option where a history of noncompliance exists. A number of options can be taken to regularize the taxpayer's position and avoid penalties, depending on the exact circumstances.

Counsel can assist in analyzing the taxpayer's position and recommend the most appropriate course of action, by taking the following steps:

- Review the historic tax position.
- Perform a tax health check.
- Review any existing advice from previous advisors.
- Where appropriate, assist in making a disclosure to H.M.R.C. or correcting offshore noncompliance.

ISRAELI COURT CASE FIRST TO INTERPRET TEN-YEAR EXEMPTION

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Nearly a decade after its enactment, *Talmi v. Kfar Saba Tax Assessor* is the first court case to address the implementation and interpretation of the special residents tax regime for new Israeli residents and veteran returning residents ("New Immigrant Benefits").

BACKGROUND

In honor of its 60th Independence Day in 2008, Israel introduced a special tax regime intended for new Israeli residents and veteran returning residents, beginning as of 2007. The New Immigrant Benefits are intended to encourage diaspora Jews and former Israelis to move to Israel by providing them with substantial tax benefits. Pursuant to the amendment, the tax benefits grant a ten-year tax exemption on foreign-source income produced or accrued outside Israel and income stemming from assets located outside Israel. The New Immigrant Benefits also grant an exemption from any tax reporting requirements with respect to foreign income and assets – meaning that new Israeli residents or veteran returning residents are liable to tax and reporting in Israel during the ten-year period only with respect to income derived from an Israeli source or an asset located in Israeli.

THE TALMI CASE – TAXATION OF NEW AND RETURNING RESIDENTS

In the *Talmi* case, an individual returned to Israel after residing in the U.K. for a period of 20 years. He was employed in the U.K. by E.M.C. (the "Company") from 1994 and continued to be employed by the Company after his return to Israel in 2007. His position after his return was Sales Area Finance Manager for the area consisting of Israel, Turkey, Greece, Cyprus, and Malta.

Three points of controversy arose between the Israeli Tax Authority and the individual:

- The individual claimed that income he received from the Company upon his return to Israel was derived in connection with assets he developed for the Company during the time he resided outside Israel as a U.K. resident. Thus, he contended, the income was foreign income that should not be taxed in Israel during the ten-year exemption period.
- The individual also claimed that the source of the income should be determined by reference to the underlying sales of the Company in each country within the region and not as asserted by the Tax Assessor on the number of days of presence in each location. The basis for his argument was that he was compensated by reference to sales volume and not time spent.

- Finally, he claimed that the date of his return to Israel was July 1, 2007, when his assignment commenced. The Tax Assessor, however, claimed he returned to Israel on January 1, 2007, which was the first day of the year in which the individual began spending more days in Israel than abroad.

In brief, the court ruled on each of the issues as follows.

- **Income Derived from Assets** – The exemption should be interpreted in a broad sense. If the income being paid bears a substantial connection to foreign assets developed prior to the date on which the individual first became an Israeli tax resident, the income was accrued from a foreign asset.

  The court looked to the legislative intent behind the enactment of the New Immigrant Benefits program. It was designed to encourage the return of individuals. It accomplished this in part by granting an exemption for income accrued outside of Israel. According to the court, the term "assets" should be broadly interpreted. Consequently, work methods, sale methods, financial products, various mechanisms, and so forth developed by an individual during the period of absence from Israel should be considered "foreign assets" when applying the exemption. Having said that, the court determined that the individual failed to prove existence of such assets.

"The tax benefits grant a ten-year tax exemption on foreign-source income produced or accrued outside Israel and income stemming from assets located outside Israel."

- **Income Derived from Employment** – The court rules that income should be allocated based on the actual location in which a service was provided. In the absence of any other evidence on the individual's part, adopting the formula set in the 2011 Income Tax Circular, according to which the allocation should be based on the business days spent by the individual in Israel and abroad, is reasonable and acceptable.
- **Date of Commencement of Residency** – The court disagreed with the position of the Tax Assessor. The process of relocating the center of vital interests ("Center of Life") of an individual to a different country does not take place abruptly. Rather, it is a gradual process, maturing over a given period of time. This is relevant to both the commencement and the termination of fiscal residency. When examining the individual's physical presence for each day in 2007, the individual spent only half his time in Israel from January 1 through May 31. However, he spent most of his time in Israel beginning at a certain point in June. In addition, his employment contract began on July 1, 2007. Consequently, the court ruled that the individual's date of return to Israel was July 1, 2007.

CONCLUSION

The New Immigrant Benefits have been in place for nearly a decade, and the ruling in the *Talmi* case is the first to discuss the regime and its interpretation. The court has taken a broad stance, which aims to maintain the original intention of the legislation. Undoubtedly, this is good news for individuals wishing to benefit from the provisions of this tax regime. However, it was a sad day for the taxpayer involved in the case. In sum, the Tax Assessor won regarding this particular taxpayer but may have lost on the issue of broader application, the starting date of residence.

COMING TO THE U.S. AFTER TAX REFORM[1]

Author
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Tags
C.F.C.
Foreign Investment
Holding Company
T.C.J.A.
U.S. Shareholder

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INTRODUCTION

Non-U.S. emerging companies continue to migrate to the U.S. to seek venture capital funding. Many founders and their attorneys have asked if the 2017 Tax Cuts and Jobs Act ("T.C.J.A.") contains changes to the tax provisions that will affect the fundamental investment structure often used prior to its enactment. The answer to that question is dependent on the particular needs and priorities of each business or investor.

Given the time that has passed since the date of enactment of the T.C.J.A., the time for broad explanations is over. Instead, this article briefly mentions the obvious changes to the law and proceeds to focus on several "sleeper provisions" that have been the domain of "elite" international tax advisors. These provisions can be quite troublesome for those who do not devote hours each day to the intricacies of tax law after the T.C.J.A. As explained below in detail, the incidence of tax for U.S. persons that own foreign enterprises has expanded exponentially. The trip wires for taxation under Subpart F have multiplied. Even if tax exposure under Subpart F can be managed, the reward is not deferral. Rather, it is immediate tax under the global intangible low-taxed income ("G.I.L.T.I.") provisions. This may be fine for corporations because tax under the G.I.L.T.I. regime is low. But it may generate highly taxed income for individual U.S. Shareholders.

OVERVIEW OF THE T.C.J.A.

Obvious changes brought about by the T.C.J.A. are well known:

- A reduction of the corporate tax rate to 21%
- An elimination of Net Operating Loss ("N.O.L.") carrybacks and limit on the N.O.L. benefit to 80% of taxable income in the carryover year[2]
- A repeal of the U.S. deferral system on foreign earnings in favor of a quasi-territorial system that taxes G.I.L.T.I. of a Controlled Foreign Corporation ("C.F.C.") on a current basis
- The adoption of a dividends received deduction for U.S. corporations receiving dividends from 10%-owned subsidiaries, along with a catch-up transition tax in 2017 that purges C.F.C.'s and other foreign corporations ("F.C.'s") that are at least 10%-owned by one or more U.S. corporations

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1 The author wishes to thank Stanley C. Ruchelman for his review of this article.

2 Thus, 20% of taxable income is taxed at 21% and the balance is carried forward indefinitely.

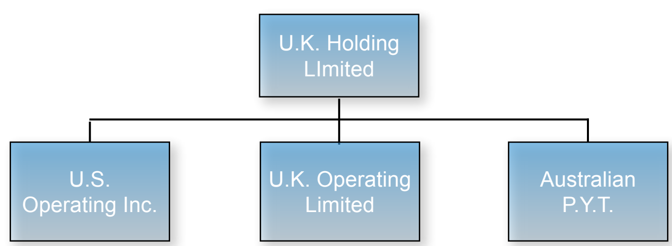
- An imposition of a minimum tax on base erosion and anti-abuse tax ("B.E.A.T.") payments to related parties outside the U.S. in the context of large multinational groups
- A preferential tax regime for foreign derived intangible income ("F.D.I.I.") of U.S. corporate taxpayers
- A restriction on the deductibility of business interest expense
- More favorable expensing provisions for asset acquisitions
- Special deductions for individuals who own pass-thru entities in certain business sectors
- A repeal of the corporate alternative minimum tax

SLEEPER PROVISIONS

Beginning in 2018, non-U.S. founders of non-U.S. businesses must navigate the sleeper provisions of the T.C.J.A. and their potential impact on F.C.'s and their U.S. investors. Founders and executives of certain F.C.'s will need to provide some of their U.S. investors with financial information so that they can meet their U.S. tax compliance requirements. In addition, the U.S. subsidiary of the F.C. may have incremental U.S. tax filings, which will provide detailed financial information regarding certain foreign affiliates owned in part by members of the foreign group and in part by others. Non-U.S. entrepreneurs looking to expand into the U.S. will need to acquire a basic understanding of the U.S. tax laws that will affect their global business and their U.S. investors.

TYPICAL F.C. HOLDING STRUCTURE

Generally, a non-U.S. startup that has successfully created a new scalable business at home will be encouraged to expand to the U.S. in order to intensify growth. A common structure employed is the following:



Under prior law, investors in U.K. Holding Limited ("U.K.H.L.") could potentially be either non-U.S. investors or U.S. investors, which can be further divided in two groups. Group 1 consists of U.S. investors who own shares representing less than 10% of the voting power of U.K.H.L. Group 2 includes U.S. investors who own shares representing 10% or more of the voting power of U.K.H.L. (commonly referred to as "U.S. Shareholders").

If Group 2 owns more than 50% of the shares, U.K.H.L. would be a C.F.C. for U.S. tax purposes. A C.F.C. today is subject to the anti-deferral rules of Subpart F and the new G.I.L.T.I. provisions (to be defined later), thus leading to current income for the U.S. Shareholders in Group 2, even if no cash distributions are received from U.K.H.L.

NEW U.S. SHAREHOLDER DEFINITION

The T.C.J.A. expands upon the circumstances in which an F.C. may be considered to be a C.F.C. by modifying the standard for an investor to be considered a U.S. Shareholder. As a result, the term U.S. Shareholder has been expanded to include an investor that owns shares representing 10% or more of the total value of shares of an F.C. Prior law looked only to the ownership of shares representing 10% or more of the total voting power of an F.C.[3]

While founders typically own voting stock, many venture capital funds may own "preferred shares" with no voting power but substantial value. For example, a venture capital fund may have invested all or most of its equity with a right of repayment that is senior to the rights of the common shares. In the past, a U.S. venture capital fund that holds only preferred shares with no voting power was not considered to be a U.S. Shareholder. Consequently, U.S. holders of non-voting preferred shares were not U.S. Shareholders for purposes of determining whether an F.C. were a C.F.C.

With the new expanded definition, that type of U.S. investor can be considered a U.S. Shareholder under the value-based test. Consequently, more F.C.'s will be C.F.C.'s, and more U.S. investors will be subject to the Subpart F regime and the G.I.L.T.I. provisions.

NEW DEFINITION OF C.F.C.

A C.F.C. is generally defined as any F.C. in which more than 50% of the total combined voting power of all classes of stock or of the total value of the stock is considered to be directly, indirectly, or constructively owned by U.S. Shareholders on any day of the taxable year.[4]

Constructive Ownership in an F.C.

In determining U.S. Shareholder and C.F.C. statuses, shares of stock owned directly, indirectly, and constructively in an F.C. are taken into account.[5] In contrast, only direct and indirect ownership — not constructive ownership — are taken into account in determining whether a U.S. Shareholder is required to include Subpart F Income in gross income and the amount to be included.[6]

The constructive ownership rules apply for purposes of determining whether (i) a U.S. person is a U.S. Shareholder; (ii) an F.C. is a C.F.C.; (iii) the stock of a domestic corporation is owned by a U.S. Shareholder of a C.F.C. for purposes of the rules taxing U.S. Shareholders when a C.F.C. makes a taxable investment in U.S. property; and (iv) a corporation or other person is related to the C.F.C. While the constructive ownership rules do not apply for purposes of determining the amount of

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3 Code §951(b).

4 Code §957.

5 Code §§958(a)–(b).

6 Code §951(a).

gross income included in a U.S. Shareholder's income, they can cause actual U.S. Shareholders of an F.C. that is not a C.F.C. to be taxed on a current basis under Subpart F income rules and G.I.L.T.I. rules.

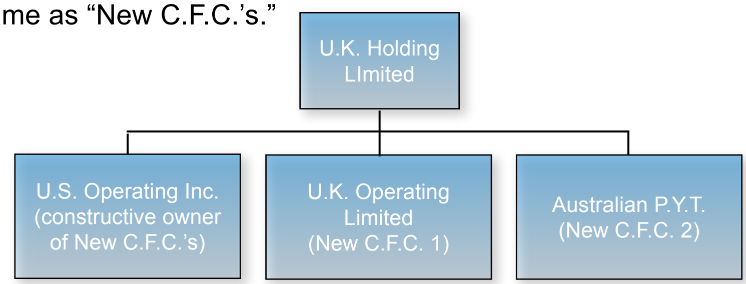
Loophole in Prior Law

Under prior law, a loophole existed that allowed tax deferred earnings of a C.F.C. to escape the U.S. tax regime when a U.S.-based group owning the C.F.C. inverted into a foreign-based group and the foreign parent acquired newly issued shares in the C.F.C. Prior law prevented ownership of the newly issued shares in the C.F.C. from being attributed to members of the U.S. group. As a result, in the right fact pattern, the C.F.C. could become an F.C. and dividends could be distributed to the foreign parent and loans could be made to U.S. affiliates without having to worry about taxation in the U.S. under Subpar F. Congress closed the loophole with the T.C.J.A., by eliminating the rule[7] that prevented the "downward" constructive attribution of stock owned by non-U.S. persons to a U.S. person.[8]

Example

For example, U.K. Operating Limited and Australian P.T.Y. are owned by a foreign parent, U.K.H.L. They can be attributed constructively to its U.S. subsidiary, U.S. Operating Inc. The repeal of the downward attribution rule leads to a surprising outcome where an innocent bystander, the U.S. Shareholder, is taxed.

In the diagram below, because U.K.H.L. owns 50% or more of U.S. Operating Inc., U.S. Operating Inc. takes the place of its parent, U.K.H.L., and is deemed to own the shares that U.K.H.L. owns in U.K. Operating Limited and Australian P.T.Y. As a result, the two latter F.C.'s become C.F.C.'s, which for purposes of this discussion we shall name as "New C.F.C.'s."



Initial Phase

If a U.S. person does not directly or indirectly own shares in U.K.H.L. representing 10% or more of the voting power or value of U.K.H.L., no income inclusion is mandated for U.S. Operating Inc. under Subpart F or the G.I.L.T.I. regime. However, there is a possibility that U.S. Operating Inc. would be required to file information returns on each of the New C.F.C.'s, although some language in the legislative history indicates that a comparable change was not made in the information reporting rules in Code §6038.[9] In any event, I.R.S. guidance issued in Notice 2018-13 waives the

7 Code §958(b)(4).

8 Code §318(a)(3).

9 See the discussion of the Senate Amendment in the Conference Committee Report to PL 115-97, 12/22/2017, at note 1529.

requirement for filing information returns where there are no direct or indirect U.S. Shareholders in the New C.F.C.'s.

Subsequent Phase

Over time, the company grows and raises new capital from U.S. investors. If one or more investors in U.K.H.L. owns sufficient shares to be considered a U.S. Shareholder of U.K.H.L. and the New C.F.C.'s, U.S. Operating Inc. (as the constructive owner of its foreign affiliates) must file information returns regarding the New C.F.C.'s. No information return is required with regard to U.K.H.L. because U.S. Operating Inc. is not a constructive owner of U.K.H.L. Failure to file these returns carries a $10,000 penalty for each C.F.C. for each year in which a compliance failure occurs.

In addition, the U.S. Shareholders of U.K.H.L., as indirect U.S. Shareholders of the New C.F.C.'s, must include in current income any Subpart F Income and G.I.L.T.I. of the New C.F.C.'s.

"The repeal of the downward attribution rule with respect to foreign parent companies has resulted in unintended consequences."

Many international tax experts believe that the repeal of the downward attribution rule with respect to foreign parent companies has resulted in unintended consequences far beyond the loophole that concerned Congress. According to the Senate Finance Committee's explanation in the Senate bill, Congress intended for downward attribution to not apply in order for an F.C. to be treated as a C.F.C. with respect to a U.S. Shareholder not related[10] to the U.S. person (*e.g.*, U.S. Operating Inc.) to whom ownership of the F.C.'s stock was attributed.[11]

A technical amendment was proposed but was rejected as unnecessary. Now, there is a question as to whether the U.S. Treasury has the "authority" to create regulations limiting the application of this rule or whether taxpayers will have to wait for new legislation in a technical corrections bill.

EXECUTIVE RESPONSIBILITIES AND RESOURCES

U.S. Shareholders will be dependent on the financial management team of a C.F.C. to provide financial information that is needed to meet U.S. tax compliance obligations. In some countries, providing the necessary information regarding the identities of other shareholders may be prohibited. Even where not prohibited, financial management may be unwilling to provide information on a timely basis, if at all.

In these situations, the information gathering process must start well before the year end of the new C.F.C. The goal is to achieve congruence between the obligations of U.S. tax law and the agenda for financial management of the new C.F.C. It is critical for financial management to have a basic understanding of the fundamental concepts of Code §6038 in order to comply with these requests.

People with specific expertise will need to be assigned (*e.g.*, I.T. assistance for data accumulation programming) and additional funding will be required for the C.F.C. to perform these tasks on behalf of its U.S. Shareholders. An example of some of the information required is described in the definitions below.

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[10] Code §954(d)(3).

[11] New York State Bar Association, Report on Section 965, no. 1388 (February 6, 2018), pp. 39–41.

REMAINING AND NEW ANTI-DEFERRAL MEASURES

One of the major changes to the U.S. tax system is the move to a quasi-territorial system where dividends of C.F.C.'s are subject to a participation exemption and are not subject to tax when repatriated. Some substantial vestiges of the prior law remain to tax current U.S. Shareholders of C.F.C.'s.

Two continuing anti-deferral regimes and one new regime apply to 2018 and future years: Subpart F Income, investment in U.S. Property, and G.I.L.T.I. The most relevant concepts are briefly defined below.[12]

Subpart F Income

Despite the implementation of the T.C.J.A., the Subpart F rules remain in effect, and as the foregoing discussion indicates, are given broader scope. Subpart F Income includes foreign base company sales income, foreign base company services income, and foreign personal holding company income.[13]

- Foreign base company sales income is income derived in connection with the purchase of personal property from a related person and its sale to any person[14] whether in the form of profits, commissions, fees, or otherwise. Exceptions exist, *inter alia*, regarding sales of a product manufactured in the country of organization of a C.F.C. and sales of a product for use and consumption in the country of organization of a C.F.C.
- Foreign base company services income is income derived from performing services for, or on behalf of, a related person where the services are performed outside the C.F.C.'s country of organization.[15]
- Branches can be treated as separate companies when a sale to a branch yields the same tax effect overseas as a sale to a related person because of the disparity in tax rates between the branch and the home office.
- Subpart F is calculated on a C.F.C.-by-C.F.C. basis and an indirect foreign tax credit is available to offset some or all of the U.S. tax on such income.[16]
- The income inclusion under Subpart F is based on a concept of "earnings and profits," although the income inclusion is not treated as a deemed dividend.

The way in which Subpart F can apply to a software company will depend on the software product that will be marketed. If the software is developed by New C.F.C. 1 in the U.K. and sold as a shrink-wrap product to New C.F.C. 2 for distribution in Australia, no Subpart F Income arises in either country because the software is considered to be a copyrighted article. Because the article is "produced" in the U.K., New C.F.C. 1 does not have foreign base company sales income. The same result

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12 A detailed discussion of the three regimes is beyond the scope of this article.

13 Code §954(a).

14 Code §954(d)(1).

15 Code §954(e).

16 Code §§901–960.

exists for New C.F.C. 2 in Australia because the article is sold for consumption and use in Australia.

If, on the other hand, the software is used as a service in an "SaaS" transaction, the key issue becomes foreign base company services income for services performed outside Australia by New C.F.C. 2.

Investment in U.S. Property

The investment in U.S. property[17] provisions continue to apply as an additional mechanism to generate current income tax for a U.S. Shareholder of a C.F.C., but only to the extent the U.S. Shareholder has not previously included the earnings for the year as Subpart F Income.[18] Once earnings are included in income, the investment in U.S. property is treated as previously taxed income ("P.T.I.") that is not taxed a second time.

Generally, an investment in U.S. property eliminates sovereign risk and for that reason in treated as a form of repatriation of earnings that is taxed to a U.S. Shareholder.

The definition of taxable U.S. property includes

- tangible property located in the U.S.,
- stock of a domestic corporation that is related,
- an obligation of a U.S. person that is related, or
- any right to use in the U.S. a copyright, patent, invention, model, design, formula, process, or similar property right the C.F.C. acquired or developed for use in the U.S.

"The obligation to recognize income on an accelerated current basis for an investment in a C.F.C. rather than an F.C. reduces the return on investment."

G.I.L.T.I.

The G.I.L.T.I. regime[19] applies to U.S. Shareholders of C.F.C.'s. G.I.L.T.I. applies only to income that is not already taxed in the U.S. either at the level of a C.F.C. or its U.S. Shareholders. Consequently, the first step in computing G.I.L.T.I. is to eliminate the items of C.F.C. income that produce current tax. These include the following items of income:

- Business income that is subject to net-basis taxation in the U.S.
- Dividends from a related C.F.C. that are not subject to tax in the U.S. at either the level of the C.F.C. or the level of its U.S. Shareholders because of Subpart F
- All other C.F.C. income that results in an immediate U.S. tax under Subpart F for its U.S. Shareholders

The remaining income is referred to as "Tested Income."

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[17] Code §§956 and 951(a)(1)(B).

