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A YEAR IN GUEST FEATURES

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EUROPEAN COMMISSION ROCKING THE BOAT AT ARM'S LENGTH

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INTRODUCTION

Many may recall the British parliamentary committee that interviewed top managers of the M.N.E.'s Google, Amazon, and Starbucks in 2012. Margaret Hodge, chairman of the committee at the time, together with other members, grilled the top managers over the tax avoidance schemes of their respective companies. The findings of the committee set things into motion and sparked the O.E.C.D. to initiate the B.E.P.S. Project. Its results were published in the autumn of 2015. Soon after, the European Commission (the "Commission") rolled up its sleeves and adopted the Anti-Tax Avoidance Package ("A.T.A.P."). Even before the introduction of the A.T.A.P., the Commission started using another approach to combat the tax avoidance schemes of M.N.E.'s: the State Aid argument. By now, various M.N.E.'s have been accused of receiving State Aid through publications that – to put it mildly – prompted some strong responses.

Because the Commission's decisions seem to be based on certain new transfer pricing rules for checking the fulfilment of the requirements of State Aid, we – as transfer pricing specialists – would like to share with you our current understanding and views on what we can derive from two specific cases: Starbucks and Apple. We will elaborate on these cases and discuss similarities and differences in the approach taken by the Commission and the O.E.C.D.

We will first describe briefly the legal framework of State Aid and our findings on the Commission's general approach to combatting the tax avoidance schemes of M.N.E.'s. Thereafter, we will expound on the Starbucks and Apple cases. We will describe the key facts of each case followed by the Commission's approach and our comments. Before arriving at our conclusion, we will comment on the O.E.C.D.'s interpretation of the arm's length principle ("A.L.P.") versus the Commission's interpretation of the A.L.P. We will conclude by making some final remarks about the Commission's approach in both cases.

LEGAL FRAMEWORK OF STATE AID

Pursuant to Article 107 T.F.E.U., the "Commission Notice on the Notion of State Aid" and the case law of the European Court of Justice, the six constituent elements of the notion of State Aid are as follows:

1. The existence of an undertaking
2. The immutability of the measure to the Member State
3. Its financing through Member State resources

4. The granting of an advantage

5. The selectivity of the measure

6. Its effect on competition and trade between Member States

Each of the constituent elements has always been assessed separately, from one to six, both by the Commission in its decisional practice and by the European Court of Justice in its own cases. In practice, the most disputed elements are economic advantage and selectivity. On the other hand, if the six requirements are met, Article 107 T.F.E.U. stipulates certain exemptions that allow Member States to achieve certain policy objectives. However, these exemptions do not apply to the Apple and Starbucks cases.

THE COMMISSION'S APPROACH

After the publication of the O.E.C.D.'s findings about the 15 B.E.P.S. action items, the Commission pursued its crackdown on tax avoidance schemes by M.N.E.'s. The Commission's insistence on adopting uniform legislative measures in respect of the implementation of Country-by-Country Reporting and the introduction of the A.T.A.P. underlines its goal. Although it is difficult to fully grasp the approach of the Commission in its State Aid decisions, the Commission appears to have chosen favorable Advanced Pricing Agreements ("A.P.A.'s") as the vehicle to set its own approach. This approach focuses on "the market prices that a stand-alone company would pay under normal business circumstances" as a new A.L.P. definition used by the Commission in State Aid cases. The Commission seems to reject the A.L.P. of the O.E.C.D. by arguing that the O.E.C.D.'s A.L.P. only applies to M.N.E.'s. As a result, stand-alone companies, which always have to pay market prices for their individual transactions, are not covered by this A.L.P. Subsequently, a comparison is made between the scrutinized company and a stand-alone company.

The general approach of the Commission's assessment regarding State Aid may be described as follows:

- The basis for a State Aid analysis is the local regulations (tax law and guidance) of the Member State, the so-called reference system.

- The Commission considers that the O.E.C.D.'s A.L.P. is only applicable for M.N.E.'s and does not apply to independent stand-alone companies. Therefore, this principle must be replaced with the Commission's own principle: the market conditions of a stand-alone company under similar business circumstances. As such, the Commission applies its own definition of the A.L.P. when performing its State Aid analyses.

- Based on this set of principles, the State Aid analysis is performed.

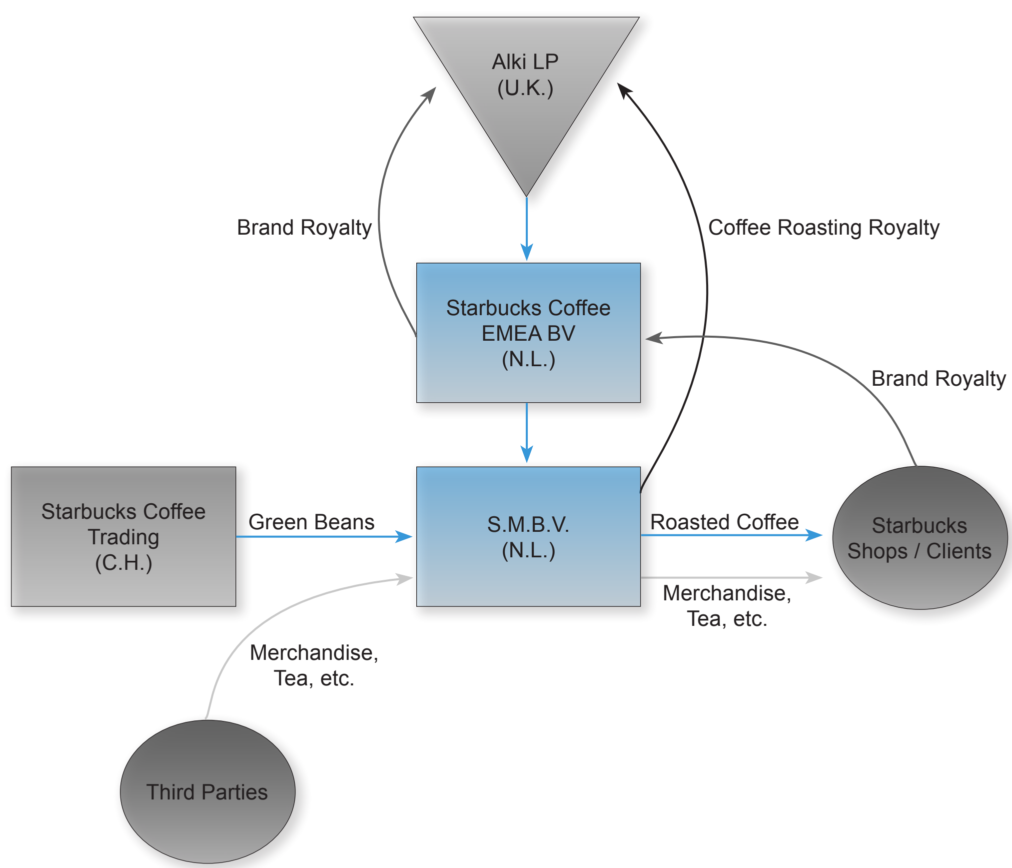
The State Aid instrument grants the Commission the authority to influence the corporate income tax paragraph within the E.U. The Commission uses that grant of authority to set aside the O.E.C.D. guidance provided in the B.E.P.S. reports and the A.L.P., and replaces that guidance with its own version (the "E.U. A.L.P."). The Commission has explicitly stated that the E.U. A.L.P. is not based on Article 9 of the O.E.C.D. Model Convention, as is the A.L.P. supported by the O.E.C.D. In other words, according to the Commission, the battle against State Aid overrides the standard of Article 9.

HOW DOES THE COMMISSION APPROACH WORK OUT IN THE CASES OF STARBUCKS AND APPLE?

The Starbucks Case

Facts

Starbucks started its activities as a coffee-roasting facility in the Netherlands in 2002, through its subsidiary Starbucks Manufacturing BV ("S.M.B.V."). The main activities of S.M.B.V. are the roasting of green coffee beans and the packaging, storage, and sale of roasted beans to Starbucks shops across Europe. S.M.B.V. purchased green coffee beans from a Swiss associated company and paid a royalty to a U.K.-based group company ("Alki LP") for licensing intellectual property rights, which are necessary for the production process and the supply to shop operators. The picture below provides a simplified overview of the transactions relevant to the Dutch A.P.A.



In 2008, an A.P.A. was granted by the Dutch tax authorities to S.M.B.V. for the arm's length remuneration of its main activity as a coffee roasting facility. The Commission concluded that the A.P.A. violated Article 107 T.F.E.U.

The Commission's Decision

In the case of Starbucks, the report of the Commission began with an analysis of the Dutch system of corporate tax and the A.L.P. that is incorporated in Article 8(b) of the Dutch Corporate Income Tax Act ("C.I.T.A."). In its analysis, the Commission appears to have accepted the Dutch system of corporate tax as the reference system but not the incorporated A.L.P. of the O.E.C.D. The Commission defines its own principle – the E.U. A.L.P. – from the perspective of a stand-alone company, which always pays market prices for all its individual transactions. Therefore, the E.U. A.L.P. criteria can be described as "the market prices a stand-alone company pays under similar business circumstances." The Commission determined the market prices through the use of information requested from Starbucks' competitors.

"The Commission defines its own principle – the E.U. A.L.P. – from the perspective of a stand-alone company, which always pays market prices for all its individual transactions."

Based on the E.U. A.L.P., the Commission rejected the use of the transactional net margin method ("T.N.M.M.") to determine an A.L.P., since this O.E.C.D. method can only be applied by M.N.E.'s and not by stand-alone companies that must always pay market prices. Instead, the Commission separately scrutinized all identified intercompany transactions and endeavoured to identify and apply market prices. Available market information was gathered, and competitors of Starbucks were requested to provide relevant information to determine market prices. Without going into specific details, the conclusion of the Commission was that the intercompany transactions of S.M.B.V. did not meet the E.U. A.L.P. applicable to State Aid cases.

The Commission concluded that State Aid was granted to Starbucks for the following reasons. First, the intercompany prices and recent price increases for the green beans from the associated Swiss entity could not be explained when compared to market prices. Second, a stand-alone company would not have paid any royalty to Alki LP since the latter company had virtually no business substance when measured by people and facilities. In that respect, the Commission noted that a license agreement is not an ordinary transaction for a coffee roaster.

Apparently, the granted State Aid was calculated by multiplying the differences in the pricing of green beans and the royalty payment with the Dutch tax rate. As a result, the Commission reasoned that the ruling constituted a form of State Aid that amounted to €20 to €30 million.

Our Remarks

The rejection of the O.E.C.D.'s A.L.P. in State Aid cases raises questions about the formal positioning of the E.U. A.L.P. and its effects on daily discussions between M.N.E.'s and national tax authorities.