[18] Code §959(a)(2).

[19] Code §951A.

In determining how much Tested Income is treated as G.I.L.T.I., actual economic drivers for generating income are ignored. Instead, all items of C.F.C. income are deemed to arise from either depreciable tangible property or intangible property used in the business. Inventory, work in progress, or supplies are excluded in the computation. If the C.F.C. is a foreign bank, the financial assets of the bank also are ignored.

The investment in tangible depreciable property is deemed to generate a 10% yield computed with reference to the adjusted basis of the property. That is reduced by interest expense allocated against the tangible depreciable property. The balance of the income is attributable to intangible property, which in turn gives rise to G.I.L.T.I.

For U.S. corporations, a 50% deduction is available for domestic shareholders to produce a U.S. tax imposed at the rate of 10.5%.[20] An indirect foreign tax credit can be claimed against G.I.L.T.I. but only to the extent the foreign taxes relate to the net tested income that generates G.I.L.T.I.[21] The Code §78 gross up of foreign taxes into income applies. Of the foreign income taxes that relate to G.I.L.T.I., only 80% are creditable.[22] In addition, no carryover of unused taxes is permitted.[23] As a result, to the extent foreign income taxes are not utilized as a credit in the year they arise, no benefit is obtained. When dividends are distributed, they are considered to be P.T.I. and are not taxed again.[24]

TAX COSTS FOR U.S. INVESTORS

For European companies hoping to drive down the Technology Silk Road, from London to New York to Silicon Valley, the broader definitions of a U.S. Shareholder and the expansion of the stock attribution rules will result in many more F.C.'s being viewed to be C.F.C.'s. Significant compliance and U.S. income tax costs could serve as a deterrent to marginal investments. For the F.C., the duty to provide more information for the U.S. investor adds to the cost of raising funds in the U.S. For the U.S. Shareholder, the obligation to recognize income on an accelerated current basis for an investment in a C.F.C. rather than an F.C. reduces the return on investment.

Table A on the following page illustrates the tax cost for an individual investor in an F.C. compared to the tax cost that would occur if the F.C. becomes a C.F.C.

The table assumes that the F.C. is a tech company with intellectual property ("I.P.") but no tangible depreciable property, which causes the U.S. investor to be taxed under the G.I.L.T.I. provisions. In addition, the calculations assume that the F.C. would pay a dividend in year two, which would be considered a qualified dividend.

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20 Code §250(a)(3)(b).

21 Code §960(d)(1).

22 *Id.*

23 Code §904(c).

24 Code §951A(f)(1).

TABLE A		
	U.S. Shareholder Holds Shares of a C.F.C., No Code §962 Election	**U.S. Shareholder Holds Shares of a Non-C.F.C.**
Non-U.S. Income	$100.00	$100.00
Non-U.S. Tax	$18.00	$18.00
F.C. Net Income	**$82.00**	**$82.00**
G.I.L.T.I.		
Income	$82.00	–
Gross-up	$0.00	–
50% Deduction	–	–
Tax Rate	37%	–
U.S. G.I.L.T.I. Tax	$30.34	–
Worldwide Tax, Year 1	**$48.34**	**$18.00**
Dividend to Shareholder	$82.00	$82.00
P.T.I., Code §959	-$82.00	$0.00
Net Dividend	$0.00	$82.00
***Dividend Tax to Individual**	**$3.12**	**$19.52**
Worldwide Tax, Years 1 & 2	$51.46	$37.52
Worldwide Effective Tax Rate	**51.5%**	**37.5%**
Net Earnings After Tax, Years 1 & 2	***$48.54***	***$62.48***
*The net investment tax applies to the dividend.		

C.F.C.

In year one, a C.F.C. has earnings of $100, which is considered to be G.I.L.T.I., and a local tax rate of 18%, generating $82 net after tax. The U.S. Shareholder would be taxable in year one at the rate of 37% of $82, resulting in a tax of $30.34 with no cash distributed to the U.S. Shareholder. The worldwide tax in year one would be $48.34 (*i.e.*, $18.00 + $30.34).

In year two, when an $82 dividend is paid, it is not taxable as it is considered to be P.T.I.; however, there is a 3.8% net investment tax on the distribution. The resulting two-year U.S. tax is $33.46, and the worldwide tax is $51.46. Assuming a constant flow of G.I.L.T.I., the investor has an inclusion in the second year that matches the inclusion in the first year.

Non-C.F.C.

On the other hand, an investor in an F.C. that is not a C.F.C. is not subject to the G.I.L.T.I. provisions. The F.C. makes no cash distribution in year one. The worldwide tax in year one is, therefore, the local tax of $18.

In year two, when a distribution is made, the U.S. Shareholder pays a tax on qualified dividends and net investment tax of 23.8% for a total of $19.52. The total U.S. tax is $19.52, and the worldwide tax is $37.52.

As the table shows, if the F.C. is a C.F.C., the worldwide effective tax rate is 51.5%, whereas if the F.C. is not a C.F.C. the effective tax rate would be 37.5% – a 37% increase in tax results from the expansion of the C.F.C. definition.

Note that tax calculations will vary with differences in facts and assumptions, tax rates in the state of residence of the U.S. investor, and the applicable effective tax rate in the foreign country.

Mitigating Factors

When considering the practical application of these rules, the results may not be quite so onerous.

"Individuals can make a technical election under Code §962 to be taxed as a corporation with regard to income taxed under G.I.L.T.I., investment in U.S. property, and Subpart F provisions."

If no U.S. Shareholder exists, the issues above are merely theoretical. On the other hand, if a U.S. Shareholder does exist, the main foreign operating company that owns the I.P. may be operating at a loss. Until earnings are generated, neither Subpart F nor investment in U.S. property issues will apply. Similarly, in early years, G.I.L.T.I. inclusions are not likely to exist in light of typical revenue streams in this sector. Further, such companies rarely pay dividends but hope to have an exit, via a sale of shares.

POTENTIAL PLANNING OPPORTUNITIES

The "Delaware Flip"

One frequently discussed solution is to flip the F.C. group under a new U.S. parent ("Topco").

In some cases, moving foreign entities or assets under a U.S. Topco could result in foreign taxes (if unrealized gains exist) or trigger clawbacks of previously granted tax incentives. If a U.S. subsidiary exists as part of an F.C. group, it would need to be distributed out from under the foreign parent company in order to avoid the creation of a "U.S. Sandwich," which could result in potential income inclusions as "investments in U.S. property." Additionally, this distribution could be subject to taxes in the local country.

Of course, a Delaware Flip makes all remaining F.C.'s to C.F.C.'s but may provide savings under the foreign derived income rules if development activity occurs in the U.S.

The Code §962 Election

In spite of the challenges created by the T.C.J.A., planning opportunities can be employed by a U.S. Shareholder to mitigate potential U.S. taxes. For example, individuals can make a technical election under Code §962 to be taxed as a corporation with regard to income taxed under G.I.L.T.I., investment in U.S. property, and Subpart F provisions.

Code §962 was enacted as part of the original Subpart F regime with an intent to allow individuals who had invested in C.F.C.'s to have the same treatment they would have had if they invested through a U.S. corporation. The principal benefit is the deemed paid foreign tax credit allowed under Code §960. However, the election takes place annually and is often not perfect.

There are three major issues that limit the potential benefits of the election and appear to deviate from the original legislative intent:[25]

- First, if earnings of a C.F.C. are included in the income tax return of a U.S. individual under Subpart F, G.I.L.T.I., or investment in U.S. property provisions without an accompanying cash distribution, an actual dividend paid in a later year is considered to be P.T.I. and is normally not taxed again. In comparison, when an election is made by an individual under Code §962, the actual dividend from the foreign corporation is taxed a second time to the extent it exceeds taxes previously paid on the Subpart F inclusion.

- Second, the tax rate on the deemed dividend is a point of controversy with the I.R.S. The issue is whether the distribution should be treated as a qualified dividend[26] taxed at a rate that does not exceed 20%. The I.R.S. contends that the tax rate should be 37%.[27] Whichever rate applies, the net investment tax of 3.8% must be taken into account. There is currently a case in the Tax Court, *Smith v. Commr.*, addressing this matter. A request for summary judgment has been filed, and the matter may be resolved without a trial as the government's position seems weak in light of the Congressional purpose of a Code §962, which was to put an individual in the same place as having formed a U.S. corporation to act as the shareholder.

- Third, under the T.C.J.A., a 50% dividend received deduction is available to reduce the G.I.L.T.I. inclusion. This dividend received deduction is available to domestic corporations. The law does not state that it is available to individuals; although, given the purpose of the Code §962 election, one would expect that this benefit should be available.

Because of the current uncertainty regarding the calculation of the corporate tax under Code §962 alternatives, U.S. Shareholders should be cautious and evaluate the matter carefully before proceeding.

Table B oo the following page shows various results depending on which of these three issues are resolved in favor of the individual taxpayer.

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[25] S. Rep't No. 1881, 87th Cong., 2d Sess. 92 (1962).

[26] Code §1(h)(11)(C).

[27] *Smith v. Commr.*, No. 14900-15.

TABLE B			
	Result of Code §962 Election		
	Worst Case	**Mid Case**	**Best Case**
Non-U.S. Income	$100.00	$100.00	$100.00
Non-U.S. Tax	$18.00	$18.00	$18.00
F.C. Net Income	**$82.00**	**$82.00**	**$82.00**
G.I.L.T.I.			
Income	$82.00	$82.00	$82.00
Gross-up	$18.00	$18.00	$18.00
50% Deduction	–	$50.00	$50.00
Tax Rate	21%	21%	21%
U.S. G.I.L.T.I. Tax	$21.00	$10.50	$10.50
F.T.C. (80% G.I.L.T.I. limitation)	-$14.00	-$14.00	-$14.00
F.T.C. Carryover	$0.00	$0.00	$0.00
U.S. Incremental Tax, Code §962(d)	$6.60	$0.00	$0.00
Worldwide Tax, Year 1	**$24.60**	**$18.00**	**$18.00**
Dividend to Shareholder	$82.00	$82.00	$82.00
P.T.I., Code §962(d)	-$6.60	$0.00	$0.00
Net Dividend	$75.40	$82.00	$82.00
Dividend Tax to individual	**$30.76**	**$29.17**	**$17.02**
Worldwide Tax, Years 1 & 2	$55.36	$47.17	$35.02
Worldwide Effective Tax Rate	**55.4%**	**47.2%**	**35%**
Net Earnings After Tax, Years 1 & 2	***$44.64***	***$52.83***	***$64.98***

In the "Worst Case," the absence of the 50% dividend received deduction results in a 21% tax rate. Thus, 80% of the $18 foreign tax is available as a $14.40 credit, leaving an incremental U.S. tax of $6.60 (*i.e.*, $21 - $14.40). The resulting worldwide tax in year one is $24.60. In year two, when a dividend is distributed to the individual, only $6.60 is allowed as P.T.I. or simply as a reduction to earnings and profits, leaving a total taxable income of $75.40. As the 20% qualifying dividend rate is not available, the dividend could be taxed at the 37% rate plus 3.8% net investment tax for a total tax of $30.76. The worldwide tax for year one and two is therefore $55.36. Certainly, selecting this alternative for a dividend-paying entity is not a good idea as the price of not making an election is only $51.46, as seen in Table A.

If some issues are resolved in favor of the individual taxpayer, the tax result could be more favorable. In the "Mid Case" calculation in Table B, the taxpayer would be entitled to a 50% dividend received deduction resulting in $10.50 of U.S. tax, which could be offset by an 80% foreign tax credit of $14.40. The additional $3.60 of excess foreign tax credit is lost because a carryover is not available, and the excess credit cannot be used against other foreign-source income. Therefore, the worldwide tax for year one is $18. In year two, when a dividend is distributed, only $10.50 is allowed as P.T.I., and $71.50 is taxable as a non-qualified dividend at 40.8%, resulting in a tax of $29.17. The worldwide tax for years one and two is $47.17. The Mid Case option results in a 17% decrease in the effective tax rate when compared to the Worst Case and is only 9% better than making no election.

Finally, if the original intent of the tax provision became a reality, the "Best Case" in Table B would be as follows. The taxpayer would be entitled to the 50% dividend received deduction along with the foreign tax credit as in the Mid Case for a worldwide tax in year one of $18. When a dividend distribution is paid in year two, only $10.50 would be available as P.T.I., leaving a dividend of $71.50. However, if the dividend were taxable as a qualified dividend at 20% plus the net investment income tax of 3.8%, the U.S. tax would be $17.02 resulting in a worldwide tax for years one and two of $35.02. The Best Case option reduces the tax by 35% in comparison to the Worst Case and is a slightly better alternative than holding shares in a U.S. domestic entity, as described below. Certainly, this option could be a real opportunity for an individual U.S. Shareholder.

The U.S. Domestic Holding Corporation

Another planning opportunity exists if an individual U.S. Shareholder were to hold investments in C.F.C.'s through a U.S. domestic corporation.

Table C illustrates the tax results of this option under the same fact pattern as above.

TABLE C		
	Domestic Company Holds Shares of a C.F.C.	**U.S. Shareholder Holds Shares of a Non-C.F.C.**
Non-U.S. Income	$100.00	$100.00
Non-U.S. Tax	$18.00	$18.00
F.C. Net Income	**$82.00**	**$82.00**
G.I.L.T.I.		
Income	$82.00	–
Gross-up	$18.00	–
50% Deduction	$50.00	–
Tax Rate	21%	–
U.S. G.I.L.T.I. Tax	$10.50	–

TABLE C		
	Domestic Company Holds Shares of a C.F.C.	**U.S. Shareholder Holds Shares of a Non-C.F.C.**
F.T.C. (80% G.I.L.T.I. limitation)	-$14.00	–
F.T.C. Carryover	$0.00	–
U.S. Incremental Tax, Code §962(d)	$0.00	–
Worldwide Tax, Year 1	**$18.00**	**$18.00**
Corporate Dividend from F.C.	$82.00	–
P.T.I., Code §959	-$82.00	–
Corporate 2nd Level of Tax	**$0.00**	**–**
Dividend to Shareholder	$82.00	$82.00
P.T.I., Code §962(d)	$0.00	$0.00
Net Dividend	$82.00	$82.00
Dividend Tax to individual	**$19.52**	**$19.52**
Worldwide Tax, Years 1 & 2	$37.52	$37.52
Worldwide Effective Tax Rate	**37%**	**37%**
Net Earnings After Tax, Years 1 & 2	***$62.48***	***$62.48***

In this calculation, the corporation gets a 50% dividend received deduction for a tax of $10.50 offset by the foreign tax credit of $14.40 as in the prior cases. The worldwide tax in year one is $18. In year two, the F.C. pays a dividend to the U.S. holding company; however, a full Code §959 deduction of P.T.I. is received. Therefore, no tax is due at the U.S. holding company level. The U.S. holding company pays a dividend to the U.S. Shareholder who pays a 23.7% dividend tax of $19.52 for a worldwide tax of $37.50.

When the worldwide tax costs of a U.S. domestic holding company holding an individual's shares in a C.F.C. is compared with the worldwide tax costs of an individual U.S. Shareholder holding shares in an F.C. that is not a C.F.C., the tax results are the same. We have come full circle.

Of course, different assumptions could have different outcomes. For example, if there were withholding taxes imposed by the non-U.S. country on the payments to the U.S. holding company or if there were different non-U.S. tax rates, the tax results would be different.

To summarize the results of this analysis, it is clear that if a U.S. Shareholder holds shares in a C.F.C. without any tax planning, the T.C.J.A. would result in an incremental tax cost of about 37%. The Code §962 election would be an option if it were possible to obtain favorable guidance on the application of both existing and new rules. At this point in time, holding shares in a domestic holding company appears to yield promising results.

	U.S. Shareholder Holds Shares of a C.F.C.				Domestic Company Holds Shares of a C.F.C.	U.S. Shareholder Holds Shares of a Non-C.F.C.
	No Election	Code §962 Election				
		Worst Case	Mid Case	Best Case		
Net Earnings After Tax, Years 1 & 2	$48.54	$44.64	$52.83	$64.98	$62.48	$62.48

OTHER PLANNING IDEAS

In addition to individual tax planning, there are other possible opportunities at the F.C. or subsidiary level to mitigate the impact of the T.C.J.A. Because of the peculiar application of the downward attribution rules in which the foreign parent is not eligible to be a C.F.C. even though its subsidiaries are C.F.C.'s, the possibility may exist to convert the parent company to the "trading company" where Subpart F and G.I.L.T.I. may not apply. Furthermore, it may be possible to convert corporate subsidiaries of foreign holding companies into pass-thru entities. However, deep dives into these strategies are beyond the scope of this article.

On a final note, one benefit resulting from the repeal of the downward attribution rule is the minimized tax exposure created by the Passive Foreign Investment Company ("P.F.I.C.") regime,[28] which sometimes applies to non-U.S. startups because of the proliferation of C.F.C.'s. An F.C. cannot be both a C.F.C. and a P.F.I.C. The C.F.C. rule trumps the P.F.I.C. regime.[29] Unfortunately, U.S. investors who own less than 10% of the F.C. could have P.F.I.C. issues that would result in current income gain or loss of qualified dividend treatment and the imposition of interest charges "deemed" ordinary and capital distributions.

CONCLUSION

In summary, non-U.S. emerging businesses looking to expand to the U.S. must carefully consider the growth path of their company, the availability of non-U.S. funding, as well as possible exit opportunities. Although it is true that venture capital funding is more abundant in the U.S. than in most other countries, many U.S. investors prefer to invest in U.S. corporations that hold the I.P. However, non-U.S. investors

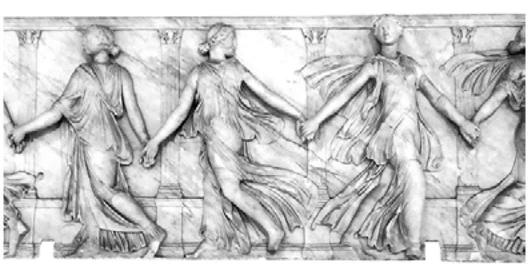
[28] Code §1291.

[29] Code §1297(d).

typically do not feel the same way. A strategic buyer could hold a new acquisition in his or her own offshore structure, shying away from a U.S. structure.

Furthermore, the reach of the U.S. tax authorities is extensive. Creating a Delaware Flip may not be the ideal solution. Creating a U.S. Topco is a one-way street and is virtually irreversible without the imposition of U.S. taxes on inherent asset gains. Although the current tax rate of 21% is attractive, many are not sure that the rate is politically sustainable. In addition, certain tax benefits not discussed in this article – like the F.D.I.I. provisions, which provide for only a 13.125% tax on a portion of income derived from servicing foreign markets with products or services – have been challenged by the World Trade Organization as illegal export subsidies.

While there are no easy answers or silver bullets, tax-planning opportunities exist for both U.S. Shareholders and non-U.S. corporations to mitigate some of the tax impact of the more onerous provisions in the T.C.J.A. The incremental cost of planning and complying with the new U.S. tax provisions are not to be underestimated. F.C.'s and their investors should examine their corporate structures and create models of various alternatives before drawing conclusions.



JOINT AUDITS: A NEW TOOL TO COMBAT CROSS-BORDER TAX EVASION

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Tags
Audit
Germany
Italy
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Tax Examination
Transfer Pricing

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INTRODUCTION

A key message arising from international initiatives to eliminate cross-border tax avoidance is the need to strengthen cooperation and enhance transparency between (i) taxpayers and tax administrations and (ii) the various tax administrations that are stakeholders in a cross-border business operation. To this end, the O.E.C.D. has introduced a new array of legal tools, one of which stands out for its innovative features: the joint tax examination.[1] This article examines the initial pilot program between Italy and Germany, comparing the joint audit process to the traditional administrative and legal processes that taxpayers must follow to challenge a proposed adjustment under a normal transfer pricing examination.

The joint audit is intended to (i) effectively tackle cross-border tax evasion, (ii) address aggressive tax planning, and (iii) establish a new cooperative and transparent relationship between revenue bodies and taxpayers. From a practical standpoint, joint audits enable examiners of different tax administrations to work as a team in jointly performing examination activities. The collection of data, the analysis of data, and face-to-face interview are conducted jointly by examiners in each of the countries involved.

In recent years, the European Commission has been urged to adopt this new examination tool[2] to address cross-border tax issues such as transfer pricing, dual residence, and aggressive tax planning schemes. The goal is to reduce the backlog of unresolved mutual agreement procedures ("M.A.P.'s") by having the relevant tax administrations conduct the examination jointly, thereby eliminating the need for M.A.P. once an examination has been completed in one country. By its nature, M.A.P. is a lengthy process that leads to uncertainty of financial results for a multinational group and is costly for tax administrations and taxpayers.

The results of the pilot project have been mixed. On the positive side, a joint audits have the potential to reduce administrative burdens for both taxpayers and tax administrations because of their streamlined fact-finding process. In addition, tax administrations believe they result in more effective tax compliance. On the other hand, critical issues have been encountered that raise questions about the availability of enough resources for tax administrations to make this tool effective. Cooperation between the tax administrations has not been as great as anticipated. The two

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1 O.E.C.D. (Forum on Tax Administration), *Joint Audit Report*, Sixth Meeting of the O.E.C.D. Forum on Tax Administration, Istanbul (September 15-16, 2010), p. 2.

2 See Communication from the Commission to the European Parliament and the Council an Action Plan to Strengthen the Fight Against Tax Fraud and Tax Evasion, COM (2012) 722.

sides frequently adopted different views as to the same transaction or methodology. Staffing was problematic. Yet, if allowed to develop may be the standard way to conduct tax examination of a multinational enterprise in Europe.

WHAT IS A JOINT AUDIT?