Such questions should be handled with great care. The O.E.C.D.'s A.L.P. has been developed over a period of more than 50 years and through the recent work of the O.E.C.D. on B.E.P.S. Thus, it is more than suitable to face challenges and offer solutions to M.N.E.'s and tax authorities. The basis of the O.E.C.D.'s A.L.P. is a thorough understanding of the relevant facts to determine and test the comparability of the conditions of intercompany transactions with transactions between comparable third parties. Therefore, there is no need for another A.L.P. We even regard the creation of the Commission's own E.U. A.L.P. as a missed opportunity to utilize the full potential of the O.E.C.D. guidance on transfer pricing.

The Commission is not primarily a tax body. Its goal is to ensure a level playing field within the European Single Market, and its officials are sensitive to *sub rosa* government actions that distort trade. In comparison, the standard of the O.E.C.D. reflects the life experience of government officials who have devoted their careers to matters related to tax policy. It should not be unexpected that tax professionals are sympathetic to tax concepts and trade administrators are sympathetic to trade law. Seen in this light, the Starbucks case indicates that winning arguments in one forum – where all M.N.E.'s can obtain comparable tax rulings – turn out to be losers in the other forum – where the business model of the smaller company sets the standard to be followed by M.N.E.'s.

Ultimately, the problem encountered by Starbucks reflects a bureaucratic disjuncture: Which of two competing competencies will control? Still to be heard are anti-trust administrators who may have a third view when an entire industry carries on business in a uniform way.

A disturbing aspect of the Commission's approach in determining market prices is the active participation of competitors in determining an acceptable business model to be imposed on Starbucks. For Starbucks, information from competitors would normally not be available. In O.E.C.D. Transfer Pricing Guidelines parlance, the use of information that is not available to taxpayers is called secret comparables. The Commission's approach leads, from a pure transfer pricing perspective, to all kinds of concerns about the comparability, intercompany effects, and lack of a more detailed understanding of the facts presented by these competitors. As a result, it is hard to determine a correct market price. Furthermore, the comparables, in this case, were not only secret but also tainted – because the comparable information was introduced by competitors responding to a request that would affect Starbucks. Therefore, the O.E.C.D. has stipulated in its Transfer Pricing Guidelines to take caution with the use of secret comparables.

"Ultimately, the problem encountered by Starbucks reflects a bureaucratic disjuncture: Which of two competing competencies will control?"

The Apple Case

Facts

Apple has two subsidiaries in Ireland, namely Apple Sales International and Apple Operations Europe. Both manufacture Apple products in Europe and hold the right to use Apple's intellectual property, for which they contribute considerable amounts for research and development ("R&D") to their U.S. parent company. The sales structure was set up in such a way that customers were contractually buying products from Apple Sales International. The Irish tax authorities granted a similar A.P.A. to both entities. The A.P.A. endorsed a split of the profits for tax purposes in Ireland between the head offices and Irish branches. The vast majority of the profits was allocated to the head offices, which did not have any employees or own premises. The head offices only held occasional board meetings. Moreover, only the Irish branches were subject to tax in Ireland. The head offices were not located in Ireland and, hence, not subjected to tax in Ireland.

The Commission's Approach

Until now, the Commission published only a summary of its reasoning to conclude that the Irish tax rulings amount to State Aid. The full reasoning is not expected to become public before 2017.

In the Apple case, two entities were under scrutiny. The Commission started by analysing the Irish system and determined that the two entities made use of sliding scale pricing. The two head offices seemed to exist on paper only, and as a result, it was unclear where they actually were located. Additionally, the head offices lacked any relevant substance. Consequently, the Commission reasoned that the A.P.A.'s provide an economic benefit to the two entities, because the branches in Ireland never would have paid that amount of profit to a third party, given the lack of relevant substance in the head offices. Finally, the Commission based the amount of State Aid on the Irish corporate income tax rate on the profits allocated by the branches to the residual Irish entities minus the minor functions, which can be allocated to the head offices.

What the Commission refused to accept is the concept that actual services were provided by affiliates in the U.S., or elsewhere, so that at the level of the Irish branches the expenses reflected value provided by the affiliates. Looked at in this manner, the issue was not an Irish issue but an issue at the level of the head offices and, in that jurisdiction, the methodology was accepted pursuant to a qualified joint cost sharing agreement.

Before issuing its decision, the Commission stated that the amount of State Aid could be lowered if more profit was allocated to the sales entities or more costs for the R&D activities were allocated in the U.S. It seems that an "always-somewhere principle" was used by the Commission, entailing that the profits should always be taxed somewhere and, if not, they will be allocated to the jurisdiction that provides the greatest tax within the E.U.

Our Remarks

To date, a complete assessment of the Apple case cannot be made because too many questions remain unanswered in the absence of a published report. Where are the head offices located? If in the U.S., a trade or business should exist. If none existed, an unacceptable tax gap has likely occurred because neither Ireland nor the U.S. levied tax. But is the existence of a tax gap sufficient justification to conclude that Ireland has granted State Aid to Apple? If the head offices are not located in the U.S., on what basis did the Commission determine that State Aid existed in Ireland?

At this point, it is not clear whether the Commission's decision is aligned with the O.E.C.D. guidelines on profit attribution with regard to allocations between head offices and branches, and how this interacts with the analysis of State Aid. Furthermore, the suggestion of the Commission to make use of an always-somewhere principle suggests that the Commission is mostly concerned that the profits are taxed and less concerned with where the profits are taxed and whether double taxation exists.

Finally, the Commission again seems to have use its own A.L.P., as it did in the Starbucks case. Remarkably, it did not scrutinize all the other intercompany transactions – like the royalties received or the lack of payments to other group companies in Europe or the U.S.

THE O.E.C.D. V. THE COMMISSION

Back in 2013, the O.E.C.D. was requested by the G-20 to start the B.E.P.S. Project. This request came after the U.K. hearings to which we referred at the beginning of this article. While the O.E.C.D. was working hard at developing its 15 B.E.P.S.

action items, the Commission did not want to wait for the outcomes and implementation. Therefore, the Commission adopted the A.T.A.P. The A.T.A.P. is meant as a B.E.P.S.-plus package and, therefore, goes even further than the outcomes of the B.E.P.S. Project.

The O.E.C.D., as the guardian of the A.L.P., seems to struggle with the recent State Aid cases of the Commission. In a recent news article, Pascal Saint-Amans, the director of the Centre for Tax Policy and Administration of the O.E.C.D., mentioned that the bulk of Apple's profits belongs in the U.S., as the profits should be aligned to R&D. Although the O.E.C.D. only provided high-level input on the recent cases, it seems that the O.E.C.D. does not agree with the new E.U. A.L.P. introduced in the State Aid cases, and it has pointed out that the functions, assets, and risks of an entity should be remunerated according to the A.L.P. established by the O.E.C.D.

"By defining a separate E.U. A.L.P. and going its own way, the Commission creates undesired confusion."

FINAL REMARKS AND CONCLUSION

We would like to add a few general comments to the Commission's approach. First, the Commission states that, as a condition for the State Aid to exist, the targeted company should be evaluated on a stand-alone basis. By doing so, the Commission ignores, or even disqualifies, the T.N.M.M. and would throw taxpayers back to the time when searches were required for exact comparables to measure the arm's length price. Thus, it regards all facts it deems to be relevant and not just specific transactions. Consequently, a similar discussion would ensue based on transfer pricing rules.

Second, the Commission focuses solely on the economic advantage criterion and disregards the criterion of selectivity. It states that the granted rulings are selective, because the economic advantage can be provided only to M.N.E.'s and not to stand-alone companies. In this way, the Commission deems the selectivity requirement fulfilled if the economic advantage requirement is met, and as a result, these two criteria are merged. The reason why the Commission has merged these two criteria is evident: It has always been difficult to prove the selectivity of rulings because they are available to everyone that applies. The current approach of the Commission has created significant uncertainty for M.N.E.'s worldwide. This has led to concerns that investments in the E.U. will be withheld.

Finally, the Commission's use of its State Aid instrument as grounds for a new definition of an A.L.P. could be viewed as a politically driven act. The Commission is seemingly grabbing the power to control direct taxes. To date, this power remains with the sovereign members of the E.U. The transfer of sovereignty regarding direct taxes has been consistently opposed by the Member States. The Commission would do well to remember that the *raison d'être* of the State Aid tool is to prevent Member States from providing special advantages to domestic companies. The use of an A.P.A. is an excellent instrument for M.N.E.'s and tax authorities to safeguard arm's length remunerations and positions, based on robust transfer pricing documentation and professional judgments. By defining a separate E.U. A.L.P. and going its own way, the Commission creates undesired confusion in this field.

In conclusion, an old saying with roots in team play comes to mind: It is better to row together than each rock the boat separately. It is not clear that the Commission understands the true meaning of this saying.

GOODS AND SERVICES TAX: A GAME CHANGER[1]

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Tags
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With the passage of the Constitution ("One Hundred and First") Act, 2016, India is now one step closer to adopting a goods and services tax ("G.S.T.") as its new indirect tax structure. Although this is only the first step in the legislative process of transition of the indirect taxes in India to the G.S.T. regime, it is a major leap towards the final implementation of G.S.T. in India.

G.S.T. has been defined as "any tax on supply of goods, or services or both except taxes on the supply of the alcoholic liquor for human consumption." In essence, G.S.T. is a comprehensive single tax that is levied on the supply of goods and services in the country. It is a value added tax that is levied throughout the supply chain with permissible credits for tax paid on inputs acquired.

Once implemented, G.S.T. is expected to provide relief to businesses by adopting a more comprehensive and wider coverage of input tax set-off and service tax set-off. Additionally, G.S.T. will subsume a majority of the central and state levies within its fold, eventually phasing out the different taxes and levies and bringing them under the umbrella of G.S.T. The existing indirect tax laws have not been able to completely remove the cascading burden of taxes already paid at earlier stages. In addition to this, there are several levies by the central government and the states on the manufacture and sale of goods and the provision of services for which no set-off for input tax credit is available. G.S.T. is expected to mitigate these indirect tax inefficiencies currently prevalent under the existing framework.

G.S.T. is not merely a tax change, but is also expected to have a multifaceted impact on business. Given its omnipresence in almost every business transaction, any change in the indirect tax regime will impact almost every level of the value chain. The implementation of G.S.T. is expected to create a paradigm shift in the Indian economy at both the micro level and the macro level. At a macro level, G.S.T. will promote transparency, cost-effectiveness, and lead to a shift from unorganized to organized trade in India. At a micro level, G.S.T. will, *inter alia*, impact an organization's supply chain, procurement, logistics, finance, taxation, and pricing policies. The basic premise behind G.S.T. is to create a single, cooperative, and undivided Indian market, thereby making the economy stronger and more powerful.