In September 2010, the O.E.C.D. issued its first joint audit report commissioned by the Forum on Tax Administration in October 2009 (the "Report"). In accordance with paragraph 7 of the Report, a joint audit can be described as follows:

- Two or more countries join together to form a single team to examine one or more issues or transactions of one or more related taxable persons (both legal entities and individuals) with cross-border business activities, perhaps including cross-border transactions involving related affiliated companies organized in the participating countries and in which the countries have a common or complementary interest.
- The taxpayer jointly makes presentations and shares information with the countries.
- The joint audit team includes competent authority representatives, joint audit team leaders, and examiners from each country.

"Joint audits have the potential to reduce administrative burdens for both taxpayers and tax administrations because of their streamlined fact-finding process."

When referring to "cross-border transactions involving related affiliated companies," it appears the focus of a joint audit report is to facilitate streamlined examination activities that target transfer pricing issues of multinational enterprises. This is an area where tax adjustments by one country can produce massive increases in taxable revenue, often producing double taxation for the multinational enterprise unless a refund of tax is obtained in another jurisdiction.

Overall, the Report provides a useful set of principles and practical guidance for governments to perform joint audits. However, the Report clearly stipulates that joint audits must be performed in accordance with the boundaries set forth by domestic provisions and within the international legal framework of each country.[3] From a European standpoint, Directive No. 2011/16/EU[4] – on the administrative cooperation in the field of taxation ("D.A.C.") – introduced the first comprehensive legal basis for E.U. Member States to conduct joint audits. According to the D.A.C., a tax administration of a Member State may submit a joint audit request to another Member State through its competent authority. The Member State receiving the request must agree to proceed. If the request is accepted, the tax examiners of the requesting Member State may take the following steps:

- They may be present in the requested Member State offices where the tax authorities carry out their duties.
- They may be present during administrative inquiries carried out in the territory of the requested Member State.
- They may interview the taxpayers of the requested Member State.

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3 See the Report, at 8.

4 Council Directive 2011/16/EU on Administrative Cooperation in the Field of Taxation, 2011 O.J. L 64/1.

- They may obtain access to documentation from the tax examiners of the requested Member State.[5]
- In light of the above features, the key components of a joint audit are as follows:
- The Member States may form a mixed single examination team, consisting of examiners from the requesting Member State and the requested Member State
- All of the examiners in the joint team are permitted to perform examinations in each of the countries involved with the same authoritative powers.
- Onsite examination activities may be performed in the requesting Member State and in the requested Member State

In 2012, the European Commission issued Communication No. 722/2012 in an effort to combat tax fraud and tax evasion, recommending Member State's develop methodologies for using simultaneous tax examinations[6] in the short term and for implementing the joint audit tool in the long term. Additionally, in the Tax Inspectors Without Borders report,[7] the O.E.C.D. referred to joint audits as a prominent way to share knowledge and build the capacity of a developing country's tax administration.

HOW COULD A JOINT AUDIT BE MORE BENEFICIAL THAN A STANDARD EXAMINATION?

As compared to a traditional examination, a joint audit may be more effective for resolving issues of double taxation in cases where it is fundamental to clarify the facts and circumstances in another country. In particular, a joint audit may be a better option with respect to (i) transfer pricing issues, (ii) residency or permanent establishment issues, and (iii) complex tax structures involving aggressive tax planning schemes.

In the first two categories, a joint approach may reduce administrative costs for both tax administrations and taxpayers. For example, the costs derived from providing authorities with substantial documentation may be reduced by simultaneously sharing the same information with multiple revenue bodies. Moreover, joint audits may increase taxpayer certainty by enabling the relevant tax authorities to more quickly establish a joint position in the course of the examination process.

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5 See D.A.C., article 11.

6 The feature that substantially differentiates a joint audit from a simultaneous tax examination – another form of administrative cooperation – is that the latter does not entail the formation of a single audit team; rather, the examiners simultaneously and independently examine tax issues in their own territories with a view to exchanging any relevant information they obtain (see the Report, *supra* note 2, pp. 15-16).

7 Tax Inspectors Without Borders ("T.I.W.B.") is a joint initiative of the O.E.C.D. and the United Nations Development Programme ("U.N.D.P.") to build tax audit capacity. T.I.W.B. programs complement broader international efforts to strengthen co-operation on tax matters and improve domestic resource mobilization in developing countries.

In the third category, a joint audit is likely to increase transparency and eliminate legal boundaries that enable aggressive tax planning.[8] Indeed, many tax fraud schemes rely on a lack of transparency and communication between tax administrations, and many could have been prevented had the tax administrations established efficient channels for cooperation and information exchange.

Consequences of an Ordinary Italian Transfer Pricing Audit

In order to better understand the potential benefits of conducting a joint audit, it is worth considering the administrative burdens related to an ordinary transfer pricing assessment that results in an upward adjustment in one country without an immediate corresponding downward adjustment in the other country. The phases described below refer to the administrative procedure under the Italian legal framework, which does not differ significantly from the steps in other E.U. countries.

- **Examination Phase:** During the examination phase, examiners analyze the facts and evaluate the arm's length nature of the controlled transactions. In order to complete these examinations, the taxpayer must provide the examiners with a substantial amount of documentation and information. These include accounting and management entries, contracts, financial statements, and trial balances of each group company). Additionally, functional interviews are conducted with local and foreign employees. At the end of the examination, an examination report is issued to the taxpayers and a copy is submitted to the assessment unit of the Italian Revenue Agency. This phase may last up to two years.

- **Assessment/Negotiation Phase:** The assessment unit of the Italian Revenue Agency is in charge of reviewing the content of the examination report and issuing the final assessment. The unit also performs its own analysis and has the authority to increase, reduce, and even cancel the proposed adjustment issued by the examiners. Furthermore, conclusions must also be reviewed by different officers where the taxpayer is entitled to further defend their position. For this reason, officers of the assessment unit may ask the taxpayer for additional documentation and, in some cases, new analysis. An example might be new benchmark analysis, which is often very time-consuming. In this phase, the taxpayer may agree to a settlement with the office. However, if no settlement is agreed upon or if the settlement leads to double taxation, the taxpayer is left with two options, only: enter into M.A.P.[9] or initiate litigation according to domestic legal provisions.

- **M.A.P./Litigation Phase:** In Italy, M.A.P. is not an alternative to the litigation procedure used to prevent claims from the assessment becoming final. According to domestic legal provisions, the Italian Competent Authority cannot enter into an agreement with another competent authority that differs from a final settlement that is reached in the Assessment/Negotiation Phase or final court decision. To this end, in order to initiate M.A.P., taxpayers must (i) file a lawsuit under the domestic provisions, (ii) submit an M.A.P. request, and (ii) if such request is accepted, submit a request for the suspension of litigation.[10]

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8 See the Report, *supra* note 2, at 9.

9 Where the other country signed a convention for the avoidance of double taxation with Italy and actually has an active M.A.P. team in operation.

10 The suspension is not automatic as the it requires the consent of the Italian Revenue Agency.

If the relevant tax treaty does not include an arbitration clause, the competent authorities are not obliged to reach an agreement. If the M.A.P. ends without an agreement, the suspended litigation will resume under domestic legal provisions. This phase may last up to ten years.

As above described, the ordinary transfer pricing audit process often includes three or four different assessments, which are conducted at different times by different persons.[11] The process is often lengthy and costly, and the outcome is highly uncertain both for tax administrations and taxpayers.

The goal of a joint audit is to limit administrative efforts through the early involvement of the competent authorities and to give certainty to taxpayers by establishing a transparent cooperation with the revenue bodies.

Joint Audit Pilot Project Between Italy and Germany

Following the European Commission's recommendation, the Italian and Bavarian tax administrations signed a memorandum of understanding regarding their intent to carry out one or more pilot joint audits on taxpayers with cross-border transactions between Italy and Bavaria. In 2013, the pilot project commenced and was divided into two phases: The first aimed to establish the grounds for performing the joint audit. The second was devoted to carrying out the specific examinations on a joint basis.

In the first phase, several meetings were held in Germany and Italy to coordinate group responsibilities for various tasks, such as the following:

- Identifying the relevant legal framework under which the joint audit would be performed
- Reaching an agreement on the tax issues to be addressed
- Identifying the criteria to select taxpayers for examination
- Forming two mixed teams of examiners, each composed of two Italian and two German examiners

Following the completion of the first phase, two multinational enterprises ("M.N.E.") were selected to be examined in connection with transfer pricing issues. The first company was headquartered in Germany with a subsidiary in Italy and the second was headquartered in Italy and with a subsidiary in Germany. The relevant legal framework was the D.A.C. and domestic law. At the start of the project, Germany had already implemented legislation allowing for joint audits. Italy introduced a joint audit provision into its domestic law in 2014, pursuant to the project.

The six-to-eight-month examination process resulted in an adjustment in prices between the associated companies. The adjustment was shared with the taxpayers involved and was agreed upon by the examiners and competent authorities of both countries. The agreement was the result of the jointly conducted examination.

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11 These include (i) the examiners, (ii) the officers of the assessment unit, (iii) the competent authorities and, where the latter cannot some to an agreement, (iv) the judges. Moreover, in Italy, there are three level of courts (*i.e.*, first, second, and Supreme Court). Therefore, one transfer pricing assessment may become seven.

In each case, the examination team jointly examined the headquarters and then examined the subsidiary. Before each on-site examination, the examination team met to plan the examination activities, including identifying documents that would be requested and the taxpayer personnel to interview. At the end of each day, a daily examination report was drafted and signed by both the examiners and the taxpayers. In the daily examination report, all the activities, documents, and interviews were summarized.[12] The examination team also held several meetings with the taxpayers to share and discuss their findings. In order to standardize joint audit reports and official communications, the documents were drafted in English.

"A joint audit may be a better option with respect to (i) transfer pricing issues, (ii) residency or permanent establishment issues, and (iii) complex tax structures involving aggressive tax planning schemes."

After finishing each examination, a final joint audit report was drafted. This report was used as grounds to issue an upward adjustment in one country along with a corresponding downward adjustment in the other country in accordance with domestic legal provisions.

The pilot project proved to be useful as it identified advantages and critical issues encountered during a joint audit. Moreover, it established a starting point for developing a more efficient solution to solve cross-border issues.

Some of the advantages of the joint audit pilot project were as follows:

- Joint audits lead to a material reduction of time needed to find shared positions between the countries involved.
- Joint audits decrease administrative burdens, related costs, and uncertainty.
- A joint audit allows for more taxpayer involvement, whereas M.A.P. is mostly limited to a discussion between competent authorities.
- The joint audit process is transparent and interactive, enabling the parties to find a solution in line with business functions, thereby fostering a more compliant environment where taxpayers see tax administrations as advisors rather than external agents to be kept outside of their business.
- A joint audit can address instances of double non-taxation, while M.A.P. can only address cases of double taxation.
- Joint audits are not unilateral tax rulings, as is the case with advanced price agreements. Therefore, State Aid risks are not an issue.
- Joint audits work.

The joint audit pilot project also highlighted certain critical issues:

- It is necessary to harmonize the legal basis for conducting joint audits. To this end, the Multilateral Instrument ("M.L.I.") may provide help in introducing the necessary tools.
- It is also necessary to harmonize the examination process among countries.
- English can be used as the standard for communicating and drafting documents; however, language can still be an issue when analyzing taxpayer contracts and other documents that are not in English.

[12] It is important to note that in Italy it is mandatory to draft a daily audit report, while in Germany it is not required.

- Staffing may pose an issue. In particular, it is necessary to have skilled examiners.
- Taxpayers cannot voluntarily enter into a joint audit.
- The outcome reached is not binding for tax administrations in the years not covered by the joint audit.

CONCLUSIONS AND NEXT STEPS

So far, M.A.P.'s have not been able to provide an efficient solution to the increasing number of double taxation controversies between E.U. and non-E.U. countries. The process is lengthy, costly, and highly uncertain – especially where arbitration is not mandatory. European competent authorities have been inundated with M.A.P. requests,[13] and the increased caseloads leave many instances of double taxation unresolved.

The pilot project conducted by Italy and Germany provides encouraging results. The two tax administrations found a shared position by jointly examining taxpayers and, in the process, avoided the burden of double taxation. The two countries are further developing this tool by investing additional resources in the international tax sector and selecting new joint audit cases. Moreover, other countries have shown interest in this project and are moving forward with first steps toward multilateral cooperation.

The pilot project demonstrated that both tax administrations are committed to the project's success. However, many questions still remain unanswered, particularly with respect to larger, more difficult cases. The pilot project revealed critical issues such as differences in domestic laws and potentially inadequate staffing resources if the number of the joint audits increases in future years. However, the main question is whether joint audits continue to be effective beyond the pilot stage.

13 "OECD Releases Mutual Agreement Procedure (MAP) Statistics for 2016," O.E.C.D.

GERMAN ANTI-TREATY SHOPPING RULE INFRINGES ON E.U. LAW

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Tags
Germany
Tax Refund
Tax Treaties
Treaty Abuse

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INTRODUCTION

On June 14, 2018, the European Court of Justice ("E.C.J.") ruled on the compatibility of the current version of the German anti-treaty and anti-directive shopping rule, section 50d paragraph 3 German Income Tax Act ("I.T.A.") 2012, with E.U. law, in particular the E.U. Parent Subsidiary Directive ("E.U. P.S.D."). German national law was found to be incompatible with those provisions of E.U. law.

The ruling marks the end of a saga that began on December 20, 2017, when the court rejected the 2007 version of German national law, section 50d paragraph 3 I.T.A. 2007. This article outlines developments beginning with the E.C.J.'s December 2017 ruling in companion cases involving Deister Holding and Juhler Holding, proceeding to the German Federal Ministry of Finance's response, and concluding with the June 2018 ruling in the GS case. Steps for foreign parent companies inside and outside the E.U. are suggested, as well.

DECEMBER 20, 2017: *DEISTER HOLDING* AND *JUHLER HOLDING* RULING

Facts and Background

The appellants, Deister Holding (formerly Traxx Investments) and Juhler Holding,1 were both companies registered in E.U. countries. Deister was resident in the Netherlands and Juhler was resident in Denmark. Each that held shares in companies resident in Germany for tax purposes. Deister Holding held a 26.5% or greater interest in several German companies. Its only shareholder was a person who was tax resident in Germany. Juhler Holding held up to a 90% interest in 25 German companies and also maintained a property portfolio. Its only shareholder was a company registered in Cyprus, whose only shareholder was, in turn, an individual tax resident in Singapore.

The German tax authorities refused to grant refunds to Deister Holding and Juhler Holding for withholding taxes paid on dividends received from their respective German subsidiaries, as both ran afoul of the conditions of section 50d paragraph 3 I.T.A. 2007. That rule stated that withholding tax relief will not to be granted in the following combined circumstances:

- Person(s) holding ownership interests in the foreign parent company would not be entitled to the refund or exemption if they derived the income directly.

1 *Deister Holding A.G. & Juhler Holding A./S. v. Bundeszentralamt für Steuern,* Joined Cases, C-504/16 & C-613/16, [2017] E.C.J.

- Any one of the following three conditions exists:
    - **Intent**: There are no economic or other valid reasons for the interposition of the foreign parent company.
    - **Business Activity**: The foreign company does not earn more than 10% of its gross income from its own business activity.
    - **Business Premises**: The foreign company does not take part in the general economic commerce via a suitably equipped business establishment.

Section 50d paragraph 3 I.T.A. 2007 does not apply to a foreign parent company having its principal class of stock regularly traded in substantial volume on a recognized stock exchange. Similarly, it does not apply to a foreign company that qualifies as an investment corporation within the meaning of the Investment Tax Act.

Both Deister Holding and Juhler Holding filed appeals in the Cologne Tax Court. The Cologne Tax Court then asked the E.C.J. whether section 50d paragraph 3 I.T.A. 2007 infringes on the E.U. P.S.D. and/or the E.U. fundamental freedoms, namely the free movement of capital or the freedom of establishment.

The E.C.J. Decisions

Regarding the *Deister Holding* (C-504/16) and *Juhler Holding* (C-631/16) cases, the E.C.J. stated that the aim of the E.U. P.S.D. is to provide a level playing field for E.U. and domestic parent companies, thereby facilitating the creation of cross-border groups. This goal requires the elimination of any tax obstacles to cross-border dividend distributions. Therefore, Member States are obliged to provide tax refunds for withholding taxes levied on dividends paid by domestic subsidiaries to their E.U. parents.

The E.U. P.S.D. allows Member States to enact exemptions from this rule where appropriate to combat tax abuse and fraud. However, those exemptions must be in line with the general principles of E.U. law, especially the principle of proportionality. The court further specified that an exemption could be considered proportional only if it solely targets "wholly artificial structures."

Concerning the German rule, the E.C.J. found this requirement was not fulfilled. Instead of requiring the tax authorities to provide at least a *prima facie* indication that a certain structure is fraudulent or abusive, section 50d paragraph 3 I.T.A. 2007 constituted an irrebuttable presumption of fraud or abuse once one of the three generic criteria was met. Moreover, it did not allow the taxpayer to prove on the basis of its unique facts, that its structure was not wholly artificial. Under these circumstances, the E.C.J. declared section 50d paragraph 3 I.T.A. 2007 was not proportional and thereby violated the E.U. P.S.D.

In addition, the court found the principle of freedom of establishment was at issue. Both Deister Holding and Juhler Holding held stakes in German subsidiaries that allowed them to exercise a certain degree of control over their subsidiary's business as opposed to a mere financial investment. The German rule was found to restrict the principle of freedom of establishment, as it discriminated against E.U. parent companies with German subsidiaries when compared to German parent companies.

When setting up a German subsidiary, an E.U. parent company and a domestic parent company would be in the same position at the outset. However, while the latter would always receive tax relief for withholding taxes on dividends paid by domestic subsidiaries, the former would only be granted a relief if it did not fall within the scope of Section 50d paragraph 3 I.T.A. 2007. Therefore, the rule was likely to hinder an E.U. parent company's ability to set up a subsidiary in Germany and thereby constituted a restriction of the principle of freedom of establishment.[2]

APRIL 4, 2018: THE GERMAN FEDERAL MINISTRY OF FINANCE'S CIRCULAR LETTER

In reaction to the E.C.J. decision, the German Federal Ministry of Finance published a circular letter[3] on April 4, 2018, governing the application of Section 50d paragraph 3 I.T.A. 2007 and, its successor clause, Section 50d paragraph 3 I.T.A. 2012 in E.U. P.S.D. cases.

The Ministry ruled that the 2007 rule should no longer be applied in pending E.U. P.S.D. cases. Concerning the 2012 version, the German Ministry of Finance modified its criteria in E.U. P.S.D. cases in order to secure compliance with E.U. law. This time, section 50d paragraph 3 I.T.A. 2012 stated that withholding tax relief will not to be granted in the following combined circumstances:

- Person(s) holding ownership interests in the foreign parent company would not be entitled to the refund or exemption if they derived the income directly.
- The gross earnings of the foreign parent company for the respective fiscal year do not originate from its own business activity.
- One of the following two conditions is met:
    - **Intent**: There are no economic or other valid reasons for the interposition of the foreign parent company.
    - **Business Premises**: The foreign company does not take part in the general economic commerce via a suitably equipped business establishment.

Again, the rule does not apply to a foreign parent company having its principal class of stock regularly traded in substantial volume on a recognized stock exchange. Similarly, it does not apply to a foreign company that qualifies as an investment corporation within the meaning of the Investment Tax Act.

According to the circular, a less rigid standard would be applied when determining whether relief would be granted. As a result

- economic or other substantial reasons for the interposition of the parent company could now also be found in the context of group strategy or group structure;

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2 The court further considered, but later denied, a justification of this restriction along the line of arguments already given in regard to the E.U. P.S.D.

3 German Federal Ministry of Finance (*Bundesfinanzministerium*, B.M.F.), B.M.F. IV B 3 – S 2411/07/10016-14, circular letter of April 4, 2018.

- the holding of shares in other companies can be considered participation in economic commerce, as long as shareholder rights are actively exercised; and
- the parent company would no longer be required to permanently employ staff to establish an appropriate business presence.

The circular letter was received with skepticism from the tax community. Several commentators doubted that the circular was enough to ensure Germany's compliance with E.U. law. Despite the modifications, Section 50d paragraph 3 I.T.A. 2012 struggled to meet several stipulations in the *Deister Holding* and *Juhler Holding* case. The most striking of its shortcomings pertained to the methodology for determining abusive structures, which continued to follow general criteria and not case-by-case facts and circumstances. Additionally, Section 50d paragraph 3 I.T.A. 2007 was only suspended for E.U. P.S.D. cases. The fundamental freedoms could continue to be violated in cases outside the scope of the E.U. P.S.D. Examples include a refusal of tax relief on grounds of a double tax treaty with an E.U. Member State or a non-E.U. country with a most-favored-nation clause.

"The approach taken in the past must be modified so that a 'one-size-fits-all' approach based on concerns over abusive tax planning is abandoned in favor of a facts and circumstances approach."

Moreover, the circular did not address royalties and interest paid by domestic subsidiaries to their E.U. parents, which also are exempt from tax according to E.U. directives but may fall under the scope of Section 50d paragraph 3 I.T.A. 2012. Hence, it was widely believed that the amended view of the Ministry of Finance on the 2012 version would not achieve compliance with the E.C.J. ruling in *Deister Holding* and *Juhler Holding*.

JUNE 18, 2018: E.C.J. RULING ON *GS*

Facts and Background

In many ways, the *GS* case (C-440/17)[4] resembles *Deister Holding* and *Juhler Holding*. GS was a holding company registered in the Netherlands. It held stakes in several subsidiaries in different jurisdictions – among those, a 90%-stake in a company tax resident in Germany. GS's sole shareholder was an individual tax resident in Germany. Apart from administering its shares, GS mainly purchased raw materials, resold them to its subsidiaries, and provided loans to its subsidiaries. For these purposes, GS had three employees in the Netherlands.

The German tax authorities refused to grant GS relief from withholding tax on dividends paid by its German subsidiary on the grounds of Section 50d paragraph 3 I.T.A. 2012. GS appealed this decision to the Cologne Tax Court, who in turn again referred the case to the E.C.J.

The E.C.J. Decision

The E.C.J. mainly relied upon the arguments already given in the *Deister Holding* and *Juhler Holding* ruling. The E.C.J. stated that Section 50d paragraph 3 I.T.A. 2012, as well as its predecessor rule, contravened the E.U. P.S.D. and restricted E.U. fundamental freedoms. Following the argumentation in *Deister Holding* and *Juhler Holding*, the court stated that a restriction of the E.U. P.S.D. and the fundamental freedoms could only be proportional, and therefore justifiable, if only "wholly artificial structures" fell within scope of the rule.

[4] *GS v. Bundeszentralamt für Steuern*, C-440/17, [2018], E.C.J.

In the view of the court, Section 50d paragraph 3 I.T.A. 2012 constituted an irrebuttable assumption of fraud and abuse once the generic criteria were fulfilled. It did not allow taxpayers to prove on a case-by-case basis that the respective structure was not wholly artificial. Therefore, the E.C.J. again held the German rule to be disproportionate, in accordance with the *Deister Holding* and *Juhler Holding* ruling. Consequently, Section 50d paragraph 3 I.T.A. 2012 was found to be noncompliant with the E.U. P.S.D. as well as the principle of freedom of establishment.

PATH FORWARD

Foreign Corporate Shareholders May Collect Tax Refunds and Obtain Relief

Both E.U. and non-E.U. parent companies located in a treaty country with a most-favored-nation clause should now be eligible for a withholding tax exemption or tax refund if economic or other valid reasons for the interposition of the foreign parent company exist per the *GS* case. Therefore, it is highly recommended that shareholders apply for a withholding tax refund if tax relief has been refused in past.

Statute of Limitations for Tax Refund

The statute of limitations for filing the refund request is four years from the end of the year in which the dividends were derived. All pending refund requests must be approved by the tax authorities now.

Royalties

The same applies to German-source taxation of royalties and interest, if any.

REACTION TO *GS* PENDING

The German legislature is now required to act. In light of clear rulings by the E.C.J. on the German anti-treaty shopping rule, the approach taken in the past must be modified so that a "one-size-fits-all" approach based on concerns over abusive tax planning is abandoned in favor of a facts and circumstances approach. The Ministry of Finance is expected to repeal the April 4, 2018, circular letter and significantly narrow the scope of the 2017 version or to suspend the provision until modifications are finalized. In addition, it appears likely that the amendment of the anti-treaty and anti-directive shopping rule will be introduced into the 2018 Annual Tax Bill.

O.E.C.D. DISCUSSION DRAFT ON FINANCIAL TRANSACTIONS – A LISTING OF SINS, LITTLE PRACTICAL GUIDANCE

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Tags
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INTRODUCTION

In early July, the O.E.C.D. Centre for Tax Policy and Administration ("C.T.P.A.") released Public Discussion Draft on B.E.P.S. Actions 8-10: Financial Transactions (the "Discussion Draft"). The Discussion Draft addresses financial transactions (*e.g.*, loans, guarantees, cash pools, captive insurance, and hedging). Like many of the other initial B.E.P.S. Project drafts, the Discussion Draft does not represent a consensus among the O.E.C.D. Member States and requires commentary, input, and further work before becoming a chapter in the O.E.C.D. Transfer Pricing Guidelines.

THE O.E.C.D. IS LATE TO THE TABLE

A reader might wonder how or why the Discussion Draft has emerged at this particular point in time, as tax authorities and legislators in various countries have already provided guidance on a unilateral basis. In a short recap of developments in financial transaction transfer pricing, we arrived at this point in approximately the following chronology:

- **1972 –** Decision in *Mixon v. Commr.*, 464 F. 2d 394 (5th Cir 1972), establishes thirteen factors that can be determinative of *bona fide* debt
- **1998 –** Decision in *Laidlaw Transportation Inc., et al v. Commr.*, T.C. Memo 1998-232, further establishes that certain of the thirteen factors can be determinative of *bona fide* debt
- **2009 –** *DSG* decision from the U.K. Tax Tribunal on captive insurance pricing
- **2009 –** "Implicit support" of a subsidiary by a parent (discussed below) emerges from the *GE Capital Canada* case
- **2010 –** GE Capital Canada "guarantee fee" case decided for the taxpayer on appeal
- **2013 –** The B.E.P.S. Project decides not to abandon the arm's length principle in favor of formulary apportionment
- **2014 –** Draft reports are issued on B.E.P.S. Actions 4 (interest deductibility), 8, 9, and 10
- **2015 –** O.E.C.D. C.T.P.A. signals the start of a project on transfer pricing for financial transactions
- **2016 –** The U.S. issues proposed regulations under Code §365 issued on treatment of related-party indebtedness

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- **2017 –** McDonald's loan case decided in Spain in favor of the tax authority
- **2017 –** Chevron loan case decided in Australia in favor of the tax authority
- **2017 –** Hesse Norge A.S. loan case decided in Norway in favor of the tax authority
- **2017 –** Adverse S BV loan case decided in Sweden in favor of the tax authority
- **2017 –** The O.E.C.D. issues revised O.E.C.D. Transfer Pricing Guidelines (the "2017 Guidelines")
- **2017 –** The U.S. Tax Cuts and Jobs Act amends the Code §163(j) business interest deduction limitation
- **2018 –** Exxonmobil Production Norway Inc. loan case decided in favor of the tax authority
- **2018 –** The Discussion Draft is released for comment

As the reader can see, the Discussion Draft is somewhat late in providing guidance. This is unusual for the O.E.C.D., which typically provides transfer pricing guidance prior to tax law, administrative guidance, and jurisprudence. Stated differently, O.E.C.D. guidance generally has been issued where little authority existed, and in a multilateral context, it has provided direction to minimize double taxation.

The Discussion Draft arrives at a time when several of the key questions in financial transaction pricing have been settled in a substantive way, though not necessarily by all O.E.C.D. Member State tax authorities. Any resulting O.E.C.D. guidance will be applied in conjunction with already existing tax law, administrative guidance, and jurisprudence when determining the appropriate treatment of a controlled financial transaction. The potential for double taxation may arise where treaty partners give varying deference to particular O.E.C.D. guidance. The lack of consensus amongst O.E.C.D. Member States on the Discussion Draft may foreshadow difficult double-tax cases between competent authorities.

CONDITIONS FOR RECHARACTERIZING DEBT

The Discussion Draft deals at length with the conditions that must exist before a treaty partner may recharacterize a debt instrument or a guarantee as equity and the means by which recharacterization could be achieved. It suggests that descriptions of recharacterized outcomes will be a focus of future work. The Discussion Draft strongly signals that the tax authority's view on financial transactions appears to skew toward transaction recharacterization, and away from providing guidance that will help companies characterize financial transactions appropriately at the issue date or help tax authorities adjust a transaction price in a reasoned way. This likely will be an area that attracts significant industry comment and demand for examples and guidance on how to be compliant given different fact patterns.

It is not uncommon for foreign tax authorities and transfer pricing practitioners to give the 2017 Guidelines the deference of enacted law. However, in the Discussion Draft, one could argue that no deference is appropriate. There are too many instances of gratuitous comments concerning the behavior of independent parties that are not confirmed with empirical evidence. Rather than making law, the document is better construed as making recommendations on best practices.

An example of an unsubstantiated statement is found in Box B.4 of the Discussion Draft. It states that if a lender lacks the functions to manage lending, it should receive a risk-free return while the managing entity receives the residual return. This is contrary to what is seen in the market. Companies and individuals pay fund managers a fee to invest capital because, ultimately, the risk to capital resides with the individual or entity investing the funds. An investment advisor may be unhappy that its client lost 50% of their investment in a risky venture, but it is the client that loses that capital, not the advisor. If this approach is adopted, we may see asset and risk considerations take a backseat to functions, contrary to market evidence.

"The Discussion Draft asks commentators to entertain a controversial presumption that an independently derived group credit rating may be taken as the credit rating for each member."

Similarly, cross-guarantees are stated in paragraph 131 of the Discussion Draft to have no value despite the well-established practice of banks requiring cross-guarantees on material loans. Collateral is also stated to be valueless in the related-party context in paragraph 52, as ownership of shares is assumed to imply ownership and control of assets.

CREDIT RATINGS

Credit ratings and their determination are discussed at length in the Discussion Draft. Several controversial ideas on how to calculate and apply credit ratings in an intercompany context are advanced.

Credit ratings are issued either for a company or for a specific issue of debt, not a corporate group in the aggregate. The rating tells the market what the odds are that a borrower will meet its debt obligations. While ratings are not issued for a corporate group, certain market participants may make the simplifying assumption that group members share the same credit rating.

In Box C.2, the Discussion Draft asks commentators to entertain a controversial presumption that an independently derived group credit rating may be taken as the credit rating for each member. The question is whether this would be useful for tax administrations and tax compliance. The answer is no, unless multiple nations agreed to create a safe harbor of this presumption. Why? Because the assumption fails to hold in important ways. Except in rare circumstances, a subsidiary can never have a higher credit rating than its parent company. A company can have less liquidity than a parent or sister company, greater relative debt service burdens, or sovereign factors that make it more prone to default. Therefore, the assumption of a group credit rating fails when tested, unless one makes strong assumptions about implicit support.

IMPLICIT SUPPORT, OR THE CREDIT "HALO EFFECT"

The Discussion Draft takes the presumption of implicit support as a given. Implicit support, which assumes a Multinational Enterprise ("M.N.E.") group member is too big to fail and therefore any default would be backstopped by the M.N.E. group or parent, is not supportable in an arm's length analysis. The Discussion Draft starts with passive association but makes a logical leap to the assumption that (i) due to the importance of an entity to a group, it would be bailed out, and as such, its creditworthiness should be somehow elevated and (ii) this credit enhancement is not compensable. This ignores the O.E.C.D.'s consensus in the 2017 Guidelines at 1.159 on synergistic benefits of group membership:

> A deliberate concerted action involves one associated enterprise performing functions, using assets, or assuming risks for the benefit of one or more other associated enterprises, such that arm's length compensation is required.

This assumption, which was stated in a footnote, may have been overlooked in the rush to issue the Discussion Draft. However, the prior guidance is still logically sound. The 2017 Guidelines suggest that deliberate support in a financial transaction context is compensable. However, the Discussion Draft indicates that a guarantee exists by default, for which no compensation is warranted.

Many descriptions of implicit support are akin to hand-waving exercises for which hard data does not exist. The Discussion Draft disparages the use of bank opinions at paragraphs 92-93 as being a departure from an arm's length approach, yet a bank opinion is likely the most credible evidence of a quantification of implicit support. In fact, in an example that references the 2017 Guidelines at paragraph 1.164, implicit support is predicated on what seems to be a bank opinion. It also fails to clarify how a potential financial bailout does not represent a (compensable) commitment of assets as described in paragraph 1.159 of the 2017 Guidelines.

Further, the Discussion Draft provides no guidance on how to measure the credit rating impact of implicit support. In the examples given at 1.164-1.166 of the 2017 Guidelines and at paragraphs 157-159 of the Discussion Draft, the credit rating effect of implicit support is simply assumed, with no guidance on quantitative estimation. Taxpayers are asked to quantify implicit support in the absence of concrete guidance, akin to asking a company to describe an unknown counterfactual state. Regrettably, the world of tax compliance places a low priority on forgiveness of flawed prior assumptions.

This lack of detail will make competent authority proceedings difficult for both tax authorities and taxpayers, where achieving relief from double taxation will be inhibited by a lack of common approach founded on reliable principles.

PRACTICAL GUIDANCE AND EXAMPLES ARE LACKING

The Discussion Draft lacks practical guidance on how to evaluate transactions. Though there are some useful points, the Discussion Draft does not offer guidance on how to analyze transactions to determine if adjustments are necessary and how to adjust terms to achieve comparability. Worse, in some cases, the proposed approach is inconsistent with arm's length practices.

In paragraphs 62 through 66, the Discussion Draft does contain a reasonable discussion of the factors taken into account to arrive at a credit rating. The comment at paragraph 62 correctly observes that it is challenging to estimate a credit rating for certain entities (*e.g.*, start-ups, special purpose vehicles, etc.). While this is true, as is the statement that independent lenders would conduct a due diligence process, there is no guidance or request for comments on what that process looks like practically. In effect, the draft says it is easy to sin here but doesn't give guidance on how to stay on compliant.

A useful observation is made in paragraph 65. It suggests that related-party transactions can influence any quantitative ratios and should be adjusted. Practitioners will be looking for some qualification to these observations to say that, to the extent controlled transactions influence the credit rating, those transactions must be shown to be at arm's length for the credit rating exercise to be reliable. Making such a qualifying statement and emphasizing the order in which transactions are examined would be important and would assist companies computing synthetic credit ratings and tax administrations evaluating the computations.

The insurance industry is as close as possible to the ideal of a transparent pricing model. In Box E.2, commentators are asked whether an actuarial analysis is an appropriate method for determining non-arm's length premiums. There is a widely-promulgated set of general methodologies available to actuaries, with available data, clear assumptions, and guidance on their application. To the extent, related-party transactions are truly insurance transactions and actuarial models exist that fit the transactions (as proposed in paragraph 166), the O.E.C.D. clearly has the opportunity to advance a robust principles-based arm's length pricing approach. We expect some debate from commentators about when such an approach is warranted. Such debate would indicate good progress toward multilateral guidance.

The Discussion Draft makes several statements about the consequences of recharacterization that are somewhat impractical. For example, in paragraph 140, the proposition indicates when a related party receives a guarantee that enhances not just its credit rating but also raises its debt capacity, a portion of the borrowed funds should be deemed to have been borrowed by the guarantor and considered a capital contribution to the borrower. There is no basis, of which we are aware, in the arm's length market. Further, how tax administrations and M.N.E.'s would go about executing a recharacterization is unexplained, likely for good reasons. A guarantee can be considered analogous to insurance for a lender. The proposed approach implies that, in some circumstances, the insurer should gain an equity interest in the borrower or policyholder in exchange for its pledge to the third-party lender. Surely, a more practical approach would be to price the impact of the credit enhancement and then price the value of the debt capacity enhancement, both of which are feasible exercises that would acknowledge the fact that the guarantor is not actually borrowing from the lender.

One might question whether some of the "solutions" to common problems proposed in the Discussion Draft should have made it into a document for public commentary. For example, the question to commentators in Box C.7 is a request to identify situations in which an M.N.E. group's average interest rate paid on external debt could be considered an internal "C.U.P." (comparable uncontrolled price). The answer seems to us to be clearly never, if we were to recognize that an average is derived from more than one number. Borrowing is highly dependent on the term of the loan, the date of the transaction, the creditworthiness of individual borrowers, etc. And, stepping back to definitions, a C.U.P. is an average of prices that, absent comparability considerations, does not constitute a price. At best this would be an alternative method, without logical underpinnings. The lack of justification for this proposition undermines the creditability of the Discussion Draft.

HINDSIGHT AND TIMING IN FINANCIAL TRANSACTIONS

Financial transactions are entered into at a specific point in time. They are based on the best quantitative and qualitative data available at this time. In hindsight, transactions can look unnecessary or excessive, such as insurance premiums paid for a fire that never occurs. The Discussion Draft acknowledges the importance of timing when it considers economic circumstances but fails to give this factor its due consideration.

The ability to manipulate the timing of a financial transaction – even within a given year – can lead to significant changes in the effective interest rate and should be of concern to tax administrations. To counteract this impact, certain requirements could be imposed, such as a requirement to demonstrate that credit analysis occurred before the issue date or that fund movements inform pricing dates and the requisite analyses.

Pricing is incredibly sensitive to timing and transactional terms can have a significant impact on interest rates. The discussion regarding the ready availability of loan data in paragraphs 83-84 does not address the fact that loans are not liquid or traded instruments and that loan data may not always be available or relevant. This is the reason why bonds, with clear terms that generally are consistent with the terms of loans and trade at volumes resulting in the reporting of pricing and other issue data, provide a practical alternative to loans when considering a source of pricing data.

Use of bond data in concert with credit ratings also addresses the fact that credit ratings are issued for issuers and securities that are actively traded. Public companies and bond issues are the primary sources of credit ratings. The Discussion Draft does not raise the comparability risks that may arise in using a credit rating to determine an arm's length interest rate on an illiquid intercompany loan. The draft skirts around the edges of this difference in paragraph 63, discussing how banks and alternative lenders utilize their own models for determining credit worthiness in special circumstances. However true, these models are specialized and proprietary and, therefore, not helpful when companies and tax authorities attempt to verify the pricing approach the other has taken.

Somewhat surprising is the Discussion Draft's lack of caution against the use of hindsight. Within the 2017 Guidelines, there are eight references to hindsight and the care required when this approach is used. Hindsight and restructuring or recharacterization go hand in hand. Paragraph 1.123 of the 2017 Guidelines cautions that restructuring of legitimate business transactions would be wholly arbitrary and lead to inequity. Therefore, great care should be taken in "delineating" between debt and equity where clear forward-looking guidance is not provided by tax administrations. This guidance is quite common and takes the form of debt-equity ratio rules, E.B.I.T.D.A.-denominated thresholds, or other mechanisms.

SUMMARY

Perhaps a plain-spoken Discussion Draft for the penitent multinational could have stated that manipulation of credit ratings can significantly impact interest rates and then recommended certain approaches to prevent companies using pricing techniques that are recognized as either non-arm's length or gross simplifications. This could have been followed by some illustrative numerical examples. A "safe list" of commercially common terms to a loan transaction, such as prepayment terms, lack of security, and liquidity requirements, would have been helpful. A "less safe list" could have been established based on how exotic a particular term is in the market and how much judgment is required to price the marginal effect of the term in practice.

"We hope the O.E.C.D.'s aggressive opening bid will be met by a request for a return to principles and practical guidance."

The O.E.C.D. released a final report on how to value "H.T.V.I." (hard-to-value intangible assets) at the same time as it released the Discussion Draft. The H.T.V.I. report was intended for use by tax authorities. The preface to the Discussion Draft does not exclude multinational corporations as a user group. Nonetheless, the O.E.C.D. has clearly signaled that it intends to depart significantly from both well-established financial transaction pricing practices and standards that are market-based or can be understood with reference to market data.

For U.S. subsidiaries of parents resident in an O.E.C.D. Member State, the Discussion Draft suggests that, eventually, loans may be accorded different treatment depending on the jurisdiction of the borrower. This may require significant modification to a multinational company's generalized global transfer pricing policy for financial transactions at the country level.

One might question whether the Discussion Draft trades clarity, for tax authorities and companies, for adherence to the arm's length principle. Commentary is invited on a number of potential approaches that are not arm's length as we have pointed out. We expect companies will tell the O.E.C.D. that this compromise in principles is not needed. We hope the O.E.C.D.'s aggressive opening bid will be met by a request for a return to principles and practical guidance that can coexist with country tax law and the behavior of financial market participants.

DUTCH CORPORATE TAX REFORM: DIVIDEND TAX REMAINS, A.T.A.D. ARRIVES, AND TAX RATES DROP

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A.T.A.D.
Corporate Tax
Dividends
Tax Reform
The Netherlands
Withholding Tax

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TAX REFORM REVISIONS

Traditionally, the Dutch budget for the new year – which includes proposed tax legislation – is presented to parliament on the third Tuesday of September, known as Princes' Day (*Prinsjesdag*) in the Netherlands. However, this year, the relevant legislative proposals will be significantly revised before they are even discussed in parliament, pursuant to the revised tax reform announced on the eve of the third Tuesday of October.

This year's budget includes certain tax proposals that were announced last autumn, when the new Dutch coalition government took office and presented its main policy goals. At the time, the new government expressed its intention to completely eliminate withholding tax on dividends distributed by Dutch companies.

One of the main purposes of abolishing this tax was to cater to the needs of large Dutch multinationals – notably Shell and Unilever. Shell and Unilever have roots in the U.K. as well as in the Netherlands, and historically they have maintained headquarters in both countries. More recently, the two multinationals have been exploring ways to reduce the level of complexity that comes with maintaining such a structure. Certain factors, such as the impending Brexit, have increased the appeal of becoming solely headquartered in the Netherlands. In particular, Unilever recently expressed a desire to rationalize its structure by centralizing all headquarters functions in Rotterdam. However, the absence of a withholding tax on outgoing dividends from the U.K. – when dividends are taxed in the Netherlands – was perceived as an obstacle to restructuring.

This led the Dutch prime minister – a Unilever alumnus – to seek elimination of the dividend tax levy as an enticement for choosing the Netherlands as a holding jurisdiction for listed companies, particularly for companies that might consider the U.K. as an alternative and would need to be persuaded to cross the North Sea when choosing a holding company location. However, a period of heavy public criticism followed, characterizing the removal of withholding tax on dividends as a "gift" to foreign shareholders. As a result, Unilever froze its corporate restructuring plans, fearing lack of support from its British shareholders. Given the political climate, the Dutch government had no choice but to reconsider its earlier proposals, which eventually led to the revised tax reform released on the eve of the third Tuesday of October.

As this article goes to press, the revisions must be tailored into amendments to the package of legislation submitted to parliament. Nonetheless, the contours at this time are quite clear:

- Corporate income tax rates will gradually be reduced even further than previously announced.

- The Netherlands will implement the E.U. Anti-Tax Avoidance Directive ("A.T.A.D.").
- Dividend tax will remain in existence for the time being.

The normal corporate income tax will be gradually reduced from 25% to 20.5% by 2021, with the first reduction occurring in 2020. At the same time, the reduced rate corporate tax for profits up to €200,000 will be gradually reduced from 20% to 15% by 2021, also with the first reduction occurring in 2020.