BRASS TACKS

As mentioned above, G.S.T. will subsume central and state levies within its fold. To this end, G.S.T. will have three charging components: central G.S.T. ("C.G.S.T.") and state G.S.T. ("S.G.S.T."), levied together on intrastate supplies of goods and services, and integrated G.S.T. ("I.G.S.T.") on interstate supplies of goods and

[1] The following was originally published in *India Unleashed* by Khaitan Legal Associates and has been modified in a manner consistent with our format.

services. The rates would be prescribed keeping in mind revenue consideration and acceptability. While the G.S.T. model will be implemented through multiple statutes, the basic features of indirect tax law, including, *inter alia*, charge ability, the definition of taxable events and taxable persons, the measure of levy, and the basis of classification, would remain uniform across these statutes.

C.G.S.T. and S.G.S.T. will be applicable to all transactions of goods and services made for consideration except those specifically exempted or outside the purview of G.S.T. (*e.g.*, "alcoholic liquor for human consumption and petroleum products") and transactions which are below a prescribed threshold.

Every person who is engaged in an interstate transaction will have to be registered under G.S.T., irrespective of the turnover limits. Interstate transactions shall be subject to I.G.S.T., which shall be collected by the central government. The input tax paid, which may include I.G.S.T., C.G.S.T., and S.G.S.T., on goods or services acquired by a person can be utilized against the payment of I.G.S.T., C.G.S.T., and S.G.S.T., in that order. Thus, the biggest transition which G.S.T. seeks to bring is the free set-off provision and utilization of inputs available.

G.S.T. RATE STRUCTURE

With the government's intention to enforce G.S.T. from April 1, 2017, the rate of tax is likely to be decided in the upcoming winter session of the Parliament. The G.S.T. rate is to be recommended by the G.S.T. Council depending on various factors, such as economic conditions, revenue buoyancy, and revenue neutral state. The G.S.T. Council is also empowered to propose a "floor rate with band" to provide flexibility to states to levy tax at rates higher than the floor rate, but within the band.

"Every person who is engaged in an interstate transaction will have to be registered under G.S.T., irrespective of the turnover limits."

COMPENSATION TO STATES

Setting aside value added tax and merging it with G.S.T. may reduce the revenue generated by states. To provide some relief, for the first five years of G.S.T.'s implementation, the central government will compensate the loss of revenue (if any) which the states may incur due to such implementation.

IMPACT ON BUSINESS

In general, G.S.T. is expected to provide a welcome relief to businesses by providing a wider coverage of input tax set-off by subsuming several central and state levies. Further, by providing a continuous chain of set-off from the manufacturer to the retailer, the tax burden of goods and services on the end-consumer is expected to reduce. This reduced tax burden will also reduce the price of exports, thereby increasing the competitiveness of Indian goods and services in international markets.

Below are some impacts that organizations will need to consider under the proposed G.S.T. regime.

Finance and Working Capital

Organizations may need to rework their budgets and working capital expectations based on the G.S.T. tax rate applicable to them in order to appropriately meet working capital requirements.

Increased Compliance

With state-wide registration required wherever an organization has an establishment, along with increased filings on a monthly basis, it is expected that compliance requirements will increase under the G.S.T. regime.

Supply Chain Management

Most goods have a multi-layered value chain structure with several layers between the manufacturer and the ultimate customers. Typically the value chain would comprise of Manufacturer → Warehouse → Wholesaler → Retailer → Customer. In this value chain, historically, warehousing was a layer largely meant to facilitate interstate branch transfers to avoid the incidence of central sales tax.

Under the G.S.T. regime, seamless input tax credit will be available on interstate transactions, thereby dispensing with the requirement of maintaining warehouses in every state. Multi-state organizations would now have the option to replace many of their small warehouses in multiple states with larger and strategically located mother warehouses in selected states. This is expected to reduce distribution costs, which can be expected to be passed on to the end consumer.

Information Technology

One of the most crucial areas in the transition process will be the technology and enterprise resource planning ("E.R.P.") alignment from the current regime to the G.S.T. regime. Accounting software will need to be aligned to the provisions of the G.S.T. law. Computer systems will have to be updated to include the new tax codes. In addition to this, new modules will need to be developed to enable generation of G.S.T.-compliant output reports and invoices.

Business Realignment

Under the G.S.T. regime, the prices of goods and services are expected to change. As mentioned above, there will be a tax credit at each level in the supply chain. Businesses may need to realign their current business models under the G.S.T. regime in order to stay competitive in the market. To this end, procurement, logistics, distribution, and pricing policies may need to be revisited. Further, businesses may also re-negotiate contracts with vendors, and, *inter alia*, decide the extent to which G.S.T. levies are to be absorbed or passed on to the consumer.

POTENTIAL HURDLES

Like all significant changes in law, G.S.T. is expected to have its set of teething issues during the transition process before the benefits, to their fullest extent, can be enjoyed by industry and consumers.

Technology Infrastructure

At present, the technology infrastructure prevalent across states operate on different platforms and differ in technical complexity. G.S.T. will require a single seamless integrated platform that can efficiently manage the requirements of tax payers across 29 states and seven union territories. The government will have to ensure that this infrastructure is in place before G.S.T. goes live.

Non-G.S.T. Items

At present, alcoholic liquor for human consumption and petroleum products are excluded from the G.S.T. basket. The government will have to be careful that frequent changes are not made to the G.S.T. basket, so as to ensure that G.S.T. will remain the tax of convenience it is desired to be rather than becoming a tax of validation.

Administrative Realignment

The G.S.T. regime contemplates the integration of and information-sharing between the C.G.S.T. and the S.G.S.T. arms. If history is any yardstick, implementation of systems which could enable harmonization and seamless flow of data between inter-governmental bodies could be both time-consuming and arduous.

Division of Tax Collections Between States

The G.S.T. regime will result in states losing their individual identities, as they will only partake in a share of the total levies collected. In order for G.S.T. to succeed, it is essential that a just and equitable formula be sought for distribution of the receipts between the states and the central government.

Different Taxing Powers

The key taxing powers are not merged under the G.S.T. regime and therefore continue to remain either with the central or state government. As a consequence, the non-G.S.T. central and state levies will continue as they are.

CONCLUSION

While the government's initiative to make G.S.T. a reality has been received with overwhelming support and favor, the roadmap to its success is not straightforward and cannot be taken for granted.

In general, G.S.T. is expected to be a boon for commerce and industry due to the expected cost reductions and lower tax rates. The ripple effect of these benefits is also expected to reach the end consumer. Further, G.S.T. will also provide an opportunity to less developed states to compete in the national market on an equal footing, thereby boosting their individual economies and the Indian economy at large. Lastly, the uniform tax rate will also improve the ease of doing business in India, which has been the mantra of the Indian prime minister.

That said, the G.S.T. regime may not be tax-favorable for all industries. For example, the cost of insurance products is expected to rise, which, if passed on to the end consumer, will negatively impact insurance penetration in the country. Further, with the dual charging components, the compliance burden on businesses is expected to increase.

Despite the setbacks, industry is optimistic that G.S.T. will live up to the expectations. The National Council of Applied Economic Research projects that the introduction of G.S.T. would lead to a G.D.P. growth in the range of 0.9% to 1.7%, and export growth between 3.2% and 6.3%.[2] Thus, G.S.T. will not just restructure indirect taxation in India, but will seminally influence the way businesses function.

While the government has its work cut out to ensure that G.S.T. is the game changer it is touted to be, its successful implementation could be a major step towards making India the economic powerhouse it is destined to become.

"G.S.T. is expected to be a boon for commerce and industry due to the expected cost reductions and lower tax rates. The ripple effect of these benefits is also expected to reach the end consumer."

[2] Report of the Select Committee on the Constitution 122nd Amendment Bill, 2014, dated July 22, 2015.

SPANISH TAX IMPLICATIONS OF NONRESIDENT PRIVATE INVESTMENT IN SPANISH REAL ESTATE

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INTRODUCTION

As global stock markets remain erratic and interest rates stay low, the Spanish real estate market has become an attractive investment opportunity for those in search of high-quality real property at reasonable prices. Major cities, such as Madrid and Barcelona, and some coastal areas have experienced growing demand translating into rising prices. While price levels remain below those in comparable cities in other countries, institutional and private investors are taking notice.

For an investor planning an intricate structure to invest in Spanish real property, it is important to recognize that Spanish tax law adopts a substance-over-form approach when it comes to taxation. Tax plans devoid of sound commercial basis and adequate substance are at risk to challenge. To illustrate, corporate structures used in Spanish real estate investments may be challenged where a corporate entity that owns the real property or that finances its acquisition

- has entered into arrangements that keep it from being tax resident for income tax treaty purposes in the country where it is formed, or
- lacks sufficient economic substance, as it may be defined for this purpose.[1]

In any event, using a corporate structure to invest in real estate may be beneficial for certain taxes and not beneficial for other taxes. This is especially true for private investors acquiring residential properties. This article provides a brief summary of the main domestic tax consequences that arise during the investment cycle of nonresident private investment in Spain.

INDIRECT AND LOCAL TAXATION

The acquisition of new residential property is subject to V.A.T. at a rate of 10% and stamp duty at a rate ranging from around 0.5% to 2.0%, depending on the region where the property is located. If the property is acquired in a resale – *viz.*, the purchaser is not the first owner – the purchase will be exempt from V.A.T. but subject to real estate transfer tax ("R.E.T.T.") at a rate generally ranging from around 8% to 10%, again depending on the region and market value of the property; a lower tax rate may apply in some circumstances.

Property tax (*Impuesto sobre Bienes Inmuebles* or "I.B.I.") is calculated annually

1 With respect to a private real estate structure held for personal use, no economic substance should be required. However, an arm's length rental payment should be made by the individual living in the property to a corporation that owns it.

on the property's cadastral value, which is assigned by the local authority and is generally lower than the acquisition or market value. I.B.I. is generally nominal and is paid to the local town.

INCOME AND CAPITAL GAINS TAX

For periods when the property is not leased out, nonresident individuals are subject to an annual nonresident income tax at a rate of 24% on imputed income, which is generally equivalent to 1.1% (or 2.0% in some cases) of the cadastral value. If the property is leased out, nonresident income tax will apply on the gross rental income. The 24% rate is reduced to 19% for residents of other E.U. Member States, as well as residents of Iceland and Norway. Residents of these countries can also deduct expenses so as to be taxed on a net income basis.

Entities that are resident in a tax haven[2] and that hold Spanish real estate are subject to a special 3% annual tax on the cadastral value of the property (or the value established for wealth tax purposes, if cadastral value is unavailable).

When properties are sold or transferred by nonresidents, a 19% tax is applied on any capital gains. In such cases, the buyer withholds 3% of the total consideration as payment on behalf of the nonresident seller. If this withholding exceeds the final tax amount owed, the nonresident can request a refund.

The withholding tax also applies to transfers of shares in companies located in a tax haven whose assets are mainly composed of Spanish real estate, whether directly or indirectly.

If the property being sold qualifies as the habitual abode of the taxpayer, the capital gain may be exempt from tax if he or she is a tax resident of Spain, another E.U. Member State, Iceland, or Norway, and if other specific requirements are satisfied. For the property to be considered the seller's habitual abode, the seller must generally have lived there for at least three years, except when marriage, divorce, or employment reasons required a change of domicile.

When urban property is sold or transferred, the increase in value of the land is subject to a tax known as *plusvalía municipal*. The amount payable depends on criteria such as the cadastral value and the number of years the property has been held. The tax is paid by the seller to the local town.

WEALTH AND INHERITANCE TAXES

Wealth tax is payable on the value of assets located in Spain, less Spanish liabilities. Nonresidents are subject to general tax rules, while residents of Spain or another E.U. Member State may be subject to the rules applicable in the region where the property is located. Madrid, for example, grants a complete rebate on wealth tax to its residents.

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[2] See the list of tax haven countries or territories as established by Royal Decree 1080/1991, as amended. The list of tax haven countries in relation to Spain is published in a special edition of *Insights*, "Outbound Acquisitions: Holding Companies of Europe – A Guide for Tax Planning or a Road Map for Difficulty?" at page 114.

Wealth tax applies annually at progressive rates ranging from 0.20% to 2.75%, which is the marginal rate for net wealth exceeding €10.7 million. For E.U. residents, the applicable rules and tax rates may differ slightly depending on the region in which the property is located. The first €700,000 of net wealth (€500,000 in some regions) are generally tax exempt. Also exempt is the first €300,000 of the taxpayer's habitual abode. This amount varies depending on the region.

For wealth tax purposes, the tax base for real estate will be the greater of

- the consideration paid for the property,
- the cadastral value, and
- the value assigned by the authorities for other tax purposes.

Debt financing can reduce the net wealth base, resulting in lower effective taxation. This will be the case only if the loan proceeds are used to acquire or improve the property and not to finance other investments.

For inheritance tax purposes, the fair market value of real property on the transfer date is taxed at progressive rates of up to 34%. Effective taxation depends on several factors, including an E.U. resident's ability to apply the rules of the region where the property is located or where the deceased was resident. Again, the tax base can be reduced if a loan has been used to acquire or improve the property.

CORPORATE STRUCTURES

Aside from the benefits of increased privacy and limited liability, property ownership through a corporate structure can offer tax advantages. Those advantages are available only if the structure has appropriate substance and was established mainly for commercial purposes, not merely for tax reasons related to holding the real estate.

In terms of indirect taxation, if the property is acquired by a Spanish company during the course of conducting an appropriate business – *e.g.*, the company owning the property is engaged in real estate development activities and meets other criteria – R.E.T.T. may apply at a low rate. Alternatively, R.E.T.T. may not apply at all if the V.A.T. exemption on second or subsequent acquisitions is waived and the seller is registered for V.A.T. purposes. Such purchases would be subject to stamp duty and V.A.T. through a self-assessment mechanism, and V.A.T. may be fully or partially relieved. In comparison, R.E.T.T. leads to higher acquisition costs.

The acquisition of more than 50% of the shares in a Spanish or foreign company could be subject to indirect taxation in the form of R.E.T.T. or V.A.T., if Spanish real estate directly or indirectly comprises at least 50% of the fair market value of the target company's assets.

In relation to capital gains taxation, several double tax treaties concluded by Spain grant exclusive taxing rights to the investor's country of residence. Most of Spain's treaties follow paragraph 4 of Article 13 (Capital Gains) of the O.E.C.D. model tax convention,[3] meaning that taxation rights are generally granted to the country in

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[3] O.E.C.D., *Model Tax Convention on Income and on Capital: Condensed Version 2014*, (Paris: O.E.C.D. Publishing, 2014).

which the underlying real estate is located. In relation to wealth taxation, nonresident individuals may not be shielded from Spanish wealth tax even if the Spanish real estate is held through a Spanish or foreign corporate structure. For example, Spanish wealth tax is applicable to individuals who reside in Russia, France, Germany, or the U.K. that directly or indirectly own Spanish real property.

Entities resident in a tax haven or other low-tax jurisdiction whose assets are mostly comprised of Spanish property can be deemed tax resident in Spain. Likewise, the right to tax capital gains arising from sales of shares in real-estate-rich companies is rarely granted to the country of residence of the ultimate investor or the transferor of the Spanish or foreign shares.

"Property ownership through a corporate structure can offer tax advantages . . . if the structure has appropriate substance and was established mainly for commercial purposes."

If the property is owned through a corporate structure, and Spain retains the right to imposed wealth tax on the shares in a company that holds mainly real property, the tax basis for wealth tax purposes will either be the net equity value of the company reported on financial statements reviewed by a statutory auditor or the highest of the following three values:

- The net equity value
- The nominal value of the shares
- The value derived when the average profits or losses of the previous three years are multiplied by a factor of five

Debt obligations incurred to finance the investment typically reduce the equity amount and interest on those obligations reduce the profit and losses during the three-year period. In either event, the effective taxation under the wealth tax regime would be lowered.

For income tax purposes, E.U. residents and residents of Iceland and Norway are entitled to deduct expenses directly linked to the income generated from the real property. As mentioned above, those residents may be subject to a 19% tax rate on net income. If the property is held through a Spanish entity, taxation on net income would be at a rate of 25% and withholding tax would likely apply to distributions. Conversely, if the property is not leased out and is held by a Spanish company, the imputed taxable income in relation to individuals – generally 1.1% of the cadastral value mentioned earlier – would not apply. The *plusvalía municipal* will only apply to gain derived from the direct sale of real property. This tax does not apply to gain on the sale of shares of the company.

As mentioned above, the transfer of Spanish shares to heirs would be subject to inheritance tax at progressive rates of up to 34% of their fair market value. Again, effective taxation could be reduced by a debt obligation incurred by the Spanish company, provided that the proceeds of the debt obligation were used to finance the real estate investment. In comparison, the transfer of shares in a foreign company may escape Spanish inheritance taxation under certain circumstances.

Regarding inheritance planning, trusts are not recognized under Spanish law and Spain does not adhere to the Hague Convention of July 1, 1985 on the Law Applicable to Trusts and on Their Recognition. Consequently, the use of a trust to hold real property may cause problems from a practical legal and tax standpoint. Relatively little jurisprudence and doctrine exist regarding the taxation of trusts, resulting in uncertainty. The Spanish Tax Authorities (*Dirección General de Tributos*) have issued rulings to taxpayers indicating that trusts generally should be disregarded for Spanish tax purposes and that transactions should be treated as if taking place directly between the settlor and the beneficiaries. In any event, trusts should be analyzed on a case-by-case basis.

CONCLUSION

In light of recent increases in the value of Spanish real property, acquisition tax planning is again of interest to potential investors from outside Spain. While income taxation of gains may not be reduced through structure planning, inheritance tax and wealth tax may be reduced through the use of a foreign corporation that is based in a tax treaty jurisdiction. The corporation must have economic substance. No matter how defined, if substance does not exist, expected tax benefits may be ephemeral.

FURTHER DEVELOPMENTS FOR U.K. NON-DOM INDIVIDUALS

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Tags
Estate Planning
Nom-Dom
Remitance Basis
Tax Residency
U.K.

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Summer is well and truly over, and as everyone started back at the office, H.M.R.C. published its latest consultation document (the "Current Consultation Document") on the proposed changes to be introduced for non-domiciled individuals ("Non-Doms") starting April 6, 2017.

ORIGINAL CONSULTATION DOCUMENT

Some aspects of the proposed changes, including a consultation document (the "Original Consultation Document") and draft legislation, were published in September 2015 as a consequence of announcements made by the U.K. government in the Summer Budget of 2015. The writer commented upon these in a previous edition of *Insights*.[1]

Those proposed changes were as follows:

- Any individual who is a Non-Dom who was born in the U.K. and has a U.K. domicile of origin will be deemed to be domiciled whenever they are resident in the U.K.
- Any individual who is a Non-Dom who has been resident in the U.K. for 15 out of the previous 20 tax years will be deemed to be domiciled in the U.K. from that point on.

At the time of the original announcements, H.M.R.C. also proposed the introduction of relief from the effect of the changes for Non-Doms who would become deemed domicile as of April 6, 2017. For example, one suggestion was to allow Non-Doms to settle assets into a trust in advance of the changes coming into effect.

The Original Consultation Document also stated that H.M.R.C. would take steps to change the rules regarding the holding of U.K. property in overseas corporate structures. Currently, the rules provide certain opportunities to reduce or extinguish stamp duty charges, and to treat both the shares of the company and, as a consequence, the underlying property as excluded from an estate for the purposes of U.K. inheritance tax ("I.H.T.").

SECOND & CURRENT CONSULTATION DOCUMENT

The Current Consultation Document sets out further details and draft legislation regarding the proposals, including protections against the deemed domicile measures and changes to the treatment of property held in overseas corporate structures.

[1] Gary Ashford, "U.K. Non-Dom Taxation – Where It Is and Where It Is Going," *Insights* 10 (2015).

Some measures are not yet fully covered, such as the Anti-Avoidance Transfer of Assets Abroad rules. It is anticipated that further documents will arrive before April 6, 2017, but the Current Consultation Document provides considerable assistance and guidance on what can be done in anticipation of the April 6, 2017 deadline.

SPECIFIC ISSUES COVERED

Inheritance Tax on U.K. Individual Property

H.M.R.C. previously advised that starting on April 6, 2017, it plans to bring U.K. residential property that is held in an overseas corporate structure under the I.H.T. net. It will do this by introducing legislation that will prevent property held in an overseas corporate structure from being treated as excluded property (and therefore outside the I.H.T. net) if the value of the shares is derived from an interest in a dwelling in the U.K. This rule will apply to both Non-Doms and trusts with settlors or beneficiaries who are Non-Doms.

Background

Many U.K. residential or investment properties are held via corporate structures, and many of those companies are located overseas. In the case of a U.K.-resident Non-Dom, the shares of an overseas company would be non-U.K. situs property. As a result, the underlying property could potentially be treated as excluded property for I.H.T. purposes, so long as the Non-Dom is not yet deemed domiciled and has not settled the shares into an offshore trust.

H.M.R.C. is proposing that property held in overseas corporate structures where the underlying value relates to U.K. property shall no longer qualify as excluded property for I.H.T.