In addition, the legislative package released on Princes' Day contains a variety of measures that change the basis of corporation tax in the Netherlands. Inevitably, a large part of this legislative package stems from the A.T.A.D. – as its first tranche (A.T.A.D. 1) must be implemented with effect from January 1, 2019. Simultaneously, certain favorable measures are included in order to soften the impact of A.T.A.D. 1.

Even though the Dutch government has emphasized that eliminating the dividend tax is not completely off the table, and it will again be considered in due course, it now seems clear that the dividend tax, in its current form, will remain in existence for some time.

Currently, Dutch intermediate holding companies that are part of corporate structures are exempt from the obligation to withhold dividend tax when profits are repatriated to shareholders. The exemption is effective January 1, 2018, and reflects a unilateral decision to exempt dividends from withholding tax for corporate shareholders based in all treaty countries, including Canada, China, Japan, and the U.S. Once Brexit is a fact, this exemption will continue to cover U.K. multinationals structuring their E.U. operations via the Netherlands. While this extension of the exemption for E.U. or E.E.A.[1] corporate shareholders was perceived initially as a "quick fix" until the dividend tax was eliminated, it now seems that this broad unilateral exemption may remain a permanent solution.

Since this Dutch unilateral withholding tax exemption appears to be more than just a passing fad, this article will consider its main features, as well as the impact of Dutch anti-abuse rules resulting from the implementation of international and supranational law. Broadly speaking, these rules aim to combat "abusive" structures, as only business structures with genuine economic activities can benefit from the exemption for group holding companies.

IMPLEMENTATION OF A.T.A.D.

As mentioned above, on Princes' Day, the legislative proposal to implement A.T.A.D. 1 was submitted to the Dutch parliament. This package provides for the introduction of controlled foreign corporation ("C.F.C.") legislation, as well as an entirely new limitation on the deduction of interest expense.

While A.T.A.D. 1 also requires the presence of an exit tax and a general anti-abuse rule, in the Netherlands these are already in place. Therefore, these elements require no further legislation, except for some minor modifications.

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[1] *I.e.*, the European Economic Area, or all the E.U. countries plus Liechtenstein, Norway, and Iceland.

A.T.A.D. 1 also contains certain measures to combat arrangements that make use of differences in qualification between tax systems. Well before the implementation date of A.T.A.D. 1, the scope of these “hybrid mismatch” rules was already extended through an amendment known as A.T.A.D. 2, although in fact there is just one directive. A.T.A.D. 2 will likely end the attractiveness of a Dutch C.V. or B.V. structure, as it forces the Dutch tax authorities to tax the income of the C.V. even though the C.V. may be transparent for Dutch tax purposes.

“One of the cornerstones of the A.T.A.D. is a measure to combat tax avoidance through the establishment of a low-taxed C.F.C.’s or permanent establishments.”

In any case, most of the hybrid mismatch rules that form the second tranche of A.T.A.D. implementation must be implemented into domestic law effective January 1, 2020. Before the relevant legislative proposal is submitted to parliament (expected early 2019), the government launched a consultation round on its draft proposal on October 29.

General Anti-Abuse Provision

The general anti-abuse provision (“G.A.A.R.”) laid down in A.T.A.D. 1 provides that a series of arrangements must be disregarded for corporate income tax purposes if they (i) are set up with a main purpose to obtain tax benefits, (ii) undermine the purpose or application of tax legislation, and (iii) are wholly artificial.

The Dutch government takes the view that this rule is part of existing Dutch tax law through the *fraus legis*, an abuse of law doctrine developed in the case law. Consequently, the Dutch government does not consider it necessary to further implement or codify this rule.

Exit Tax

Under current Dutch law, an exit tax is due upon the relocation of a company’s seat to a place outside the Netherlands as if capital gains are realized from the move. The exit tax triggers the realization of pregnant gains and the triggering of all reserves when assets are transferred abroad. Therefore, the A.T.A.D. provision requiring E.U. Member States to levy an exit tax does not require new legislation.

However, implementation of A.T.A.D. 1 will require some minor changes to existing regulations. Under A.T.A.D. 1, exit tax must be paid within five years for transfers of assets within the E.E.A. The period is substantially shorter than the current 10-year period provided in Dutch law. Furthermore, A.T.A.D. provides that, while interest may be charged for deferred payment of the exit tax, the posting of security for the tax payment is required only if the tax collector can clearly demonstrate that a risk of nonpayment exists.

As a final point, current Dutch law taxes gains when a Dutch enterprise transfers assets to a foreign permanent establishment. In this case, A.T.A.D. 1 does not require taxation upon transfer, meaning that no legislative change is required in this respect.

C.F.C.’s

One of the cornerstones of the A.T.A.D. is a measure to combat tax avoidance through the establishment of a low-taxed C.F.C.’s or permanent establishments and the transfer of mobile assets to the C.F.C. or permanent establishment. Income derived by the transferee from the mobile assets is taxable in the Netherlands at the level of the Dutch shareholder. This measure follows B.E.P.S. Action 3.

In brief, a foreign corporation is a C.F.C. where (i) a taxpayer holds, independently or together with affiliated entities or persons, a direct or indirect interest of more than 50% in an entity or (ii) the Dutch entity maintains a permanent establishment abroad that is taxed as if it were a foreign corporation. This means that it will also be relevant for Dutch companies to know whether lower-tier C.F.C.'s derive profits from mobile assets.

Under A.T.A.D. 1, broadly, a choice is made between two taxation models:

- **Model A:** Passive income derived by the C.F.C. (*e.g.*, dividends, royalties, and interest) is included in the tax base of its parent company if this income is not distributed by the C.F.C. promptly.
- **Model B:** The profits reported by the C.F.C. are allocated to functions performed in the Netherlands on the basis of the arm's length principle (*i.e.*, a transfer pricing approach).

The Dutch government currently takes the position that the Netherlands already applies Model B because the arm's length principle is codified in article 8b of the 1969 Corporate Income Tax Act ("C.I.T.A."). Nonetheless, it would like to do more than strictly necessary with respect to C.F.C.'s. For this reason, the government has opted for Model A treatment for C.F.C.'s established in a state appearing on the E.U. list of non-cooperative countries (the "E.U. blacklist") or with a low statutory tax rate, which is defined to be less than 7%. However, if the C.F.C. performs an economic activity of substance, its income will remain exempt.

The government has chosen this measure to deter tax avoidance arrangements from occurring in the Netherlands. To emphasize that the Netherlands no longer wants to be a participant in such arrangements, the fact that double taxation arises is explicitly accepted. For example, in situations where a C.F.C. is held indirectly and C.F.C. rules also apply on the level of a share-linked intermediary, the Netherlands does not take into account the tax payable by that share-linked intermediary.

An exhaustive list of states identified on the basis of the above criteria will be drawn up annually and published in a ministerial regulation. It will be based on the E.U. blacklist for the preceding calendar year or on the statutory tax rate as of October of that year.

A C.F.C. performs an economic activity of substance if it meets the substance requirements that apply as of April 1, 2018, for the purposes of the dividend withholding tax exemption. This includes payroll costs of at least €100,000 and office space available for at least 24 months.

Several additional exceptions apply. Under one, the additional C.F.C. measure will not apply if the C.F.C. mainly receives benefits other than the tainted benefits. Under a second exception, the C.F.C. measure will not apply where (i) the C.F.C. is an entity (not a permanent establishment), (ii) a financial business is carried on by the C.F.C., and (iii) the C.F.C. regularly receives tainted benefits in transactions with third parties.

The income of the C.F.C. will be determined according to Dutch standards. For example, an arm's length fee will be taken into account for an interest-free receivable.

Interest Deduction Limitations

The A.T.A.D. provides for a generic interest deduction limitation, known as the earnings stripping measure, which will be introduced for financial years commencing on or after January 1, 2019. Under this provision, the deduction for net interest expense is capped at 30% of the taxpayer's earnings before interest, tax, depreciation, and amortization ("E.B.I.T.D.A.") or €1 million, whichever is higher. Because the cap is placed on net interest expense, gross interest income of the taxpayer is fully deductible by gross interest expense. Note that interest income or expense relates to the cost of borrowing, whether the arrangement is structured as a loan, a financial lease, or a comparable agreement. The earnings stripping limitation applies only to the extent the interest expense exceeds the interest income. Note that the term "interest" includes currency exchange results on the principal and the interest installments. To the extent that currency risk on loan principal and interest payments is protected by an offsetting hedge, the effect of the hedge must be taken into account. In addition, the cost of the hedge is to be treated as interest expense or an offset to interest income, as the case may be.

E.B.I.T.D.A. is determined under a five-step process:

1. Determine profits under applicable Dutch tax standards.

2. Adjust the profits for certain tax-exempt items – notably, exempt participation benefits, as well as the deduction allowed with regard to gifts.

3. Increase the profits determined under the first two steps by the total depreciation and write-downs of assets taken into account during the year.

4. Decrease the profits determined under the first three steps by any write-downs of an asset that has been recaptured during the year.

5. Increase the profits determined under the first three steps by the net interest expense incurred during the year.

Interest to be capitalized in a year will be taken into account for the purposes of the 30% rule as well, meaning that the profits will not be adjusted for any such capitalization. However, the limitation of the deduction of other (*i.e.*, noncapitalized) interest expense will take precedence where the 30% criterion is exceeded. In that case, the interest to be capitalized may indeed be capitalized if, and to the extent that, the interest is less than 30% of the E.B.I.T.D.A. and carried forward to a subsequent year if, and to the extent that, it exceeds 30% of the E.B.I.T.D.A.

All net interest expense in excess of the cap can be carried forward to subsequent years in which net interest expense is below the cap and can be deducted to the extent of the unused cap in the carryover year. There is no limitation on the length of the carryover period. However, certain anti-abuse provisions will be adopted to prevent taxpayers from acquiring companies with excess deduction capacity or excess interest expense that may be absorbed by the acquiring group. Under one measure, if the ultimate beneficial ownership in the taxpayer changes substantially, the carried-forward interest arising before the change in ownership can no longer be taken into account. A change in ownership is substantial if more than 30% of the shares of the company changes hands. Another rule covers the overlap between carried-forward net interest and the consolidated group regime.

An earnings stripping measure applies to a consolidated tax group. Where a group does not compute income on a consolidated basis, but instead computes income on a standalone basis for each company, a threshold of €1 million per company can be used. In certain fact patterns, multiple caps may exceed 30% of E.B.I.T.D.A. computed on a consolidated basis. Should this rule result in large numbers of de-consolidations, corrective legislation may be considered.

As was previously announced, for the purposes of the earnings stripping measure, the government has opted for the following enforcement rules in regard to A.T.A.D. 1:

- There will be no group exemption.
- Stand-alone entities will not be exempt.
- Financial institutions will not be exempt.
- The option to delay implementation until 2024 is rejected.
- There will be no grandfathering of existing loans.

Finally, certain interest deduction limitations in the C.I.T.A. will be abolished when the earnings stripping measure comes into effect. The abolished provisions will include the following:

- The deduction limitation for excessive participation interest (article 13l C.I.T.A.)
- The deduction limitation for excessive acquisition interest (the acquisition holding company provision in article 15ad C.I.T.A.)
- The limitation of the holding company loss set-off (article 20[4] through [6] C.I.T.A.)

Nonetheless, two specific interest deduction limitations will be maintained:

- Article 10a C.I.T.A. (targeting base erosion)
- Article 10b C.I.T.A. (targeting international mismatches)

DIVIDEND TAX EXEMPTION

Where a Dutch parent company owns at least 5% of the nominal share capital of another Dutch company, the shareholding is eligible in principle for the participation exemption. Therefore, dividends distributed by the relevant subsidiary are exempt from corporate income tax in the hands of the parent company. In domestic situations, because the dividend is exempt at the shareholder level, the subsidiary is not required to collect withholding tax.

When the Parent Subsidiary Directive ("P.S.D.") was implemented in the early 1990's, a similar exemption was introduced for corporate shareholders based in E.U. Member States. Even though the P.S.D. contains a higher threshold for exemption than the Dutch participation exemption, case law from the European Court of Justice has established that the qualifying ownership percentage for exemption in intra-E.U./E.E.A. situations may not exceed the domestic threshold.

Following last year's tax reform, the scope of the existing exemption for E.U. or E.E.A. corporate shareholders was extended to corporations resident in any jurisdiction that has an income tax treaty with the Netherlands in effect where there is a clause governing the taxation of dividends. The content of the dividends article is not material. As an example, the unilateral exemption applies to qualifying Canadian-resident companies under the Netherlands-Canada Income Tax Treaty even though the treaty provides only for a reduced withholding tax rate of 5%. Similarly, the unilateral exemption applies to qualifying Chinese-resident companies under the Netherlands-China Income Tax Treaty, which reduces withholding rates on dividends to 5% in some circumstances and 10% in others. It also applies to qualifying U.S.-resident companies under the Netherlands-U.S. Income Tax Treaty when those companies do not qualify for the exemption provided under the treaty.

Because the proposed legislation contains its own test for qualification and is a unilateral provision requiring no concurrence by a treaty partner, the exemption can apply even though the recipient of the dividend fails to meet any of the tests under the limitation on benefits ("L.O.B.") clause in the treaty. This makes the Netherlands an attractive location for a European holding company owned by a group based in the U.S. or Japan, where the relevant income tax treaties contain detailed L.O.B. clauses that are not always easy to meet. Clearly, a unilateral exemption that applies irrespective of reduced treaty rates and specific treaty requirements significantly improves the position of the Netherlands as a European "hub" for multinational enterprises headquartered in the world's largest economies, such as Canada, China, Japan, and the U.S. – all of which are important trading partners for the Netherlands.

The unilateral exemption is subject to an anti-abuse rule. This rule stems from supranational E.U. law, which the Netherlands must implement, and international rules suggested by the O.E.C.D., which the Netherlands may codify.

"The exemption can apply even though the recipient of the dividend fails to meet any of the tests under the L.O.B. clause in the treaty."

Within the E.U., a special G.A.A.R. provision was inserted into the P.S.D., and the G.A.A.R. is now part of A.T.A.D. 1, as discussed above. Also, the multilateral instrument ("M.L.I.") developed by the O.E.C.D. within the context of the B.E.P.S. Action Plan provides for a principle purpose test ("P.P.T."). Even though the P.P.T. is conceptually different than the G.A.A.R. it has a similar effect. While, at present, an applicable dividend clause in a tax treaty may override a domestic anti-abuse rule, the P.P.T. will gradually become an integral part of bilateral tax treaties as the M.L.I. is adopted worldwide.

The Dutch anti-abuse rule starts with a subjective test, which essentially requires an analysis of whether avoidance of Dutch dividend tax was a main purpose for setting up the structure. This is considered to be the case if the Dutch entity making the distribution would be required to withhold more dividend tax on its distributions had the direct shareholder not been inserted into the structure.

What follows then is an objective test, which entails an assessment of whether the structure is artificial, either by itself or in conjunction with a series of artificial arrangements or transactions that lack valid business reasons reflecting economic reality. Essentially, this the mantra formulated by the European Court of Justice in its ruling in the *Cadbury Schweppes* case.

If the direct shareholder conducts an active business to which its shareholding in the Dutch entity is attributable, valid business reasons reflecting economic reality are generally deemed present. However, where the direct owner is merely an intermediary holding company, the assessment becomes more complicated. In that set of circumstances, the indirect shareholder of the Dutch entity must conduct an active business enterprise. In addition, the intermediary holding company must have a linking function (*schakelfunctie*) between that active company and the Dutch entity. Under the Dutch anti-abuse rule, that linking function must be substantiated. Most of the relevant substance criteria are of a general nature and would apply to any company. However, two additional substance requirements apply specifically to an intermediary holding company:

The intermediary holding company must incur salary costs equal to at least €100,000 for employees performing the activities that function as a link between the indirect owner and the Dutch entity. These employees may be hired from group companies through a salary-split arrangement. However, the part-time employees must perform their activities for the intermediary holding company in the jurisdiction where that company is established.

- The intermediary holding company must have its own office space at its disposal, and that space must be equipped and actually used for the performance of its activities for a period of at least 24 months.
- If the intermediary holding company meets all of these relevant substance requirements in its jurisdiction, then "valid business reasons reflecting economic reality" are considered to be present.

Pursuant to E.U. case law on which the Dutch rule is based, the taxpayer must be allowed to provide evidence demonstrating economic reality where the two-pronged test is met.[2] This would imply that even if its foreign shareholder does not meet all of the relevant substance requirements, the Dutch company making the profit distribution should still be allowed to demonstrate that the intermediary holding company was put in place for "valid business reasons reflecting economic reality." This may be particularly relevant for joint venture vehicles and private equity structures.

CONCLUSION

Across the globe, the landscape for international tax is in a constant state of change. Recently, the Netherlands accelerated the change by revising an elimination of withholding tax on dividends paid to foreign shareholders after it was announced with great fanfare, but before the provision was actually enacted. This change was accompanied by adoption of several rules embodied in A.T.A.D. 1, including a G.A.A.R. rule, an exit tax for corporations, a C.F.C. anti-abuse rule, a cap on the deductibility of interest expense, and a limited exemption from withholding tax on cross-border dividend payments in the context of an income tax treaty and the presence of economic substance for the direct or indirect shareholder. In this context, certainty is obtainable for an international tax plan only if it reflects the law that was, the law that is, and the law that may be.

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2 See "German Anti-Treaty Shopping Rule Infringes on E.U. Law," *Insights* no. 8 (2018), p. 4.

EXTENSION OF GERMAN TAXATION OF FOREIGN COMPANIES HOLDING GERMAN REAL ESTATE

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Tags
Germany
Corporate Tax
Income Tax
International Tax
Real Estate

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On August 1, 2018, the German Federal government proposed draft legislation that will expand the scope of German taxation to cover the sale of shares in "real estate rich companies" by nonresident taxpayers. In the coming months, the draft will be subject to further discussion in the German parliament. The draft legislation proposes that capital gains from shares in foreign companies will be subject to German taxation if the share value consists of more than 50% German real estate. The sale of shares by certain institutional investors (*e.g.*, foreign corporations and domestic and foreign investment funds) is not expected to be covered by the draft legislation.

The draft legislation raises practical questions regarding implementation. These include questions regarding

- accounting and reporting requirements,
- methods that should be used when determining the value of German real estate and all other assets owned by a company in order to conclude that the company is a real estate rich company,
- the way in which German tax resulting from the adoption of the proposed legislation will interface with conflicting provisions of existing double taxation treaties,
- tax filing duties of a nonresident shareholder of a real estate rich company,
- identifying those nonresident investors that will be affected by the draft legislation once effective, and
- resolving possible double taxation issues when the shareholder's country of residence determines that it has the primary or exclusive right to tax gain from the disposition of shares

In addition to a straightforward set of facts, the draft legislation contains provisions applicable to loans extended to a real estate rich company by a nonresident lender.

BACKGROUND

A foreign shareholder's capital gain from the sale of shares in a foreign-based real estate rich company is not subject to German taxation under existing law. The capital gain is subject to tax only if the investor holds at least a 1% interest in the company and the corporate entity being sold has its corporate seat or place of effective management in Germany.

In contrast to the domestic legal situation, Germany's most recent double taxation treaties ("D.T.T.'s") assign Germany the right to tax such capital gains. For example, the D.T.T.'s with Luxembourg and France specify that capital gains are subject to German taxation if the share value consists of more than 50% German real estate,[1] and the D.T.T. with the Netherlands allows for German taxation if the company's assets consist of more than 75% German real estate.[2] These provisions are in line with Art. 13 (4) of the O.E.C.D. Model Tax Convention, which has contained a "land-rich company" clause since 2014. According to these provisions, all capital gains from these sales of shares are taxable in the country where the real estate assets are located, regardless of the company's other assets.

Notably, D.T.T.'s can only restrict the right to tax. They cannot establish or expand the right of a contracting party to impose tax. In practical terms, this leads to an unequal distribution of taxing rights between Germany and its treaty partners whenever the domestic law of the treaty partner does not have a similar requirement allowing gain to be taxed only if the real estate rich company maintains its registered seat or place of effective management within the treaty partner jurisdiction. The treaty partner can tax gain from the sale of shares of a German company when real estate located in the treaty partner jurisdiction comprises the principal category of assets of the German company. In comparison, Germany cannot tax gain from the sale of a treaty partner corporation even if German real estate comprises most of the assets of company resident in a treaty partner jurisdiction as long as neither the registered seat nor the place of effective management is in Germany. The draft legislation[3] is intended to correct this, establishing equivalent rights for Germany to impose tax in these cases.

DETAILED OVERVIEW OF DRAFT LEGISLATION

"Capital gains from shares in foreign companies will be subject to German taxation if the share value consists of more than 50% German real estate."

In order to extend the German right to tax, the following amendments to existing law are proposed:

Extension of the Tax Liability to Foreign Companies Under Sec. 49 EStG

New Provision

The draft provides an expansion of German tax liability to capital gains arising from the sale of shares in foreign companies that are rich in German real estate. Notably, the new Sec. 49 (1) No. 2 lit e) cc) of the German Income Tax Act (*Einkommensteuergesetz* or "EStG") will not require a registered seat or place of effective management to exist in Germany in order for German tax to be imposed – as is required by the existing Sec. 49 (1) No. 2 lit e) aa) EStG.

In the future, capital gains will be taxed in Germany when the following requirements are met:

- **Real Estate Assets of More than 50%:** Capital gains arising from the sale of shares of a nonresident company will be subject to German tax if more than 50% of the share value of the company arises from German immovable

[1] Art. 13 (2) D.T.T. Lux; Art. 7 (4) D.T.T. Fra.

[2] Art. 13 (2) D.T.T. NL. Germany's D.T.T. with the U.S. deviates from this as it currently does not contain such a provision.

[3] *Entwurf eines Gesetzes zur Vermeidung von Umsatzsteuerausfällen beim Handel im Internet und zur Änderung weiterer steuerlicher Vorschriften*, formerly *Jahressteuergesetz* 2018, BR-Drs. 372/18.

property at any time during the 365 days preceding the sale. The real estate can be held directly by the company or indirectly through shares in other corporations holding immovable property.

- **Shareholding of at Least 1%:** In line with the present legal framework, only capital gains associated with a shareholding that exceeds a 1% threshold at any time within the last five years are taxed.[4] In other cas-es (shareholding below 1% during the last five years), the sale of shares will remain free of German tax.

Determination of the Real Estate Threshold

In accordance with the 2017 O.E.C.D. Model Tax Convention, the relevant real estate threshold will be determined over a set period of time. Accordingly, capital gains will be taxed as soon as the 50% threshold has been exceeded during the 365 days preceding the sale, provided that the shares were economically attributable to the seller at this point in time.[5] It is expected that tax avoidance schemes will be prevented by looking at a period of 365 days instead of looking only at the date of the sale, as in the 2014 O.E.C.D. Model Tax Convention. If only the date of sale is relevant, the 50% threshold can be avoided by capital injections of cash, securities, or movable assets to dilute the proportion of real estate assets on the date of sale.

The real estate threshold is determined based on the book value of assets only, and liabilities are excluded in computing value. The reliance on book value leads to an incongruity that allows indirect German real estate gains to go untaxed for the shareholder of a real estate rich company when German real estate in an appreciating market is mixed with non-German real estate in a stable or depreciating market.

Example 1: Nonresident Owns Real Estate in Germany and Elsewhere

Corporation X, a nonresident company, owns two parcels of real estate. Parcel A is located in a German city undergoing significant appreciation in the value of assets. Parcel B is located in a Turkish city where values are stable when measured in Turkish Lira. On the date of acquisition, Parcel A is worth €400,000, and Parcel B is worth the Lira equivalent of €500,000. The apportionment of land value to building value is the same for both parcels and depreciation is computed under equivalent rules and useful lives in both countries. After the properties have been held for three years, the fair market value of Parcel A increases to €600,000, and the fair market value of Parcel B remains at the Lira equivalent of €500,000. This reflects increased value in terms of Lira but depreciation in the value of the Lira in relation to the Euro.

Under these facts, the book values of the two parcels should reflect that not more than 50% of the value of the nonresident corporation's shares is attributable to German real estate. However, 54.5% of the total fair market value of the nonresident corporation's shares will be attributable to German real estate.

For cases where German real estate is held indirectly, the explanatory statement on an earlier draft of the bill from the Federal Ministry of Finance suggested that the 50% threshold would be determined on a consolidated basis. However, this clarification was not included in the subsequent government draft bill.

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4 Sec. 17 EStG.

5 Cf. Sec. 39 of the German General Tax Act (*Abgabenordnung* or "AO").

Date of Application

The new regime will apply to transactions occurring after December 31, 2018.[6] A revaluation of cost basis for the shares is adopted so that only net increases in value after December 31, 2018 are taxed. Since the draft law uses the term "value changes," both increases and decreases will be relevant for taxation purposes.

Impact of the Amendments

In our view, the new legislation will most likely have the following consequences:

Taxable Capital Gains from the Sale of Shares

Whether the sale of shares in a foreign real estate rich company will trigger German tax depends on the shareholder's legal form:

> **Example 2: Shareholder Is a Corporation**
>
> Corporation X has a corporate seat or place of effective management outside of Germany and holds a significant amount of shares (at least 1%) in the non-German real estate company Y. The share value of Y consists of more than 50% real estate assets located in Germany. Neither X nor Y have a permanent establishment nor permanent representative in Germany.

Under current German tax law, the capital gains from the sale of shares in this example would not qualify as taxable domestic income.

In the future, the new provision will lead to the taxation of such capital gain as domestic income.[7] However – by application of German domestic rules – the capital gains should be 100% tax-exempt. This is the result of "intercompany privilege"[8] and the Federal Tax Court decision that held the provision to tax 5% of the gain as non-deductible business expenses[9] does not apply to a sale of a foreign corporation, unless it has a permanent establishment or a permanent representative in Germany.[10]

If the selling shareholder is an investment fund in accordance with German investment tax law, capital gains should also be tax-exempt since capital gains from the sale of shares in corporations by an investment fund are generally tax-exempt pursuant to Sec. 6 (5) No. 1 InvStG.[11]

However, foreign investors who cannot claim any of the tax exemptions outlined above – such as certain finance and insurance companies to which the exemption of Sec. 8b (7) and (8) KStG does not apply[12] – are taxable on the whole capital gain.

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6 Sec. 52 (45a) EStG.

7 Sec. 49 EStG in connection with Sec. 8 (1) of the German Corporate Income Tax Act (*Körperschaftsteuergesetz* or "KStG").

8 The intercompany privilege provision under Sec. 8b (2) s. 1 KStG sets out that capital gains received by a corporation are fully tax-exempt; however, 5% of these capital gains are considered non-deductible business expenses.

9 Sec. 8b (3) s. 1 KStG.

10 Federal Tax Court of 31 May 2017, I R 37/15, Federal Tax Gazette II 2018, p. 144.

11 German Investment Tax Act (*Investmentsteuergesetz* or "InvStG").

12 Sec. 8b (7) and (8) KStG.

Example 3: Shareholder Is an Individual

Individual A, a German nonresident, holds a significant number of shares (at least 1%) in German nonresident real estate company B. The share value of B consists of more than 50% real estate assets located in Germany. B does not have a permanent establishment or a permanent representative in Germany.

In contrast to the current law, the sale of shares by a nonresident individual will become a taxable transaction. Taking the partial-income method[13] into account, 60% of the capital gains will be taxable, and 40% will be exempt. This is also true if the selling shareholder is a partnership. In this case, the tax consequences depend on whether the partner is a corporation or an individual.

Example 4: Attribution of Shares

Individual A, a German nonresident, holds 10% of German nonresident company B (which holds no real estate assets). On July 1, 2017, A sells 9.5% of his shares in B. B acquires German real estate on March 1, 2018, and meets the German real estate threshold of more than 50% of total value. B sells all real estate holdings on February 1, 2019. A sells his remaining 0.5% of shares in B on March 1, 2019, to the individual C (also a German nonresident), who sells her shares on June 1, 2019.

A's capital gains realized upon the sale of shares on March 1, 2019, are subject to German tax under the new provision. A holds at least 1% of the shares during the 5-year period preceding the sale, and more than 50% the share value of B is attributable to German real estate during the 365 days preceding the sale. The fact that B acquired real estate to a relevant extent only after A reduced its shareholdings to less than 1%, should not justify a different conclusion. The explanatory statement to the draft legislation explains that the 1% shareholding threshold is not required to be met at the time the 50% real estate threshold is exceeded.

However, the capital gains realized by C are not subject to German taxation because the shares in B were not attributable to C[14] when B fulfilled the relevant real estate assets threshold (March 1, 2018, until February 1, 2019).

Restrictions Due to D.T.T.'s

Depending on the country of residence of the selling shareholder – whether it is a treaty jurisdiction or a country with which Germany has no D.T.T. in effect – the tax liability may vary. The rules set out above also apply to foreign shareholders that are resident in countries with which Germany does not have a D.T.T. in effect.

In cases involving a country with which Germany has signed a D.T.T., the German tax liability and right of Germany to impose tax must be assessed under the provisions of the relevant D.T.T. Several older D.T.T.'s do not contain real estate rich company clauses. Examples are the D.T.T.'s concluded with Belgium or the U.S. Under these D.T.T.'s, gains from the sale of shares in real estate rich companies are taxable only in the contracting state in which the seller is resident. Consequently, the

[13] The partial-income method under Sec. 3 No. 40 lit c) EStG sets out that certain capital gains are 40% tax-exempt.

[14] According to Sec. 39 AO.

proposed legislation will not impact investors located in the relevant treaty jurisdiction until the D.T.T. is renegotiated.

Other D.T.T.'s may result in different thresholds. For example, the D.T.T. with the Netherlands contains a 75% real estate threshold, which means that capital gains will not be liable to German tax if the share value attributable to German real estate is more than 50% but not more than 75% of the total value.

Finally, other D.T.T.'s may result in periods of assessment for determining the real estate threshold that depart from the 365-day rule under domestic law. Like all of Germany's current D.T.T.'s that contain a real estate rich company clause, Art. 13 (2) of the D.T.T. with Luxembourg stipulates that only the date of sale is relevant for determining whether the value threshold is met for German real estate. In contrast to the draft legislation, exceeding the 50% threshold on another date during the 365-day period preceding the date of sale is not relevant. This means that the capital gains of an investor located in Luxembourg, or a country with a similar provision in its D.T.T. with Germany, will be subject to German tax only if the share value consists of more than 50% German real estate on the date of sale. It is worth noting, however, that Germany will change these provisions in its D.T.T.'s by implementing the Multilateral Instrument[15] so that all German D.T.T.'s will contain the 365-day period, provided that the contracting state in each affected D.T.T. agrees to such an amendment.

Practical Implementation

Issues remain in the draft legislation regarding the determination of the real estate threshold, itself. Contrary to the usual practice of determining book values on a specific closing date, it might now be necessary to assess the book value of the underlying real estate assets on each day throughout the year in order to determine whether the 50% threshold has been exceeded at any point during the 365 days preceding the sale. Additional issues arise for the determination of the real estate threshold in the case of indirect shareholdings. The 365-day review period may also lead to double taxation as Example 5 illustrates:

> **Example 5: Multiple Taxation Due to the 365-Day Period**
>
> The value of the shares of -S.à.r.l. Y, located in Luxembourg, consist of more than 50% German real estate. On November 1, 2018, Y sells all its German properties and acquires real estate assets located in Country B, which account for more than 50% of the share value from the date of their purchase. On March 1, 2019, shareholder X, a German nonresident individual, sells his shares.

The capital gains realized by X are taxable in Germany under the new provision because the value of the shares in Y consisted of more than 50% immovable German property during the 365-day period. If Country B has a similar regulation, the capital gains are taxable in Country B as well. The right to tax these capital gains is also assigned to Germany according to the D.T.T. with Luxembourg as soon as the 365-day period is introduced in this treaty. Assuming that the D.T.T. between Luxembourg and Country B contains such a 365-day review period (in line with the 2017 O.E.C.D. Model Convention), the capital gains from a single sale of shares are

15 See Art. 9 MLI.

subject to tax in two countries. Of course, the competent authorities of Germany and Luxembourg could agree to provide relief in order to avoid double taxation. The right of countries to avoid double non-taxation should not be a basis to impose double taxation where aggressive tax planning is not involved.

Further questions with regard to the practical implementation arise concerning listed foreign real estate companies:

- How will foreign share deals be monitored?
- How will the German tax authorities control tax filing duties?

Today, these and other practical questions remain unanswered.

"The sale of shares in foreign real estate corporations could potentially trigger (limited) domestic taxation in Germany."

Provisions Addressing Certain Loans

The draft legislation contains a provision stipulating that capital gains from the sale of real estate located in Germany will include changes in the value of other assets or obligations that are related to the real estate.[16] An example involves changes in the value of loans taken out to finance German real estate. Such value changes may be attributed to movements in currency value between the stated denomination of the obligation and the value of the Euro. Alternatively, they may be attributed to an enhanced credit position of the corporation issuing the debt obligation to finance the real estate.

Accordingly, income realized at the level of the debtor from a creditor's waiver of a loan that was taken out to finance real estate would lead to limited taxable earnings in Germany. In contrast to current case law,[17] there would be taxable income in Germany when a parent company waives a loan to its foreign subsidiary that was used to finance the acquisition of German real estate.

CONCLUSION

In view of the current draft law, the sale of shares in foreign real estate corporations could potentially trigger (limited) domestic taxation in Germany. In cases where the selling shareholder is either a nonresident individual or a specified foreign finance and insurance company, the capital gain might become entirely taxable in Germany.

Given that the pending changes would enter into force after December 31, 2018, any contemplated share sale transaction involving German real estate assets should be reviewed and, to the extent necessary, should be completed prior to the close of 2018, if possible.

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16 Sec. 49 (1) No. 2 lit. f) s. 3 EStG-draft.

17 Federal Tax Court of 7 December 2016, I R 76/14, Federal Tax Gazette II 2017, p. 704.

CORPORATE MATTERS:

ICHABOD CRANE VISITS HIS EXECUTIVE EMPLOYMENT ATTORNEY

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Tags
Contract Law
Corporate Law
Employment Law

The Legend of Sleepy Hollow is a wonderful story that often comes to mind this time of year. As you may remember, Ichabod Crane, the central character, comes from obscure origins before he accepts the job of village schoolmaster in Sleepy Hollow, N.Y. After Ichabod meets a terrifying Halloween apparition, little is heard from him.

It turns out, however, that – like many executives accepting a position of responsibility – Ichabod Crane sought counsel from a knowledgeable employment attorney both before he was hired and after his academic employment came to an abrupt end.

Since all the participants are long dead and even the strongest attorney-client privilege fades after 200 years, I believe it is time to reveal the never-before told details of Ichabod's conversations with his lawyer:

THE FIRST MEETING: JUNE 15, 1790

Attorney: Well, Schoolmaster Crane, I have reviewed your proposed employment agreement with the Board of Education of Sleepy Hollow. It seems a bit light on actual monetary compensation.

Ichabod: I get room and board as well. Aren't there some tax implications from that type of remuneration?

Attorney: Yes, but I don't think we need worry about that; it will be more than a century until they enact a Federal income tax.

Ichabod: That's good.

Attorney: But I don't like the provision in here that allows the Board to reduce your compensation if they determine that you are a "Prodigious Feeder." How realistic is that?

Ichabod: I like to eat. Working all day with children makes you hungry.

Attorney: Let's see if we can't eliminate that clause. . . . It also seems to me that there are important protections for you that are missing from this draft agreement.

Ichabod: Such as?

Attorney: One of the most important parts of any executive

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employment contract or offer letter is to specify the amount and timing of severance payable to you in case things simply don't work out, and you are terminated without Cause. There's nothing about severance in here, and there isn't any definition of what constitutes Cause.

Ichabod: Is that bad?

Attorney: You are an employee "at will," so the absence of these protections could make it meaningfully harder for you to obtain a decent termination package.

Ichabod: Anything else?

Attorney: The clause that says that in the event of a controversy with your employer, you have to go to arbitration before a magistrate in the neighboring village of Tarrytown who has experience sitting on a school board – someone like that is likely to be biased against you. Do you understand the difference between arbitration and being able to bring a case in court?

Ichabod: How much is it going to cost me to have you negotiate a better deal for me?

Attorney: 2, maybe 3, British shillings.

Ichabod: Let me think about it. I'll get back to you.

SEVERAL MONTHS LATER: NOVEMBER 13, 1790

Attorney: Schoolmaster Crane, good to see you. I wondered what had happened after I never heard from you again. You seemed to have suffered some kind of head injury?

Ichabod: I was hit by a flying pumpkin.

Attorney: I don't do personal injury work.

Ichabod: And I've lost my job.

Attorney: I'm sorry to hear that. Did you ever get the contract changes we discussed?

Ichabod: No, but it's a complicated story. I was courting the boss's daughter . . .

Attorney: Office romances can be very problematical these days.

Ichabod: And I wound up being bullied. I must have a bullying claim.

Attorney: Did this bullying take place in the workplace?

Ichabod: Not exactly. There was this local tough named Brom Bones, and there was a Headless Horseman . . .

Attorney: Are you quite certain you've recovered from that nasty head injury?

Ichabod: I know there isn't any teacher's union yet, but maybe I have some claim for severance.

Attorney: What about a disability discrimination claim based on your mental state? Did you tell your employer that you were having hallucinations about some Headless Horseman and ask for a reasonable accommodation at work?

Ichabod: That was no hallucination. It was a flying pumpkin.

Attorney: I know a top mental health professional who doubles as an expert witness.

Ichabod: All I want is some compensation. How much will it cost me to pursue a claim?

Attorney: Unless you can get the Headless Horseman to pay your legal fees, it will cost a great deal more than if you had listened to me before signing your contract.

THE MORAL OF THIS STORY

Don't be shilling wise and pound foolish. A bad employment contract could definitely come back to haunt you.

ALTA ENERGY AFFIRMS TREATY BENEFITS: A CANADIAN CASE STUDY FOR APPLYING THE M.L.I.

Authors
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Tags
Canada
Capital Gains
M.L.I.
O.E.C.D.
P.P.T.
Tax Treaties

INTRODUCTION

The Tax Court of Canada in *Alta Energy Luxembourg S.A.R.L. v. The Queen*[1] ("*Alta Energy*") and its interplay with Canada's potential future application of the principal purpose test ("P.P.T.") under the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the "Multilateral Instrument" or "M.L.I.") designed by the O.E.C.D., which Canada signed on June 7, 2017.

Alta Energy resulted from an assessment of Alta Energy Luxembourg S.A.R.L. ("Luxco"), a company resident in Luxembourg for the purposes of the double income tax convention concluded between Canada and Luxembourg (the "Canada-Luxembourg Treaty"),[2] following its sale of shares of Alta Energy Partners Canada Ltd. ("Canco") to Chevron Canada Ltd. ("Chevron"), an arm's length party.

It should be noted that a Notice of Appeal was filed with respect to *Alta Energy* with the Federal Court of Appeal on October 1, 2018.

BACKGROUND

In the spring of 2011, Blackstone Group LP and Alta Resources LLC (together, the "Investors") formed Alta Energy Partners, LLC ("USco"), a limited liability company formed pursuant to the laws of Delaware. In June 2011, the Investors incorporated Canco, a wholly owned subsidiary of USco. Canco was granted the right to explore, drill, and extract hydrocarbons from an area in Alberta designated under licenses (the "Licenses") granted by the government of Alberta.

Pursuant to the double income tax convention between Canada and the U.S. (the "Canada-U.S. Treaty"),[3] a sale of Canco by USco would likely have resulted in a capital gain subject to tax in Canada as well as the U.S.; the Investors had been advised that the total investment in Canco was expected to grow between $300 and $400 million in two years.

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1. 2018 TCC 152.
2. *Convention Between the Government of Canada and the Government of the Grand Duchy of Luxembourg For the Avoidance of Double Taxation and the prevention of Fiscal Evasion with respect to Taxes on Income and on Capital,* signed on September 10, 1999, as amended by the Protocol signed on May 8, 2012.
3. *Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital*, as amended by the Protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007.

"Canadian income tax is payable on the gain realized from the disposition of Taxable Canadian Property . . . that is not Treaty Protected Property."

The Investors determined that the decision to have Canco held by USco was a mistake[4] and realized that a restructuring was necessary in order to address current[5] and future adverse income tax consequences.

In December 2011, the Investors corresponded with Luxembourg tax authorities regarding the tax regime that would be applicable should a corporation resident in Luxembourg (*e.g.*, Luxco) dispose of the shares of Canco.[6]

In April 2012, the Investors formed Luxco. Luxco was formed in order to hold the Investors' participations in Luxembourg and in foreign companies.[7] Luxco's sole shareholder, *Alta Energy* Canada Partnership, was a partnership established pursuant to the laws of Alberta.

On the same day, USco transferred the shares of Canco to Luxco (the "Transfer"). The Transfer would have resulted in a capital gain in Canada to USco, except that the Canada Revenue Agency (the "C.R.A.") accepted that Canco's shares on the date of the Transfer had a fair market value ("F.M.V.") equal to USco's adjusted cost base in Canco, resulting in zero gain. However, the court noted[8] that the Investors undoubtedly incurred significant legal costs in connection with the establishment of the revised structure.

Canco continued to acquire additional Licenses. In September 2013, Luxco agreed to sell its shares of Canco to Chevron (the "Sale").

Relying on Articles 13(4) and 13(5) of the Canada-Luxembourg Treaty, Luxco did not pay any income tax in Canada with respect to the Sale.

TAX CONSEQUENCES UNDER THE INCOME TAX ACT AND THE CANADA-LUXEMBOURG TREATY

Pursuant to the Income Tax Act (Canada) (the "I.T.A."),[9] Canadian income tax is payable on the gain realized from the disposition of Taxable Canadian Property, as defined in the I.T.A.,[10] that is not Treaty Protected Property, as defined in the I.T.A.[11]

Luxco conceded that the shares of Canco were Taxable Canadian Property at the time of the Sale because the shares of Canco derived more than 50% of their value

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4 *Supra* note 1, para. 19.

5 *E.g.*, anti-deferral rules in Subpart F of the Code.

6 *Supra* note 1, para. 21.

7 *Id.*, para. 22.

8 *Id.*, para. 25.

9 R.S.C., 1985, c.1 (5th Supp.).

10 Subsection 248(1) of the I.T.A. Generally, a share of the capital stock of a corporation (*e.g.*, Canco) is Taxable Canadian Property if, at the time of its disposition or within 60 months prior to that time, more than 50% of the F.M.V. of the share was derived, *inter alia*, directly or indirectly from one or any combination of the following: (i) real or immovable property situated in Canada, (ii) Canadian Resource Properties, (iii) Timber Resource Property (as defined in subsection 13(21) of the I.T.A.), and (iv) options or interests with respect to any of the foregoing.

11 Subsection 248(1) of the I.T.A.

from Canadian Resource Property, as defined in the I.T.A.[12] However, Luxco contended that the shares of Canco were Treaty Protected Property and therefore exempt from tax under the I.T.A.

Treaty Protected Property is defined[13] as follows:

> . . . property any income or gain from the disposition of which by the taxpayer at that time would, because of a tax treaty with another country, be exempt from tax under Part I [of the I.T.A.].

Article 13 of the Canada-Luxembourg Treaty governs, *inter alia*, capital gains realized by a resident of one contracting state (Luxembourg) arising from the disposition of property in the other state (Canada).