Properties Affected

H.M.R.C. is proposing the application of the new rules to any property which is a "dwelling." The definition of a dwelling was introduced in Finance Act 2015 for the purposes of capital gains tax on disposals by nonresidents of residential property in the U.K. This includes

- Any building which is used or suitable to be used as a dwelling,
- Any building which is in the process of being constructed or adapted for use as a dwelling, and
- The grounds on which such a building is situated.

The new I.H.T. rules will also apply to trustees. The rules will not have any minimum value threshold, nor does H.M.R.C. intend to provide an exclusion for residential properties that are transferred on arm's length terms to a third party or used as a main home.

Changes of Use

H.M.R.C. acknowledges that a residential property may have previously been used for a nonresidential purpose, and therefore, it proposes the introduction of a two-year rule similar to that which currently applies for the purposes of I.H.T. Business

“H.M.R.C. proposed significant changes to the Non-Dom regime that would broadly limit the extent to which long-term, U.K.-resident Non-Doms could continue to benefit from the regime.”

Property Relief (“B.P.R.”). This rule states that if the shares in an overseas corporate structure derive their value from a U.K. property I.H.T. will apply if the property was used for a residential purpose at any point in the two years before the I.H.T. event. There will be provisions to apportion I.H.T. charges on a property that has been used for both residential and other purposes at the same time (*e.g.*, property consisting of commercial premises with a flat above).

Debts

In Finance Act 2013, H.M.R.C. tightened the rules by which debt could be used to reduce a liability for I.H.T. purposes. H.M.R.C. has confirmed that it will continue to apply these rules in the new proposals.

As such, any debts which are not related to the property will not be taken into account when determining the value of the property subject to I.H.T., and H.M.R.C. intends to disregard any loans made between connected parties. Furthermore, where an offshore entity holds debts related to U.K. residential property alongside other assets, it will be necessary to take a *pro rata* approach with regard to that debt in calculating the amount of the I.H.T. base.

Administrative Matters

H.M.R.C. is proposing new reporting requirements so that a property cannot be sold until any outstanding I.H.T. charges are paid. Under this provision, a new liability may be imposed on any person who has legal ownership of a property, including the directors of a company that holds a property, to ensure that I.H.T. is paid. The relevant legislation will be published later in 2016. These rules will apply to all chargeable events that take place after April 6, 2017.

Deemed Domicile Rules for Long-Term U.K. Residents

Background

Prior to the release of the Current Consultation Document, H.M.R.C. proposed significant changes to the Non-Dom regime that would broadly limit the extent to which long-term, U.K.-resident Non-Doms could continue to benefit from the regime. A specific deemed domicile rule already exists for I.H.T. purposes, under which Non-Doms resident in the U.K. for 17 out of the previous 20 years are deemed to be domiciled in the U.K (the “17/20 Rule”). However, the new proposal would establish a general cap on the number of years that the Non-Dom regime could apply, after which any resident Non-Dom would be taxed on the arising basis[2] in the U.K. in the same manner as all other U.K.-resident and domiciled citizens.

H.M.R.C. has already issued draft legislation for this proposal. It will deem those individuals who were U.K. residents in 15 out of the previous 20 tax years as domiciled in the U.K. for both income tax and capital gains tax purposes (the “15/20 Rule”). The proposed new rule will essentially follow the same principles as the 17/20 Rule, albeit for a shorter threshold period, and will include any years in the U.K. under the age of 18. The new shorter deemed domicile period will also apply for I.H.T. and will replace the 17/20 Rule.

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[2] Under the arising basis, income is taxed when and as it arises. Remittance to the U.K. is immaterial.

H.M.R.C. has confirmed that an individual can "lose" their U.K. domicile status if they become nonresident and spend at least six years overseas (four years for I.H.T. purposes).

Updates Within the Current Consultation Document

An interesting and significant point in the Current Consultation Document is that H.M.R.C. has confirmed that the residence tests will follow current law, which is a combination of the Statutory Residence Test for tax years 2012-2013 onwards and existing case law for prior years, as there was formerly no real legislation in this area. Given the historical problems that have arisen from uncertainties over residence under common law, one can see that application of the residence tests may not be as straightforward to apply as H.M.R.C. intends.

In the Current Consultation Document, H.M.R.C. clarified that split tax years will be counted towards one of the 15 years under the proposed deemed domicile rules.

Protections Proposed to Lessen the Impact of the Changes

Capital Gains Tax

H.M.R.C. proposes that individuals who will be deemed domiciled on April 6, 2017 under the 15/20 Rule shall be able to rebase directly-held foreign assets to the market value of the assets on April 5, 2017. Those individuals who become deemed domiciled after April 2017 and those who are deemed domiciled because they were born in the U.K. with a U.K. domicile of origin will not be able to rebase their foreign assets.

Mixed Funds Opportunity

A welcome development within the Current Consultation Document is that H.M.R.C. is introducing a window to clean up mixed funds.

Prior to arrival in the U.K., it is always advisable for a future Non-Dom to segregate his or her banking accounts into pre-arrival capital, income, and gains – in addition to a few other categories. The purpose of this is essentially to maintain the character of each component of the account so that any future remittance to the U.K. will be taxed at the appropriate rate, *i.e.*, 45% income tax, 28% capital gains tax (recently reduced to 20%), and to distinguish capital, which can potentially be brought into the U.K. without any tax charge.

Where segregation has not taken place, mixed funds arise and any future remittance will therefore contain a mixture of the various parts. There are specific rules for mixed funds that essentially tax any part of the funds at the highest rate first (*e.g.*, as income). Without a significant amount of work, H.M.R.C. might well contend that the whole remittance should be taxed at 45%.

Under the latest proposals, Non-Doms with mixed funds will have the opportunity to review the funds and separate out the different parts into clean capital, foreign income, and foreign gains. They will then be able to remit from the newly-segregated accounts as they wish. There will be no requirement for Non-Doms to make remittances from their newly-segregated accounts in any particular order or within any particular period of time.

This special treatment will apply only to mixed funds that consist of amounts deposited in banking and similar accounts. Where the mixed funds take the form of assets, an individual will have to sell any overseas assets during the transitional window and separate the sale proceeds in the same way as any other money.

To benefit from mixed fund cleansing, the remittance basis user will have to be able to show an audit trail for the offshore funds. This opportunity will be available to any Non-Dom, including those born in the U.K. without a U.K. domicile of origin and individuals who will be deemed domiciled under the new rules. An individual need not be resident in the U.K. in April 2017. This window for this benefit will last for one tax year from April 6, 2017.

The matter of whether a trust, treated as a relevant person under the remittance rules, will also be able to clean up its mixed funds is currently not clear. It would appear logical to allow this, but we will have to wait and see.

"To benefit from mixed fund cleansing, the remittance basis user will have to be able to show an audit trail for the offshore funds."

Nonresident Trusts

Nonresident trusts have always been very useful to Non-Dom clients, as they allow for non-U.K. situs assets to remain outside the U.K. estate for I.H.T. purposes, even beyond the point that the 17/20 Rule starts to apply, when settled before that point. Additionally, Non-Dom settlors and/or beneficiaries claiming the remittance basis are only taxed on income or gains to the extent they are remitted to the U.K.

H.M.R.C.'s proposal to deem those who fall under the 15/20 Rule as U.K. domiciled for all taxes potentially has significant effects for Non-Doms holding assets in non-resident trusts. Whilst the proposed rule simply reduces the threshold of the current I.H.T. deemed domicile rule by two years, any Non-Dom individual who is deemed domiciled would not be able to use the remittance basis. As a result, where these individuals receive distributions or have an interest in income and gains from a trust, they would then be liable for tax on any resulting income or gains.

To limit the burden of the proposed changes, H.M.R.C. has again proposed certain protections. One proposed protection is that Non-Doms who set up offshore trusts before they are deemed domiciled under the 15/20 Rule will not be taxed on trust income and gains that are retained in the trust or its underlying entities. Another proposed protection is that excluded property trusts will have the same I.H.T. treatment as at present (except where there is U.K. property, as discussed below).

Proposed Changes for Specific Taxation Areas for Nonresident Trusts

Attribution of Gains to Settlors (§86 T.C.G.A. 1992)

Section 86 taxes chargeable gains on any individual who is resident and domiciled in the U.K. and who has an interest in settled assets that are held in a nonresident trust or which are attributable to the trustees via an underlying company. The current §86 rules do not apply to Non-Doms, meaning that Non-Doms with an interest in an offshore trust will only be taxed on gains that are distributed to them and, even then, only when those gains are remitted to the U.K.

Under the proposed changes, §86 will be extended to include Non-Doms who are deemed domiciled. In order to mitigate the effects of this new application, H.M.R.C. is proposing to tax the Non-Dom only on any gains in relation to a trust established prior to becoming deemed domiciled when any distribution is made to the Non-Dom or a member of the Non-Dom's family. In this context, a family member is defined as the settlor, the spouse, or children under the age of 18. Additions made to a trust after the changes come into force will also potentially take away the protections.

The protections above will not be afforded to any person who is deemed domiciled as a result of having been born in the U.K. with a U.K. domicile of origin. Furthermore, any gains being taxed on the settlor under these proposals will be matched to the underlying gains in the nonresident trust.

Attribution of Gains to Beneficiaries (§87 T.C.G.A. 1992)

Section 87 taxes any U.K.-resident individual on capital payments they receive from a nonresident trust to the extent that there are chargeable gains arising in that trust. The legislation applies regardless of the individual's domicile status and includes, *inter alia*, the settlor of the trust. However, those currently taxed under §87 can elect to apply the remittance basis.

Following the introduction of the new deemed domicile rule and the proposed changes to §86 mentioned above, settlors of trusts will no longer be taxed under this clause. It is proposed that U.K.-resident individual beneficiaries who receive capital payments or benefits from a nonresident trust or underlying entity and who are deemed to be domiciled in the U.K. will be subject to capital gains tax under §87, regardless of where the benefits are received. The current rules of matching underlying gains in the nonresident trust to distributions will continue.

Settlements Legislation (§624 I.T.T.O.I.A. 2005)

The settlements legislation is an income tax provision which taxes any income of an individual settlor who has retained an interest in a settlement, including a nonresident trust. The legislation also taxes the settlor on any income arising to the settlor's unmarried minor children, on capital payments from a nonresident trust, on loans, and on capital payments made by bodies associated with a nonresident trust. Currently, where U.K.-resident Non-Doms are potentially taxed under this provision, those who claim the remittance basis are taxed only on foreign-source income remitted to the U.K.