Article 13(4) and (5) of the Canada-Luxembourg Treaty states:

> 4. Gains derived by a resident of a Contracting State from the alienation of:
>
> (a) shares (other than shares listed on an approved stock exchange in the other Contracting State) forming part of a substantial interest in the capital stock of a company the value of which shares is derived principally from immovable property situated in that other State; or
>
> (b) an interest in a partnership, trust or estate, the value of which is derived principally from immovable property situated in that other State,
>
> may be taxed in that other State. For the purposes of this paragraph, the term "immovable property" *does not include property (other than rental property) in which the business of the company, partnership, trust or estate was carried on*; and a substantial interest exists when the resident and persons related thereto own 10 per cent or more of the shares of any class or the capital stock of a company.
>
> 5. Gains from the alienation of any property, other than that referred to in paragraphs 1 to 4[14] shall be taxable only in the Contracting State of which the alienator is a resident. [emphasis added]

The parties agreed that the shares of Canco derived their value principally from immovable property situated in Canada (per Article 13(4)(a) of the Canada-Luxembourg Treaty); at issue was whether the shares of Canco fell into the exemption for immovable property in which the business of the company (*e.g.*, Canco) was carried on (the "Immovable Property Exemption"). If the shares of Canco fall into the Immovable Property Exemption, the Sale should not be subject to tax in Canada pursuant to Article 13(4)(a) of the Canada-Luxembourg Treaty and should only be

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12 Subsection 66(15).

13 Subsection 248(1) of the I.T.A.

14 The parties did not raise arguments regarding Articles 13(1)-13(3) of the Canada-Luxembourg Treaty.

subject to tax in Luxembourg pursuant to Article 13(5) of the Canada-Luxembourg Treaty. In contrast, if Canco were found not to carry on its business through Canadian Resource Properties, the Sale should be subject to tax in Canada pursuant to Article 13(4)(a) of the Canada-Luxembourg Treaty and subsection 2(3) of the I.T.A.

As an alternative, the Minister of National Revenue (the "Minister") raised an argument under Canada's general anti-avoidance rule ("Canada's G.A.A.R.")[15] contending that a misuse or abuse of the I.T.A. and/or the Canada-Luxembourg Treaty resulted from the fact that Luxco, although a resident of Luxembourg for the purposes of the Canada-Luxembourg Treaty,[16] was created and became the owner of the shares of Canco for no purpose other than avoiding Canadian income tax on any gain that Luxco might realize from the Sale.[17]

DISCUSSION AND ANALYSIS

Does the Sale Fit into the Immovable Property Exemption?

As noted above, when a nonresident of Canada disposes of Taxable Canadian Property, Canada asserts the right to tax the nonresident on the gain, unless the property is Treaty Protected Property. The parties in *Alta Energy* agreed that Luxco's shares in Canco constituted Taxable Canadian Property on the basis that they derived more than 50% of their F.M.V. from Canadian Resource Properties;[18] the disagreement was whether the shares constituted Treaty Protected Property.

The court's reasoning began with its determination that Articles 13(1) and 13(5) of the Canada-Luxembourg Treaty assisted in illustrating the purpose of Article 13(4).[19] Article 13(1) of the Canada-Luxembourg Treaty provides that gains derived from the disposition by a party in one jurisdiction (*e.g.*, Luxembourg) of immovable property in another jurisdiction (*e.g.*, Canada) will be subject to tax in the state in which the property was located (*e.g.*, Canada). Article 13(4) of the Canada-Luxembourg Treaty supplements this rule by preventing a taxpayer from simply conducting a share sale, rather than an asset sale, in order to avoid tax in the jurisdiction in which the immovable property is situated.[20]

The court appears to have determined that this rule indicates a general principle that, in concluding the Canada-Luxembourg Treaty, Canada and Luxembourg generally gave up their rights to tax capital gains as an incentive to promote capital inflows, except when the gain was principally derived from immovable property other than immovable property in which a business is carried on.[21] According to the court, Article 13(5) of the Canada-Luxembourg Treaty embodied that principle.[22]

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15 Section 245 of the I.T.A.

16 Article 4.

17 *Supra* note 1, para. 75.

18 *Supra* note 10.

19 *Supra* note 1, paras. 39 and 40.

20 *Id.*, para. 41.

21 *Id.*, paras. 39-41.

22 *Ibid.*

The court also relied heavily on a 1991 position paper (the "Position Paper")[23] authored by an official of the Government of Canada.[24] According to the Position Paper,[25] the C.R.A. received numerous requests for technical interpretations concerning what is meant by "property, other than rental property, in which the business of the company was carried on" ("Excluded Property") in the application of certain double income tax conventions signed by Canada and in the context of resource industries.[26] The Position Paper was written in response to those requests and provides as follows:

> **Positions** . . .
>
> 3. Oil and gas reserves, *mines and royalty interests are Excluded Property if the owner is actively engaged in the exploitation of natural resources and if such assets are actively exploited or kept for future exploitation by such owner,* subject to exceptions resulting to hydrocarbons in the Canada-United Kingdom Convention. [emphasis added][27]

The Position Paper also provides the rationale for its positions.

The court interpreted the comments in Position 3 as setting out two conditions for oil and gas reserves to qualify as Excluded Property: (i) The corporation must be actively engaged in the exploration of the reserve, and (ii) the reserve must be actively exploited or kept for future exploitation by the owner.[28]

The court then discussed the nature of the oil and gas exploitation industry (the "Industry"). Generally, the court described how the Industry requires significant up-front capital investment and a trial and error methodology for finding and exploiting reserves, acknowledging that not every part of a working interest can be exploited at once.[29]

In order to maximize the opportunities for exploiting a reserve, the court determined that Canco, directly and indirectly, purchased multiple Licenses and took steps to "properly delineate the part of the formation that it controlled in order to plan how and when it would drill wells, extract hydrocarbons, and bring the hydrocarbons to the market."[30] Canco was not drilling on all areas for which it had Licenses but chose locations to drill based on their likelihood to benefit the entire operation. The court focused on the fact that Canco was at all times using the best practices of the Industry to develop its reserves.[31]

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23 The authors obtained a copy of the Position Paper from the court. The author of the Position Paper is G. Arsenault; the Position Paper is dated February 28, 1991.

24 *Supra* note 1, para. 42.

25 In the *Background* section on page 1.

26 See also *supra* note 1, para. 44.

27 We note that the Position Paper was published in 1991; it is unknown whether the positions in the Position Paper reflect the current positions of the C.R.A.

28 *Supra* note 1, para. 45.

29 *Id.*, paras. 46-68.

30 *Id.*, para. 65.

31 *Id.*, para. 64.

“The negotiators of the Canada-Luxembourg Treaty intended for the Immovable Property Exemption to be granted in accordance with Industry practices.”

In arguing that the shares of Canco did not constitute Excluded Property, the Minister took the position that only the properties where the Licenses were being actively used – *i.e.*, where drilling was actually taking place – could constitute Excluded Property. In other words, the Licenses to exploit hydrocarbons located under land being drilled could constitute Excluded Property on the basis that those properties were each a property in which the business of Canco was being carried on; however, Licenses to exploit hydrocarbons located under land that Canco was not drilling would not be Excluded Property, as Canco would not be conducting business on parcels where no drilling was actively taking place.

The court disagreed with this reasoning. The court determined that the Canada-Luxembourg Treaty negotiators “intended for a resource property to qualify as Excluded Property when such property is developed in accordance with the industry’s best practices.”[32]

In its interpretation of the Canada-Luxembourg Treaty, the court determined that the purpose of the Immovable Property Exemption is to attract foreign direct investments and that it is, therefore, also reasonable to assume that the negotiators of the Canada-Luxembourg Treaty intended for the Immovable Property Exemption to be granted in accordance with Industry practices.[33] This would mean that, although Canco was not drilling on all of the properties for which it had Licenses, so long as Canco obtained the property for use in its exploitation operations in a manner that was in keeping with Industry practices, Canco could be said to be carrying on its business in such properties for the purposes of Article 13(4) of the Canada-Luxembourg Treaty.

The court further determined[34] that the Minister’s interpretation would have been contrary to the terms expressed in the Position Paper, which included in the definition of Excluded Property, assets that are “actively exploited or *being kept for future exploitation*” [emphasis added], provided that the corporation was otherwise carrying on an active business.[35]

Although the Position Paper is not binding law, the court stated that, because it was a stated position from the C.R.A., taxpayers should be able to rely on it.[36]

Since Canco was conducting its business on all of the properties for which it had Licenses, the court determined that such properties constituted Excluded Property, such that the Sale fit within the Immovable Property Exemption and should not be subject to tax in Canada.[37]

Does Canada’s G.A.A.R. Apply to the Transactions?

While a full analysis of Canada’s G.A.A.R. is outside the scope of this article, generally, section 245 of the I.T.A. can apply to prevent a taxpayer from realizing a tax benefit once a transaction or series of transactions meet three criteria:

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32 *Id.*, para. 64. The court also added, in note 10, “In this regard, I share the opinion expressed in the Position Paper.”

33 *Id.*, para. 68.

34 *Id.*, para. 55.

35 *Ibid.*

36 *Id.*, para. 56.

37 *Id.*, para. 69.

- The transaction or series of transactions resulted in a "tax benefit."[38]
- The transaction or series of transactions constituted an "avoidance transaction."[39]
- It cannot reasonably be considered that the transaction or series of transactions would not result directly or indirectly in (i) a misuse of the provisions of the I.T.A., a tax treaty, or similar legislation, or (ii) an abuse having regard to the provisions of the I.T.A., tax treaty, or similar legislation read as a whole.[40]

Luxco agreed that, as a result of the restructuring, there had been a tax benefit and an avoidance transaction but argued that the avoidance transaction was not abusive.[41] The only issue before the court was whether or not there had been a misuse or abuse of a provision of the I.T.A. or the Canada-Luxembourg Treaty.

Pursuant to jurisprudential procedure concerning Canada's G.A.A.R.,[42] the court first looked to the "object, spirit, and purpose" of the I.T.A. and the Canada-Luxembourg Treaty, noting that statutory interpretation under Canada's G.A.A.R. differs from traditional word-based interpretation.[43] The court restated the general application of Canada's G.A.A.R. analysis:[44]

> Whereas, under the modern rule of statutory interpretation the analysis seeks to determine what the meaning of a provision is, under the GAAR, statutory interpretation is used to determine the object, spirit or purpose of the provision.[45] The object, spirit or purpose is the rationale underlying the provision. Transactions may be found abusive of a provision's underlying rationale, even though they comply with the literal, contextual and purposive meaning of the words of the statute.[46]

The court briefly dealt with arguments as to whether the Sale could be a misuse or abuse of provisions of the I.T.A. and determined that it could not:

> It is clear that those provisions[[47]] are not intended to operate in the case where a non-resident realizes a gain from the disposition of the 'treaty protected property' . . . I have concluded that the [shares of Canco] are 'treaty protected property.'[48]

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38 As defined in subsection 245(1) of the I.T.A.

39 As defined in subsection 245(3) of the I.T.A.

40 Subsection 245(4) of the I.T.A.

41 *Supra* note 1, para. 70.

42 See, *e.g.*, *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54.

43 *Supra* note 1, para. 71.

44 *Ibid.*

45 *Copthorne Holdings Ltd. v. R.*, 2011 SCC 63 [2011] 3 S.C.R. 721 (S.C.C.), para. 70.

46 *Id.*, para. 109.

47 Sections 38 and 39, subsection 2(3), and para. 115(1)(b) of the I.T.A.

48 *Supra* note 1, para. 74.

Having determined that the shares of Canco were Treaty Protected Property, which should be exempt from tax under the I.T.A., the court stated that all of the provisions of the I.T.A. operated in the manner intended by Canadian Parliament – *i.e.*, exempting Treaty Protected Property from Canadian tax. Therefore, the Sale should not have resulted in any misuse or abuse of the I.T.A.

The remaining question was whether there had been a misuse or abuse of the Canada-Luxembourg Treaty.

The Minister argued that the misuse or abuse resulted from the fact that Luxco, although a resident of Luxembourg for the purposes of Article 4 of the Canada-Luxembourg Treaty, was created and became the owner of the shares of Canco for no purpose other than avoiding Canadian income tax on the gain realized on the Sale. The Minister also noted that Luxco paid no tax in Luxembourg with respect to the Sale.[49]

The court stated[50] that the avoidance of "foreign tax" is irrelevant and further stated that the term "tax benefit" does not include a tax benefit under foreign law.[51]

The court went on to state that, under an analysis of Canada's G.A.A.R., the court was required to identify the rationale underlying the particular provisions of the Canada-Luxembourg Treaty, and not "a vague policy supporting a general approach to the interpretation of the [Canada-Luxembourg Treaty] as a whole."[52]

Similar to the court's analysis with respect to Canada's G.A.A.R. concerning the I.T.A., the court generally found that the provisions of the Canada-Luxembourg Treaty were applied by Luxco in the manner in which they were intended.

The court made several references to the particularities of some of Canada's other tax treaties. The court noted that the Canada-Luxembourg Treaty does not contain a limitation on benefits provision[53] ("L.O.B. Provision") that might deny access to treaty benefits[54] and further noted that the Canada-Luxembourg Treaty includes a

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49 *Supra* note 1, para. 75.

50 *Id.*, note 14.

51 The court also stated at para. 85:

> When the [Canada-Luxembourg Treaty] was negotiated, the Canadian treaty negotiators were aware of the fact that Luxembourg allowed its resident to avoid Luxembourg income tax on gains arising from the sale of shares of foreign corporations in broad circumstances. In this light, if Canada wished to curtail the benefits of the [Canada-Luxembourg Treaty] to potential situations of double taxation, Canada could have insisted that the exemption provided for under Article 13(5) [of the Canada-Luxembourg Treaty] be made available only in the circumstance where the capital gain was otherwise taxable in Luxembourg. Canada and Luxembourg did not choose this option. It is certainly not the role of the court to disturb their bargain in this regard

52 *Supra* note 1, para. 77.

53 As can be found in Article XXIX A of the Canada-U.S. Treaty.

54 *Supra* note 1, para. 80.

specific carve-out for immovable property in which the business of a company is carried on (*i.e.*, the Immovable Property Exemption).

The court stated that it is important to consider the O.E.C.D.'s Model Tax Convention on Income and Capital[55] and its commentaries (the "O.E.C.D. Model Treaty") because the O.E.C.D. Model Treaty often serves as a baseline in Canadian treaty negotiations.[56] The court noted that the Immovable Property Exemption is not included in the O.E.C.D. Model Treaty and, as a result, the inclusion of the Immovable Property Exemption in the Canada-Luxembourg Treaty is significant because it demonstrates a specific intention of one or both of the parties to the Canada-Luxembourg Treaty to diverge from the usual approach.[57]

> The OECD Model Treaty does not include a carve-out for immovable property in which the business of the company is carried on. Departure from the model tax treaty may be significant as it demonstrates the intent of one, or both, parties to diverge from the general approach. When there is no common agreement on a specific point at the start of the negotiations, a divergence may be the result of a bargain struck by the parties. In the instant case, it is apparent that the parties intended to depart from the [O.E.C.D. Model Treaty]. This departure involved carving out from the definition of immovable property properties where economic activities were carried on.
>
> Parties to a tax treaty are presumed to know the other country's tax system when they negotiate a tax treaty; they are presumed to know the tax consequences of a tax treaty when they negotiate amendments to that treaty. The OECD commentaries highlight that some states—like Luxembourg—generally do not tax capital gains: OECD commentary on Article 13, 28.12. It is then the responsibility of the state that does tax capital gains to prevent a double exemption if it wishes to do so.[58]

The court went on to say that if Canada wanted to prevent Luxembourg residents from escaping taxation on transactions that are not taxed in Luxembourg, it could have considered this when negotiating the Canada-Luxembourg Treaty, but did not. It was therefore "certainly not the role of the court to disturb their bargain in this regard."[59]

The Minister also raised the argument that benefits for Luxco under the Canada-Luxembourg Treaty should be denied because Luxco's actions constituted "treaty shopping," which should constitute an abuse of the Canada-Luxembourg Treaty.[60] The term "treaty shopping" is not defined in the I.T.A. nor in any double income tax convention signed by Canada. The O.E.C.D. Glossary of Tax Terms defines "treaty shopping" as:

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55 Dated December 18, 2017.

56 *Supra* note 1, para. 82.

57 *Id.*, para. 83.

58 *Id.*, paras. 83 and 84.

59 *Id.*, para. 85. See also *supra* note 50.

60 *Id.*, para. 92.

TREATY SHOPPING – An analysis of tax treaty provisions to structure an international transaction or operation so as to take advantage of a particular tax treaty. The term is normally applied to a situation where a person not resident of either the treaty countries establishes an entity in one of the treaty countries in order to obtain treaty benefits.

Again, the court referred to other tax treaties to which Canada is a party and compared this issue to the L.O.B. Provision in the Canada-U.S. Treaty.[61] The court noted that the U.S. had developed comprehensive anti-treaty shopping rules that demonstrate how parties could impose conditions other than residence in order to curtail treaty shopping.[62]

Instead, the court stated[63] that the O.E.C.D. Model Treaty,[64] published at the time of the signing of the Canada-Luxembourg Treaty, as well as the Canada-Luxembourg Treaty, only contain "a very narrow" anti-abuse or treaty shopping rule in Articles 10, 11, and 12, based on beneficial ownership and impacting only dividends, interest, and royalties (respectively).[65]

The court did note, however, that Canada's Department of Finance has been in the process of reconsidering the country's bilateral approach to treaty shopping and, in 2013, released a consultation paper[66] (the "Consultation Paper") requesting comments from taxpayers. In summary, the Consultation Paper proposed two approaches: (i) the continuation of the bilateral (treaty) approach or (ii) a new approach that would lead to the enactment of a domestic anti-treaty shopping rule that, potentially, would override all of Canada's tax treaties (the "Domestic Approach"). The court commented that Finance favored the Domestic Approach since such domestic legislation could be enacted more swiftly than international treaties.[67] Finance indeed had previously confirmed this by announcing in the 2014 Federal Budget[68] that it would proceed unilaterally under the Domestic Approach and provided proposed anti-treaty-shopping rules (the "Proposed Rules"). The Proposed Rules have not been enacted through Canadian legislation.

The court stated that the Minister sought to achieve the same result using Canada's G.A.A.R. as should be achieved under the Proposed Rules, *i.e.*, to use Canada's

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[61] The court referenced Article XXIX-B of the Canada-U.S. Treaty (being the article relating to Taxes Imposed by Reason of Death); however, we respectfully believe that the court meant to reference Article XXIX-A of the Canada U.S. Treaty.

[62] *Supra* note 1, para. 94.

[63] *Id.*, para. 93.

[64] O.E.C.D. Model Tax Convention on Income and on Capital, June 1998.

[65] In *Alta Energy* (*supra* note 1), the court states (in para. 93) that the certain types of income include dividends, rents, and royalties and not dividends, interest, and royalties; however, the court does make note of Article 11 of the Canada-Luxembourg Treaty, which governs interest.

[66] Consultation Paper on Treaty Shopping – The Problem and Possible Solutions, August 12, 2013.

[67] *Supra* note 1, para. 95.

[68] Budget 2014, Annex 2 – Tax Measures: Supplementary Information, Consultation on Tax Planning by Multinational Enterprises.

G.A.A.R. in order to "deal with what Finance now believes is an unintended gap in the [Canada-Luxembourg Treaty]."[69] Relying on prior case law,[70] the court ruled that the Minister could not rely on Canada's G.A.A.R. to deal with an unintended gap in the Canada-Luxembourg Treaty[71] and generally supported the Federal Court of Appeal's view[72] that a taxpayer cannot misuse or abuse a treaty by claiming an exemption provided by the treaty.[73]

It should be noted that the court also quickly rejected an argument by the Minister that Luxco should be denied benefits under the Canada-Luxembourg Treaty because it was a "conduit."[74] The court determined that Luxco was the beneficial owner of the shares of Canco and stated that the Minister's argument that Luxco was acting as a conduit appeared to be inconsistent with the Minister's acceptance of Luxco as the "beneficial owner" of the shares of Canco, based on the fact that Luxco was the lawful recipient of the proceeds from the Sale.

Having determined that the Sale fit within the Immovable Property Exemption and that there was no misuse or abuse under Canada's G.A.A.R. or the Canada-Luxembourg Treaty, the court ruled in favor of Luxco.

As previously noted, the Minister filed a Notice of Appeal with respect to *Alta Energy* with the Federal Court of Appeal on October 1, 2018.

How Would the Multilateral Instrument and the P.P.T. Impact the Transactions?

Canada and Luxembourg have each signed the M.L.I., although, as of the time of writing, neither has deposited its instrument of ratification, acceptance, or approval with the O.E.C.D.[75] The Parliament of Canada had its first reading of Bill C-82 – An Act to Implement a Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the "Bill") – on June 20, 2018, in the House of Commons of Canada. The Bill had its second readings in the House of Commons on September 28, 2018, and October 15, 2018, and, as of the time of writing, has been referred to the Standing Committee on Finance.

Article 7(1) of the M.L.I. provides a rule, often referred to as the P.P.T., designed to prevent perceived tax treaty abuses. Article 7(1) of the M.L.I. states:

> 1. Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to

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69 *Supra* note 1, para. 98.

70 *Garron Family Trust (Trustee of) v. R.*, 2009 TCC 450, and *Garron Family Trust (Trustee of) v. R.*, 2010 FCA 309.

71 *Supra* note 1, para. 98.

72 In *Garron Family Trust (Trustee of) v. R.*, 2010 FCA 309.

73 *Supra* note 1, paras. 99-100.

74 *Id.*, paras. 86-89.