The new deemed domicile rules will potentially tax U.K.-resident deemed domiciled individuals on a worldwide arising basis, and where the legislation applies, they may be liable for tax on all income arising in the nonresident trust. H.M.R.C. is proposing additional protections so that deemed-domiciled individuals will be taxed on income of a nonresident trust set up before they were deemed domiciled only to the extent that a "family benefit" is conferred. A family benefit is conferred where any of the protected income is applied for the benefit of or paid to any of the following:

- The settlor
- The spouse
- A minor child or grandchild
- A closely-held company in which a participator falls within the scope of the settlements legislation
- The trustees of a settlement of which a beneficiary falls within the scope of the settlements legislation

- A body connected with such a settlement

Anti-Avoidance for Transfers of Assets Abroad (Chapter 2, Part 13 I.T.A. 2007)

The Transfer of Assets Abroad legislation ("T.o.A.A.") is anti-avoidance legislation designed to prevent U.K.-resident individuals from avoiding U.K. income tax by transferring the ownership of assets to persons abroad while still being able to enjoy the benefit of the income generated by those assets. Essentially, T.o.A.A. exists to catch transactions or funds that would potentially escape income tax due to overseas arrangements. H.M.R.C. taxes transferors on the underlying income, or transferees (including beneficiaries) on the amounts they receive. Currently, T.o.A.A. allows for any individual claiming the remittance basis to be liable for income tax only on U.K.-source income and foreign income that it is remitted to the U.K.

The new deemed domicile rules will potentially tax U.K.-resident, deemed-domiciled individuals on any foreign income arising in or paid by a structure, wherever it is received. However, H.M.R.C. is proposing changes that partially remove the application of the provisions of the T.o.A.A. legislation that would affect deemed-domiciled settlors who set up a nonresident trust before they become deemed domiciled. This is to prevent them from being taxed on the foreign income of the trust or any underlying entity paying out dividends to the trust.

Under the proposed new rules, H.M.R.C.'s intention is that, rather than being taxed on the arising basis, foreign-source income will be taxed at the time any benefits received. If the settlor, the spouse, a minor child, or other relevant person receives any actual benefits from the trust – *e.g.*, by way of an income or capital distribution or enjoyment of trust assets – the distribution will trigger the imposition of tax on the settlor to the extent that it can be matched against relevant foreign income arising in that year.

"T.o.A.A. exists to catch transactions or funds that would potentially escape income tax due to overseas arrangements."

The full details of the proposed changes to the T.o.A.A. provisions have yet to be released. However, the details provided to date appear to suggest that some of the same principles under which beneficiaries are currently taxed on gains under §87 T.C.G.A. (see above) will be applied to the underlying income of the trust (*i.e.*, the distribution will be matched and taxed accordingly). H.M.R.C. has advised that it will publish further details on these proposed changes later in the year.

Born in the U.K. with a U.K. Domicile of Origin

H.M.R.C. has already stated that it proposes to treat any individual born in the U.K. with a U.K. domicile of origin as U.K.-domiciled while they are resident in the U.K.

Many, if not all, of the protections being proposed by H.M.R.C. to lessen the impact of the April 6, 2017 changes will be denied to those caught under this provision. This includes the opportunity to make settlements into nonresident trusts prior to arrival in the U.K. The resulting nonresident trusts would be treated as relevant property trusts once the individual becomes resident in the U.K.

However, H.M.R.C. is offering some relief from these provisions. For the purposes of I.H.T., the individual will not be treated as being domiciled in the U.K. until they have been resident for at least one of the two tax years prior to the year in question.

This would apparently provide some opportunity to settle matters in trust before becoming resident in the U.K. Whilst the resulting trust would be a relevant property trust when the individual is resident, the assets may still effectively sit outside the U.K. estate for I.H.T. purposes. However, it is understood that these individuals will be taxed on a worldwide basis for income tax and capital gains from the point they become U.K. residents.

Business Investment Relief

Building on the government's 2015 Autumn Statement, H.M.R.C. has also set its interest on ways business investment relief ("B.I.R.") may be modified to encourage foreign investment in U.K. business by remittance basis users. Clearly, given June's Brexit referendum result, one may suggest that this issue has risen to even greater prominence than when the 2015 Autumn Statement was first issued.

For those unfamiliar with B.I.R., it provides an exemption to the remittance basis rules that was introduced on April 6, 2012. B.I.R. helps U.K. businesses to attract inbound investment by allowing individuals who use the remittance basis to bring overseas income and gains to the U.K. without any tax liability if it is done for commercial investment purposes. The scheme effectively treats funding for qualified investments as if not remitted to the U.K. and therefore not liable to tax.

The range of companies in which a qualifying investment can be made under the scheme is quite wide. The definition includes an investment in:

- A company carrying on a commercial trade or preparing to do so, including one whose activities consist of generating income from land,
- A company carrying out research and development activities,
- A company making commercial investments in trading companies, and
- A holding company of a group of trading companies.

There are no restrictions preventing the scheme from being used for investments in a company with which an investor has a separate involvement, such as holding a director's position and receiving arm's length compensation for services provided in the ordinary course of business. Any investment must be made within 45 days of the date on which the funds are brought into the U.K.

Unlike other government schemes designed to encourage investments, there is no monetary limit on an individual's investments under B.I.R. However, the scheme is not available for investments to acquire existing shares nor is it available for investments in companies that are listed on a recognized stock exchange.

H.M.R.C. has indicated that any changes to B.I.R. would feature in Finance Bill 2017 and therefore be introduced on April 6, 2017.

CONCLUSION

Despite the Brexit vote, the U.K. government appears to be committed to limiting some of the benefits of the Non-Dom rules. However, for the newly arrived non-U.K.-born Non-Dom, there are still great opportunities and potentially 15 years of full benefits under the Non-Dom regime.

Even when the 15-year threshold has been reached, the individual in question has choices. The individual might, for example, settle assets into a trust. Provided that there are no distributions to family members, the assets could potentially sit within that trust without encountering taxable consequences. Various trust-related options will likely be considered between now and April 6, 2017, along with various other options that may provide for income tax deferment, such as an offshore life insurance bond.

Alternatively, some Non-Doms may actually decide to leave the U.K. – at least for a sufficient amount of time to reset the 15-year clock. For those who choose to do this, it is worth remembering that, depending on the circumstances, they may still have quite a generous allowance of days, which grants them continued access to the U.K. Departure need not amount to an all-or-nothing solution.

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

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

ARTICLE 1 – SERVICE P.E. CLAUSE

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

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

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

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

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

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

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

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

ARTICLE 2 – TREATMENT OF INTEREST INCOME

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

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

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

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

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

ARTICLE 3 – FEES FOR TECHNICAL SERVICES

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

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

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

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

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

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

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

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

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

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

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

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

- An entity shall not be entitled to the benefits of the Mauritius Tax Treaty (including the newly inserted concessional capital gains taxation) if the entity's affairs are arranged in the country of residence primarily for the purpose of taking advantage of treaty benefits. This would include entities not having *bona fide* business activities.
- A shell or conduit company shall not be entitled to benefits under the Mauritius Tax Treaty. An entity will be treated as a shell or conduit company if, in the immediately preceding 12 months, it did not incur expenditures on operations in its country of residence of at least 1,500,000 Mauritian rupees or 2,700,000 Indian rupees, as the case may be. However, an entity is deemed not to be a shell or conduit company if it is listed on a recognized stock exchange in its country of residence.

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

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

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

ARTICLE 5 – SOURCE RULE FOR TAXATION OF OTHER INCOME

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

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

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

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

ARTICLE 6 – EXCHANGE OF INFORMATION

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

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

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

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

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

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

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

ARTICLE 7 – ASSISTANCE IN COLLECTION OF TAXES

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

- Both countries shall lend assistance to each other in the collection of "revenue claims" arising out of any taxes.
- The term revenue claims refers to the amount owed with respect to taxes of every kind and description (including interest, administrative penalties, and costs of collection or conservancy related to such taxes), insofar as this taxation is not contrary to the provisions of the tax treaty or any other instrument signed by both countries.

- Both countries will be obliged to accept and collect revenue claims of the other country and take measures for conservancy, subject to the fulfillment of certain conditions.
- Revenue claims accepted by a country shall not be subject to time limits or accorded any priority applicable to a revenue claim under the laws of that country or accorded any priority applicable in the other country. No proceedings with respect to the existence, validity, or the amount of a revenue claim can be brought before the courts in the country accepting the revenue claim.

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

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

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

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

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

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

CONCLUSION

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

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

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

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

ITALY MODERNIZES TAX TREATMENT OF L.B.O. TRANSACTIONS

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Tags
Investment Banking Fees
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Leveraged Buyout
Management Buyout
Shareholder Loans

On March 30 2016, the Italian Revenue Agency issued the Circular Letter No. 6/E (the "Circular Letter"), which confirms the characterization of a Leveraged Buyout ("L.B.O.") from a tax perspective and addresses certain tax issues that typically arise from this type of transaction. The Circular Letter was designed to create a favorable environment for foreign investment in Italy and to reverse negative publicity arising from interpretative uncertainty over tax consequences.

In this respect, the Circular Letter provides important clarifications concerning

- the deductibility, for corporate income tax ("C.I.T.") purposes, of interest expense incurred in connection with acquisition loans and shareholder loans;
- the appropriate tax treatment, for C.I.T. and V.A.T. purposes, of transaction costs and other fees charged by private equity firms to a target company ("Target") and/or acquisition company ("Bidco"); and
- the taxation of capital gains realized at exit and the reduction of withholding tax on outbound dividends under an applicable Double Tax Convention ("D.T.C."), E.U. directive, or provision of domestic law.

INTEREST DEDUCTIBILITY

Over the past few years, the deductibility of interest incurred in connection with mergers of L.B.O. acquisitions has been challenged by the Italian tax authorities. The typical argument in these matters may be summarized as follows:

- The interest expense was not linked to borrowings incurred in the course of the business activities of Target.
- The L.B.O. transaction was simply a tax-driven transaction involving the pushdown of debt in order to obtain a tax advantage from the resulting interest expense, thereby reducing Italian tax on Target's cash flows.
- In transactions involving foreign investors mainly, the borrowing was not made for business reasons in Italy. Rather, it was incurred at the direction of the ultimate controlling shareholder. This leads to a contention that the borrowing is a form of service rendered by the acquired company for the benefit of the controlling foreign shareholder. The service must be compensated with an arm's length fee, which happens to be equal to the interest deduction.

Breaking with the past, the Circular Letter clarifies that, as a general principle, deductibility of interest on the acquisition loan should be allowed, subject only to ordinary limitations, which include a cap that is approximately 30% of earnings before interest, taxes, depreciation, and amortization ("E.B.I.T.D.A."). In addition, a more

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reasonable transfer pricing rule is applied by Italian Revenue Agency. On the basis of the Circular Letter, the revised treatment is as follows:

- Interest expense borne by a company set up to accomplish the acquisition (either a special purpose vehicle ("S.P.V.") or an existing Bidco) is recognized as being functionally connected to the purchase of Target. Therefore, the deduction of interest expense on third-party debt should be allowed either in the case that the transaction is concluded with (i) the merger of S.P.V./Bidco and Target or (ii) the creation of a fiscal unity between S.P.V./Bidco and Target.

- L.B.O. transactions are recognized as being grounded on sound economic reasons, as they are aimed at acquiring control over Target and this structure (including the debt push down) is usually requested by third-party lenders. Therefore, the leveraged transaction should not be regarded *per se* as abusive. The transaction should only be viewed as abusive when the operation is intended to obtain an undue tax benefit that is contrary to the spirit and objective of the law. An example would be a re-leveraged transaction without a change of control.

- The contention that S.P.V./Bidco acts for the benefit of its ultimate foreign controlling company has been abandoned. On the contrary, following the O.E.C.D. Transfer Pricing Guidelines, if the foreign parent company raises funds on behalf of the subsidiary that uses those funds to acquire a new company, the parent company would generally be regarded as providing a service to the subsidiary for which remuneration would be requested. This could justify the deduction of a service fee (in addition to interest) at the level of the subsidiary.

"Based on the new guidelines, the Italian Tax Authorities may decide to reconsider earlier tax assessments and pending litigation that are based on legal claims that debt pushdowns are generally abusive."

Based on the new guidelines, the Italian Tax Authorities may decide to reconsider earlier tax assessments and pending litigation that are based on legal claims that debt pushdowns are generally abusive. This reassessment would not include instances in which the transaction was specifically aimed at creating an artificial interest expense deduction, which may be the case with re-leveraged transactions within the same group.

SHAREHOLDER LOANS

The Circular Letter explains that interest expense incurred by S.P.V./Bidco on loans granted by foreign shareholders is subject to transfer pricing rules that apply the arm's length principle. Under exceptional circumstances, shareholder loans may be recharacterized as capital contributions where the facts so indicate. For example, an abusive transaction may be presumed to exist if one or more of the following situations occur:

- The reimbursement of the shareholder loan and the payment of the interest are subordinate to payment of loans/interests to third-party lenders.

- The ratios provided under the financial covenants do not consider the shareholder loan as debt and interest accrual as an expense (as opposed to equity).

- The payment of the interest and principal are subject to the same restrictions imposed on dividends distributions and capital reductions.

- In general terms, the shareholder loan and the accompanying interest expense are characterized by lenders as if they are equity capital and dividends.

If recharacterized, the following consequences arise:

- Interest expense accruals on shareholder loans are not deductible.
- Interest payments made in respect of shareholder loans may be subject to withholding tax as dividends.
- The Allowance for Corporate Equity ("A.C.E.") benefit – *i.e.*, a deduction of a notional return equal to 4.5% of the increase in equity – should increase (but specific anti-abuse rules should be considered in order to quantify the benefit).

The Circular Letter states that, in respect of past situations, administrative penalties should be waived since taxpayers have been misled by the interpretative uncertainty of the relevant law.

CORPORATE TAX TREATMENT OF FEES

The Circular Letter states that advisory fees (such as transaction or monitoring fees) charged by a private equity firm may be deducted by Target as long as an economic benefit is derived from the services received. In comparison, fees for services that are provided for the benefit of the investors but paid for by Target are not deductible by Target. Identifying the benefitting party is a factual exercise and all facts and circumstances surrounding the payment must be examined.

The following factors may indicate that advisory fees are paid for services that do not benefit Target:

- Fees paid by Target offset some or all of the management fees due by the fund.
- The amount of the fees paid to the private equity firm or advisory firm exceeds an arm's length amount that is customary for the types of services rendered.
- Payment of the fees is tied to the same limitations provided for dividend distributions to the private equity firm.
- Where the portfolio company is acquired by a consortium of private equity funds, fees charged by the various advisory firms are in proportion to the shareholdings of each private equity firm.

V.A.T. TREATMENT OF FEES

The Circular Letter states that, if S.P.V./Bidco is a passive investor that does not participate in the management of Target, input V.A.T. on various transaction costs may not be recovered by the S.P.V./Bidco used to effect the transaction or a successor company created through a merger with Target ("Mergerco"). In addition, Target is not entitled to recover V.A.T. on services provided for the benefit of the investor group.

EXIT TAX TREATMENT OF CAPITAL GAINS AND DIVIDENDS

Capital gains realized by a foreign S.P.V. that directly holds the shareholdings in the Italian Mergerco or Bidco are taxed at exit as follows:

- Under domestic rules, capital gains realized by non-Italian resident entities are taxable at an effective tax rate of approximately 14%.
- Capital gains realized by white-listed resident entities upon the disposal of a non-substantial shareholding (capped at 20% of voting rights or 25% of share capital) of an unlisted company are exempt from tax.
- Capital gains realized by foreign entities upon the disposal of a non-substantial shareholding (capped at 2% of voting rights or 5% of share capital) of a listed company are exempt from tax.
- Pursuant to Article 13 of a D.T.C. based on the O.E.C.D. Model Tax Convention, capital gains derived from the sale of shareholdings are taxable only in the state of residence of the shareholder.

EXIT TAX TREATMENT OF DIVIDENDS

Dividend distributions from an intermediary Italian holding company that owns shares of Target are taxed at exist as follows:

- Dividends are subject to ordinary withholding tax (currently 26%), which may be reduced pursuant to an applicable D.T.C.
- Dividends distributed to an E.U. parent company may benefit from full exemption from Italian withholding tax under the E.U. Parent-Subsidiary Directive (the "P.S.D."), as implemented in Italy.
- If outbound dividends do not qualify for full exemption under the P.S.D., the E.U. parent company may, in principle, claim the benefit of a reduced withholding tax rate of 1.375%.[1]

"The limitation on benefits deals only with investments made by funds established in blacklisted countries through an E.U. holding company."

LIMITATION ON EXIT TAX BENEFITS

According to the Circular Letter, where the fund is established in a country that does not allow for adequate exchange of information, the intermediary E.U. holding company will not be entitled to tax relief when it does not have sufficient economic substance. In the absence of substance, the intermediary holding company is viewed as having been artificially created to take undue advantage of the benefit provided for in the P.S.D. and/or D.T.C.'s as well as domestic rules that reduce the tax burden on exit.

In the absence of economic substance, an intermediary entity is deemed to have been artificially set up as mere a conduit to its beneficial owner. A non-Italian entity may be viewed as lacking economic substance where the following conditions are met:

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[1] D.P.R. 600/1973, art. 27, para. 3-ter.

- It has a light organization. For example, it does not have full-time employees on its staff and does not have offices and equipment other than those made available by third-party companies through management service agreements. It does not carry out real economic activity, or it has little or no discretion in the decision-making process of its business.
- It does not carry out real economic activity, or it has little or no discretion in the decision-making process of its business.
- It acts as a mere financial conduit in the context of a specific arrangement involving receipts and disbursements that are symmetrical in terms of amount and timing and are not subject to further withholding tax in the state of residence.

If the fund is established in a blacklisted country and the intermediary holding company would be disregarded based on the above arguments, capital gains realized upon the disposal of Target's shares would be subject to tax in Italy and outbound dividends from Italy would be subject to ordinary withholding tax, as if the fund invested directly. Nonetheless, when the fund is set up as a transparent entity, treaty benefits may be claimed directly by the ultimate parent fund's investors under certain circumstances.

WHITE LIST

The above-mentioned limitation deals only with investments made by funds established in blacklisted countries through an E.U. holding company. It should not apply when the fund is located in a country allowing for an adequate exchange of information (a so-called whitelist country) that is also in compliance with E.U. principles.

Countries allowing for adequate exchange of information are currently listed in Ministerial Decree 4 September 1996. This legislation was issued pursuant to Legislative Decree No. 239/1996, which sets the rules for taxation of interest on bonds and similar notes from Italian issuers. Legislative Decree No. 147/2015 introduced recent changes and stated that the white list should be rewritten and updated by ministerial decree every six months, so as to include all the (new) countries that meet the requirements in the intervening time and are therefore considered whitelisted.

In 2015, a number of Tax Information Exchange Agreements ("T.I.E.A.'s") were ratified by the Italian government, including an agreement with the Cayman Islands, Guernsey, and Jersey. Following these developments, and considering the level of actual cooperation attained with regard to exchange of information, there is no longer justification for countries having T.I.E.A.'s with Italy to be excluded from the white list. Therefore, even before a new list is formally issued, it is reasonable to treat these countries as whitelisted.

CANADA ADOPTS CHANGES TO TRUST & ESTATE TAXATION RULES

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Tags
Canada
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INTRODUCTION

On January 1, 2016, new income tax rules came into effect regarding the Canadian taxation of trusts, particularly testamentary trusts, and estates (the "New Rules"). These rules were first proposed in the 2013 Federal Budget under measures intended to address concerns over abusive tax planning. Draft legislation, proposing a series of amendments to Canada's *Income Tax Act* (the "Act"), was released in early 2014 and revised during the summer of 2014.

Organizations representing the Canadian tax, trust, and estate industries have expressed serious concern with the New Rules. In particular, industry representatives took issue with the amendments to the taxation of spousal and similar trusts and questioned the practicality of the New Rules with regard to the use and application of charitable tax credits by Canadian estates. In spite of these concerns, the New Rules received royal assent at the end of 2014, to take effect at the start of 2016.

Following discussions with industry representatives – which have been ongoing from the time the New Rules received royal assent – Canada's Department of Finance ultimately addressed the most pressing concerns by proposing further amendments to the Act. These proposed amendments were released on January 15, 2016.

This article provides a general overview of the New Rules and the problems they present with regard to the taxation of spousal and similar trusts and the use of charitable donation tax credits by Canadian estates. The article also discusses the manner in which the Department of Finance has proposed to remedy these problems.

BACKGROUND TO THE NEW RULES

As indicated above, Canada's 2013 Federal Budget included a surprise for tax and estate practitioners. Previously, Canadian testamentary trusts and estates were subject to taxation at graduated rates similar to the graduated rates for individuals. This contrasted with the single tax rate for *inter vivos* trusts, which was the highest marginal tax rate applicable to individuals in the province of the trust's residence. In the 2013 Federal Budget, the Canadian government announced that it was considering the elimination of graduated tax rates for testamentary trusts. This announcement was followed by a consultation paper, released on June 3, 2013, that proposed, *inter alia*, the application of the highest marginal tax rate to all trusts created by will and all income earned by estates for tax years ending more than 36 months after the death of the relevant individual.