75 A requirement for the M.L.I. to come into effect with respect to the Canada-Luxembourg Treaty. For additional information on parties to the M.L.I. and implementation status, see Signatories and Parties to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

> conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement.

"If the benefit is in accordance with the 'object and purpose' of the relevant provisions of a treaty, Article 7 should not apply to undo the tax benefit."

The court did not address the application of the M.L.I. or the P.P.T. in *Alta Energy*; however, since the transactions at issue occurred in 2013, it is unlikely that the M.L.I. would have been applicable.

There are similarities between Article 7(1) of the M.L.I. and Canada's G.A.A.R. For example, pursuant to the P.P.T., one must consider whether there has been an arrangement or transaction that resulted directly or indirectly in a benefit. Recall that, pursuant to Canada's G.A.A.R., there must be a transaction or series of transactions that resulted in a tax benefit.

In *Alta Energy*, Luxco essentially admitted that the transfer of the shares of Canco by USco to Luxco was not arranged primarily for a *bona fide* purpose other than to obtain a tax benefit.[76] As a result, Luxco may have also failed the first part of the P.P.T.

However, the P.P.T. also includes a saving provision: If the benefit is in accordance with the "object and purpose" of the relevant provisions of a treaty, Article 7 should not apply to undo the tax benefit, notwithstanding the impugned transaction's principal purpose.

This language is similar to the third prong of Canada's G.A.A.R., which asks courts to determine the object, spirit, and purpose of the relevant provisions of the applicable legislation or treaty and only apply Canada's G.A.A.R. when there has been a misuse or abuse of such provisions.

In determining that the rationale behind the Immovable Property Exemption in Article 13(4) of the Canada-Luxembourg Treaty was "to exempt residents of Luxembourg from Canadian taxation where there is an investment in immovable property used in a business,"[77] the court resolved that there was no misuse or abuse of the relevant provisions of the Canada-Luxembourg Treaty. Therefore, Canada's G.A.A.R. did not apply to undo the tax benefit provided by the Canada-Luxembourg Treaty.

Had the court been required to consider Article 7(1) of the M.L.I. in *Alta Energy*, it seems likely that the result would have been the same. If the benefit that the transactions provided was only to exempt Luxco, a resident of Luxembourg, from tax on an (indirect) disposition of immovable property used in an active business, then this should be in accordance with their object and purpose, under the court's understanding of the relevant provisions of the Canada-Luxembourg Treaty.

The so-called misuse or abuse language in Canada's G.A.A.R.[78] implies a more serious threshold than one might expect to be imposed under the M.L.I. Practically

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76 *Supra* note 1, para. 70.

77 *Id.*, para. 100.

78 Subsection 245(4) of the I.T.A.

though, Canadian courts have generally conducted the misuse or abuse analysis by determining whether the avoidance transaction at issue frustrated the object, spirit, or purpose of the provisions at play, and applying Canada's G.A.A.R. in situations where transactions have done so. This analysis may be similar to what courts will be asked to do when considering the P.P.T. under the M.L.I.

CONCLUSION

The court's decision in *Alta Energy* was based on the court's understanding of Articles 13(4) and 13(5) of the Canada-Luxembourg Treaty. While the court did not expressly consider the M.L.I., its reasoning is informative with respect to how a future court might work its way through a P.P.T. analysis. As the analyses under Canada's G.A.A.R. and the M.L.I.'s P.P.T. appear to be quite similar, it may be helpful to look to prior Canadian decisions on Canada's G.A.A.R. for discussions regarding how future courts, Canadian and otherwise, may interpret and apply the P.P.T. under the M.L.I.

REVISED SWISS CORPORATE TAX REFORM WILL KEEP SWITZERLAND A TOP CORPORATE LOCATION

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Corporate Tax
Tax Reform
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INTRODUCTION

This article focuses on the latest developments in the long-awaited Swiss corporate tax reform. In order to give an overview of the reform in its latest iteration, this article offers historical background, presents the key measures of the new reform, assesses the current outlook for the project, and summarizes its results for corporations.

BACKGROUND ON THE REVISED TAX REFORM

Swiss Corporate Tax Reforms I and II

In the first iteration of its corporate tax overhaul, the Swiss Corporate Tax Reform 1997 ("C.T.R. I"), Switzerland introduced various measures to improve its reputation as an attractive jurisdiction based on corporate tax rules. Included in the C.T.R. I were measures such as a comprehensive exemption for participation income and participation profits of holding, mixed, and principal companies and finance branches ("Status Privilege"). These measures resulted in a substantial or complete exemption from income tax on the cantonal and communal levels for status privilege companies.

After the implementation of C.T.R. I, Switzerland experienced an influx of holding companies and companies qualifying for Status Privilege, which prompted a new corporate tax reform in 2007 ("C.T.R. II"). C.T.R. II was intended to improve upon C.T.R. I and to further establish Switzerland as a holding company location. Notably, C.T.R. II led to a partial tax exemption for qualifying participations in order to prevent double taxation on dividends for substantial shareholders and to the implementation of the capital contribution principle.

International Pressure on the Swiss Corporate Tax System

Simultaneously, Switzerland's corporate tax law became the focus of attention from the O.E.C.D., the G-20, and the E.U. The main criticism of these international institutions was that Switzerland enabled multinational companies with Status Privilege to shift profits globally without being taxed at the base where the income was obtained. At the peak of the tax dispute, the O.E.C.D. put Switzerland on a "grey list" of countries that were not compliant with commonly agreed-upon O.E.C.D. standards

Rejection of Swiss Corporate Tax Reform III

In connection with this international pressure and Switzerland's desire to recover its position as a fair and attractive tax location, the Federal Council and the Federal Assembly developed a new corporate tax reform that was introduced initially in 2015 ("C.T.R. III"). The initial version of C.T.R. III was compliant with international tax standards, including the O.E.C.D.'s B.E.P.S. Project, and contained, among other things, the required abolition of the Status Privilege. At the same time, it would have enabled Switzerland to be competitive from an international tax perspective.

Nevertheless, Swiss left-wing parties did not agree with C.T.R. III and launched a referendum to prevent adoption. Switzerland has a long history of placing certain legislative proposals to a vote by all citizens as a means of enhancing participatory democracy. Ultimately, Swiss voters rejected C.T.R. III in a referendum held in February 2017.

"One of the most important actions of T.R.A.F. is the abolition of status privilege on a cantonal level."

This allowed Status Privilege to remain in force, notwithstanding international pressure. For companies that were active on a cross-border basis, this situation lead to legal and planning uncertainties.

T.P. 17 and T.R.A.F.

After the rejection of C.T.R. III, the Federal Council released a revised corporate tax reform called Tax Proposal 17 ("T.P. 17") on March 21, 2018. The majority of the measures in T.P. 17 corresponded to measures in C.T.R. III but were more balanced in order to reach a political consensus. Nonetheless, before T.P. 17 reached a vote in the Federal Assembly, it was unclear whether the parties would reach an agreement on the matter.

For this reason, a new CHF 2 billion per year subsidy for the Federal Social Security Scheme ("A.H.V.") was added to the T.P. 17 proposal as a form of socio-political compensation. With this addition, the new corporate tax reform, now called the Federal Act on Tax Reform and A.H.V. Financing ("T.R.A.F."), was adopted with a clear majority by the Swiss Federal National Assembly on September 28, 2018.

The first measures of T.R.A.F. could enter into force in 2019 if no referendum is held challenging its enactment. Some small parties have already announced that they will call for a popular referendum against T.R.A.F. In this case, T.R.A.F. would most likely be put to the people's vote in May 2019. Accordingly, implementation of T.R.A.F. would be delayed by at least a year.

T.R.A.F. – KEY MEASURES

Revocation of Status Privilege, Disclosure of Hidden Reserves, and Capital Tax Relief

Revocation of Status Privilege

One of the most important actions of T.R.A.F. is the abolition of Status Privilege on a cantonal level so that the Swiss tax jurisdiction is again compliant with international tax standards (*e.g.*, the B.E.P.S. Project).

Disclosure of Hidden Reserves for Status Privilege Companies

As a result, status privilege companies remaining in Switzerland will be forced to transition from privileged to ordinary taxation. In such a case, a so-called two-rate system is applicable. Profits relating to hidden reserves obtained under Status Privilege will be subject to a five-year limited special rate. Cantons will be free to determine this special tax rate. The disclosure of hidden reserves ensures a competitive income tax burden and is intended to encourage current status privilege companies to remain in Switzerland.

Step-up of Hidden Reserves for Companies Relocating to Switzerland

Companies relocating to Switzerland can disclose foreign hidden reserves to the Swiss tax authorities. These companies will benefit from a step-up in basis and can amortize the tax-free disclosed hidden reserves annually at an applied rate, thereby reducing taxable income during the amortization period. If these companies later relocate from Switzerland to a foreign jurisdiction, an exit tax will be due on the hidden reserves (as is already the case under preexisting law).

Capital Tax Relief

Another measure to mitigate the future tax burden on status privilege companies is capital tax relief. As such companies now benefit from a low capital tax rate, the cantons will in the future be allowed to lower the taxable capital on patents (and similar rights), qualifying participations, and intra-group loans to maintain their international corporate tax attractiveness.

PATENT BOX AND DEDUCTIONS FOR RESEARCH AND DEVELOPMENT ACTIVITIES

Patent Box

The Patent Box regime is another key measure of T.R.A.F. Net profits from patents and similar rights such as supplementary protection certificates and varieties of plant rights are to be taxed in a metaphorical box in which up to 90% of the cantonal-level tax can be eliminated. To be compliant with the modified nexus approach developed by the O.E.C.D., the Patent Box is applicable only if the corresponding tax-reduced research and development ("R&D") expenditures have already been recaptured and taxed.

Net profits from patents and similar rights are calculated according to the so-called residual-method. The starting point for this method is the overall profit of the product associated with the patent or the overall profit of the company. All profits that are not related to the patent itself are deducted from the overall profit and subject to ordinary taxation. The remaining net profit will be taxed in the Patent Box. The residual-method is very similar to the calculation used for the U.K.'s Patent Box regime.

The Patent Box regime provides benefits for cantonal tax only. All cantons must adopt the regime.

DEDUCTIONS OF R&D ACTIVITIES

In addition to the Patent Box, T.R.A.F. will authorize cantons to introduce an R&D Super-Deduction of up to an additional 50% of business-related costs for R&D activities undertaken in Switzerland. The term R&D activities was outlined very broadly when introduced and is aligned with Article 2 of the Swiss innovation law ("F.I.F.G.") as well as with common standards determined by the O.E.C.D. Basic research, scientific application, and knowledge-based R&D will all be deductible.

The R&D Super-Deduction will be calculated by adding 135% of labor costs plus 80% of invoiced third-party R&D costs to the general R&D costs. The total amount will then be multiplied by a maximum factor of 1.5, resulting in the deductible R&D costs. The invoiced third-party R&D costs must be performed in Switzerland.

RELIEF RESTRICTION

T.R.A.F. includes a restriction to prevent excessive deductions, which could erode the cantons' tax base. Hence, the aggregate tax relief based on the Patent Box, the R&D Super-Deduction, and deductions for self-financing cannot exceed 70% of the taxable profit. The 70% relief restriction also includes depreciation costs associated with a cantonal Status Privilege.

Increased Dividend Taxation and Adjustments to the Capital Contribution Principle

Increased Dividend Taxation

T.R.A.F. will increase the partial tax exemption for dividend income of individuals from qualifying participations introduced by C.T.R. II at the Federal level from 50% (for business investments) or 60% (for private investments) to a standard rate of 70%. At the cantonal level, the relief method will be harmonized and a compulsory tax rate of at least 50% will be implemented. The cantons will have the discretion to set the actual rate, provided that it is at least 50% of the standard rate.

Adjustments of the Capital Contribution Principle

T.R.A.F. will apply a repayment restriction on the capital contribution principle introduced by C.T.R. II for companies listed on the SIX Swiss Exchange. Those listed corporations will be entitled to distribute tax-exempt capital contribution reserves only if they simultaneously pay ordinarily-taxed dividends of at least the same amount. Intra-group dividends are not affected by this adjustment. Moreover, the same rules will be applied to the issue of bonus shares and nominal value increases from capital contribution reserves.

Extension of the Lump-Sum Foreign Tax Credit for Permanent Establishments

In order to prevent double taxation, Swiss permanent establishments of foreign companies will be entitled to claim relief for withholding taxes on income from third countries. The amount claimed will be set at a flat rate notwithstanding the actual withholding tax imposed.

Additional Measures

High-tax cantons (*e.g.*, Zurich, Geneva, and Berne) will have the opportunity to implement a notional interest deduction ("N.I.D.") on excess capital. So far, only the canton of Zurich would meet the requirements for introducing the N.I.D.

With respect to private restructurings, the scope of future tax-free capital gains or repayments of contributed reserves associated with share transfers to wholly controlled holding companies will be limited.

The cantons' share of the Federal direct tax revenue will be raised from 17% to

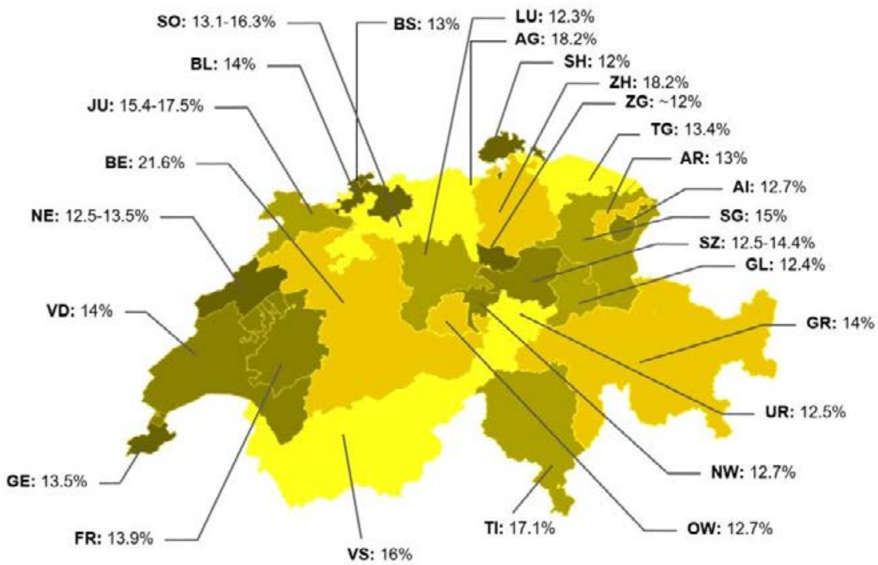
21.2%. In return, the cantons are obliged to consider the needs of cities and communes in connection with the increase of their share.

Finally, and as mentioned above, the Federation will be obligated to pay a higher share of the A.H.V. since it benefits from T.R.A.F. It is expected that over CHF 2.0 billion per year will be raised for financing the A.H.V.

"It is expected that the majority of the Swiss cantons will provide tax rates on pre-tax income between 12% and 18%."

REDUCED CANTONAL TAX

Although not directly covered by T.R.A.F., another key part of the planned tax reform is that the cantons will also generally reduce their cantonal profit tax rates. This will enable Switzerland to remain attractive to former status privilege companies as well as companies planning to relocate to Switzerland or incorporate in Switzerland. The above-mentioned increase of the canton's share of the Federal direct tax enables the cantons to further reduce their tax rates. Based on official announcements made by the cantonal governments, it is expected that the majority of the Swiss cantons will provide tax rates on pre-tax income between 12% and 18% including (direct Federal taxes). The map below illustrates the reduced profit tax rates anticipated in each canton:



OUTLOOK FOR CORPORATIONS

T.R.A.F. is intended to achieve several goals for Switzerland:

- It restores legal and planning certainty for Swiss companies that operate on a cross-border basis.
- It reestablishes the reputation of Switzerland as a fair and attractive tax location in a way that is consistent with B.E.P.S. and the demands of the E.U.
- With the abolition of Status Privilege, T.R.A.F. ensures that all companies in Switzerland will be taxed at the same rate, with the exception of those eligible for the Patent Box regime and the R&D Super-Deduction.

Switzerland intends to continue an active ruling practice to provide certainty as to Swiss tax imposed on certain cross-border transactions. This will allow corporations to request an advance ruling from the competent tax administration on the tax treatment of a contemplated transaction. If the tax authorities approve the ruling, the tax treatment is binding, provided the taxpayer strictly follows the fact pattern on which the ruling is based. Note that a tax ruling cannot result in an obvious deviation from clear tax rules. In addition, it is not a binding contract. Therefore, if a new law is enacted that mandates a different result, the ruling will no longer bind the competent tax administration.

Nonetheless, the ruling practice will enable customized tax solutions based on best practices and promote a positive relationship between taxpayers and tax authorities.

THE U.K. DIGITAL SALES TAX – IT COULD BE YOU

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Digital Economy
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INTRODUCTION

On November 7, 2018, the U.K. government confirmed that it will proceed with the introduction of a digital services tax ("D.S.T.") on large businesses from April 2020. The government concluded that certain business models derive huge value from the participation of U.K. users, which is largely untaxed.

A digital service or product provider outside the U.K. might think that it would not be covered by the tax. Unfortunately, this view would not be correct as – like the G.D.P.R. – the tax is based on the user's jurisdiction and has a global reach.

D.S.T. will charge 2% tax on any revenues that can be "linked" to U.K. users, regardless of where the provider is located and irrespective of whether the business has a physical presence in the U.K.

Note that this is a tax on revenue, not profit, which means the U.K. government takes the view that it can ignore obligations under income tax treaties.

To fall within the D.S.T., a large non-U.K. digital service or product provider need only have U.K. user-related revenues from business activities in one or more key areas: search engines, social media platforms, and online marketplaces.

Unknown at this time is how H.M.R.C. will define the revenues to which the tax will apply. Notwithstanding a 53-page consultation document, H.M.R.C. has not identified the actual hallmarks of tax jurisdiction. The overarching message of the consultation is that, although it is all very difficult, businesses will know if they are supposed to be within the scope of the tax or not and will self-assess their liability accordingly. If a business does not reach the conclusion that H.M.R.C. wants, it can expect a "just and reasonable" recalculation of the tax due.

Regarding the tricky matter of how revenue is linked to user participation, no clear guidance has been given in the consultation document, and many in the market have questioned how a decent definition can even be formulated. The tax is chargeable on revenues generated from defined activities that are linked to the participation of a U.K. user. But, what does that mean?

It is clear that the proposed approach to defining the participation of a U.K. user is incredibly broad – it covers not just advertising revenue from advertisements aimed at U.K. users but pretty much anything involving a U.K. user, even a click on a page by accident.

It comes as a surprise that H.M.R.C. expects large businesses to simply know the accurate location of people clicking on their pages. The task should not be underestimated. There are entire companies dedicated to writing software that determines and tracks where users are located. Moreover, in a world where data protection and data misuse are hot topics, these practices have come under public scrutiny.

DETERMINING COVERAGE UNDER THE THREE TARGETED AREAS

"Although it is all very difficult, businesses will know if they are supposed to be within the scope of the tax or not and will self-assess their liability accordingly."

Consultation is ongoing, and in terms of scope, there is no proper sense yet of where the boundaries will lie.

The definition of activities relating to online marketplaces and search engines are relatively narrow and more or less as expected.

However, the definition of a social media platform is much wider. It covers anything from typical social networks to blogging, review, and discussion platforms. It may even extend to online gaming.

D.S.T. is explicitly not a tax on

- online sales of own goods,
- online advertising,
- data collection,
- financial and payment services,
- the provision of online content,
- sales of software or hardware, or
- television or broadcasting services.

Additional exemptions may emerge as the public consultation continues on the proposals.

£500 MILLION THRESHOLD

To fall within the ambit of the tax, a business must generate revenues from the three key areas of at least £500 million globally. Smaller players will not be caught until they start to play in the big leagues. This is problematic since rapidly growing businesses are caught as soon as they pass the threshold, and while the first £25 million of relevant U.K. revenues are exempt, imposing the tax is anti-competitive towards smaller players trying to compete with the global giants.

Particularly problematic is how a business is supposed to isolate in-scope activities when various activities are undertaken. A tax compliance nightmare can be expected even if a company is not, in the end, within the rules. Especially troubled will be those businesses that only have a small proportion of revenue generated from the activities in question but have to spend significant time and fees working out whether D.S.T. should be charged, at all.

There is a proposed safe harbor, but it will entail a costly compliance exercise. The idea is sensible. A company runs an alternative D.S.T. calculation if it has a very low profit margin or is loss making. However, the formula will be difficult to apply in practice, as it first relies on a capability to identify the U.K. profit margin within an international business and then forces the company to apply a whole subset of tax assumptions – varying that margin around what costs are allowed and how overheads are split and excluding exceptional items.

The tax is meant to be temporary, and the U.K. government has promised a formal review in 2025 that would repeal the D.S.T. if an "appropriate international solution" is in place. However, a comprehensive global solution does not look likely to happen anytime soon – the O.E.C.D. must get its Member States to agree. The O.E.C.D. is not making any headway at reaching a consensus and looks unlikely to do so by 2020.

"The U.K. is the first European country to introduce unilateral measures, but it probably will not be the last."

The U.K. is the first European country to introduce unilateral measures, but it probably will not be the last – France and Italy are also pushing for action. At the same time, the European Commission is proposing its own version for the E.U. While adoption of the E.U. approach has been stalled by E.U. politics, with Member States arguing about its terms, an E.U.-wide digital tax is on the horizon, and no one would be surprised to see it adopted in the near term.

CONCLUSION

A digital tax with global reach has been announced in the U.K. It is one of many such taxes proposed in Europe. How the U.K. tax will work in practice is anyone's guess. One certainty at this time is that the cost of demonstrating whether a company is or is not covered will be expensive. If covered, the cost of demonstrating the boundaries of U.K. user-related revenue may be even more costly.

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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.

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