The Federal government's primary concern was that testamentary trusts were being used in an abusive manner to avoid the payment of tax. In certain cases, the Federal government noted that multiple testamentary trusts were formed in order to benefit from graduated rates multiple times. Estates were taxed in the same manner as testamentary trusts under the law then in effect, and the Federal government expressed the view that the administration of certain estates was being unduly delayed for tax-motivated reasons.

The Federal government also expressed concern with deferral of tax on transfers of property to spousal or similar trusts, which are commonly used as part of Canadian tax and estate planning. Under prior law, the tax imposed on an inherent gain at the time of the transfer was deferred until the death of the beneficiary spouse. In general, all of the net income of a spousal or similar trust was payable to a surviving spouse during his or her lifetime, and discretionary payments of capital could also be made to the surviving spouse during that period. Spousal and similar trusts have become particularly attractive in circumstances involving multiple marriages or blended families.

To a lesser extent, the Federal government was concerned with inter-provincial tax planning involving opportunities that could be derived from manipulating the domicile of trusts. Prior to the New Rules, planning opportunities existed to access lower provincial tax rates based on the tax residence of a trust's trustee.

GRADUATED RATE ESTATES

Based on the Federal government's view that the time required to administer most Canadian estates is 36 months, the New Rules provide that graduated tax rates will apply only to taxation years ending within the first 36 months after the individual's death. During this period, estates are referred to as "graduated rate estates" ("G.R.E.'s") under the New Rules. After the 36-month period, G.R.E. status terminates and a continuing estate will be taxed only at the highest marginal tax rate applicable to individuals in its province of residence. Any testamentary trusts established under the terms of an individual's will are also taxed at the highest applicable marginal tax rate from the time of inception.

SPOUSAL AND SIMILAR TRUSTS

The New Rules introduce changes to Canadian income tax consequences upon the death of a surviving spouse. The new paragraph 104(13.4)(b) of the Act (which forms part of the New Rules) provides that, upon the death of a surviving spouse who is a beneficiary of a spousal trust, the capital gains arising from the deemed disposition are to be taxed in the surviving spouse's estate and not in the trust. Many industry leaders raised concerns regarding the fairness of this provision. It results in considerable inequity when the beneficiaries of a surviving spouse's estate are different from the residuary beneficiaries of the trust. In blended family situations, the capital gains tax liability triggered by the surviving spouse's death was typically borne by the estate. This diminished the overall property available for distribution to the beneficiaries of the estate. At the same time, the capital property of the trust could be distributed to the residuary beneficiaries of the trust and the recipients would take a cost base equal to fair market value of the property received.

A second major concern with the treatment of spousal and similar trusts under the New Rules is the risk of "stranding" charitable donation tax credits ("C.D.T.C.'s,") in a trust that gifts property to a charity after the death of the surviving spouse.

Because the tax liability associated with the surviving spouse's death will be borne by the estate and not by the trust, the trust may not have sufficient income tax payable to obtain a benefit from the donation tax credit. In the one-year period between the adoption and the effective date of the New Rules, practitioners had time to review estate plans in order to identify those involving spousal trusts that would be adversely affected. Typically, estate plans involving blended family situations and residual beneficiaries that differed from the beneficiaries of the surviving spouse's estate were most at risk.

CHARITABLE DONATION TAX CREDITS

Under the New Rules, an estate that is a G.R.E. for the purposes of the Act is generally permitted to allocate C.D.T.C.'s to any of the following taxation years:

- The taxation year of the estate in which the donation was made
- An earlier taxation year of the estate
- The two taxation years of the individual preceding his or her death

"The Federal government's primary concern was that testamentary trusts were being used in an abusive manner to avoid the payment of tax. In certain cases, the government noted that multiple testamentary trusts were formed in order to benefit from graduated rates multiple times."

In general, publicly listed securities and units of mutual funds are exempt from capital gains tax, which arises on an individual's death, if the property is donated to a charity by the individual's estate following his or her passing. The capital gains tax exemption is only applicable to the taxation year of the individual's death.

Industry representatives raised concerns over the feasibility of completing all charitable gifting within the 36-month G.R.E. period in complex estate situations.

PROPOSED CHANGES TO THE NEW RULES

In response to a submission made by the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada, the Department of Finance indicated in November 2015 that it was seeking to understand the concerns raised in respect of the New Rules. On January 15, 2016, the Canadian Department of Finance released legislative proposals to amend certain portions of the New Rules.

The amendments proposed by the Department Finance are aimed principally at the apparent inequity caused by new paragraph 104(13.4)(b) of the Act. The proposed amendments introduce a new paragraph 104(13.4)(b.1), which limits the application of paragraph 104(13.4)(b) to circumstances involving a surviving spouse who meets the following criteria:

- Immediately prior to his or her death, the surviving spouse was resident in Canada.
- The surviving spouse was a beneficiary of a post-1971 spousal or common law testamentary trust that was created by the will of a taxpayer who died before 2017.

If these conditions are met, the trustee or administrator of the surviving spouse's estate may jointly elect with the trustee of the spousal or common law partner testamentary trust to have paragraph 104(13.4)(b) of the Act apply, with the result that the capital gains arising as a result of the surviving spouse's death will be taxed in the estate and not in the spousal or common law partner trust.

For deaths occurring before 2017, there may be compelling tax reasons to make this election. For example, it may be beneficial to make use of the election if there is a capital gain in a spousal trust and, at the time of the surviving spouse's death, he or she had personal capital losses that otherwise could not be used.

"In the coming months, individuals with estate plans developed in contemplation of the New Rules should revisit planning done prior to the proposed amendments."

As previously noted, the joint election in proposed paragraph 104(13.4)(b.1) of the Act will only be available for spousal trusts created by the will of a taxpayer who died before 2017. Otherwise, the capital gains tax deemed to be recognized in a spousal or similar trust upon the death of a surviving spouse will continue to be taxed in the trust (at the highest marginal tax rate applicable to the trust) and not in the estate of the surviving spouse, as under prior law.

The Department of Finance's proposed amendments to the New Rules also extend the time during which testamentary trusts may allocate C.D.T.C.'s. While the existing legislation allows for the allocation to be made only within a 36-month period following an individual's death, the proposed changes would extend this period to 60 months. According to a Department of Finance release regarding the proposed amendments, it appears that any C.D.T.C.'s arising from donations made after the estate ceased to be a G.R.E. would be allocable among either (i) the taxation year in which the donation was made or (ii) the last two taxation years of the individual.

CONCLUSION

In general, the Department of Finance's proposed amendments to the New Rules would apply from the 2016 tax year. If implemented in the proposed form, the amendments will be welcomed by many individuals, families, and industry members. As drafted, the proposals provide more flexibility with respect to the taxation of capital gains and the period for claiming C.D.T.C.'s. They also restore a perceived sense of fairness to the taxation of spousal and similar trusts.

In the coming months, individuals with estate plans developed in contemplation of the New Rules should revisit planning done prior to the proposed amendments. Others should evaluate how the Department of Finance's proposed amendments will affect their estates and planned charitable giving.

U.K. ADOPTS PUBLIC REGISTER OF PEOPLE WITH SIGNIFICANT CONTROL OVER U.K. CORPORATIONS

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INTRODUCTION

With effect from April 6, 2016, U.K. companies and L.L.P.'s are required to maintain a statutory register setting out the individuals who are considered "persons with significant control" ("P.S.C.'s"). The requirement was introduced by the Small Business, Enterprise and Employment Act 2015 and is designed to create more transparency around the ownership of companies.[1]

With effect from June 30, 2016, U.K. companies and L.L.P.'s will be subject to a further requirement to register that information with Companies House. The P.S.C. information will be available to the public.

POLITICAL CONTEXT

International pressure for transparency has been a recurring theme in recent years, as transparency has become increasingly high on many political agendas. Its proponents have included the G-20, the Financial Action Task Form ("F.A.T.F."), and the International Monetary Fund ("I.M.F."), and it was also the focus of E.U. anti-money laundering directives.

The immediate genesis of this particular measure began life in 2013, as a personal commitment by the U.K.'s prime minister, David Cameron, to introduce a public register of beneficial ownership. It was certainly a brave move, and businesses were alarmed. It was also unexpected, given that Prime Minister Cameron had previously decided to withdraw a proposal for public registers from the Lough Erne G-8 agenda – in part on the basis that other G-8 countries were unlikely to endorse the proposal.

As part of the consultation process that followed, a number of bodies, including the Law Society, voiced concerns. Inevitably, many of the concerns were based on issues of personal privacy. Policy initiatives preserving personal privacy are increasingly maligned, but few would suggest that public policy requires us to make available on Google the contents of our bank accounts or other statements of personal wealth. Yet, as significant wealth is held through the medium of companies, commentators have argued that this is exactly the effect of a public register of beneficial ownership of shares. The U.K. takes for granted its (relative) political stability and assurance of personal security. However, this position is not mirrored in all jurisdictions.

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[1] The authors would like to acknowledge the contribution of Alice Foster, trainee solicitor at Memery Crystal LLP. Ms. Foster will qualify into the corporate department of the Firm in September 2016.

There was also particular concern that the U.K. would be the first jurisdiction to create and maintain a central public register of beneficial ownership. Investment might therefore be diverted from the U.K. to other jurisdictions. Although many jurisdictions have paid lip service to the concept of transparency and there are a number of supranational efforts to introduce further disclosure, this is generally limited to disclosure between government agencies (in particular, tax collection agencies). Although a number of jurisdictions offer information to the public in relation to the share registers of companies, the U.K. is the first to extend the breadth of transparency to include ultimate beneficial ownership, as opposed to nominee ownership.

PERSON OF SIGNIFICANT OF CONTROL DEFINED

The legislation is complex, but essentially, a P.S.C. is someone who meets one or more of the following conditions:

- Directly or indirectly owns more than 25% of the share capital
- Directly or indirectly controls more than 25% of the voting rights
- Directly or indirectly holds the right to appoint or remove a majority of the board of company directors
- Exercises, or holds the right to exercise, significant influence or control over a company
- Exercises, or holds the right to exercise, significant influence or control over activities of a trust or firm which itself meets one or more of the first four conditions

The legislation contains detailed provisions relating to the interpretation of these conditions and includes anti-avoidance provisions.

In the vast majority of cases, it will be easy to determine whether any particular individual is a P.S.C. – it will be a straightforward binary analysis. However, in the context of more complex structures, the determination will be much more difficult. For example, convoluted cross-border investment structures comprising share capital of different classes, shareholder agreements, and investment agreements will require a lengthy, cumbersome, and undoubtedly expensive analysis. The legislation is designed to identify ultimate beneficial ownership – these are individuals, not companies or other legal entitles. Therefore, there are provisions to "look-through" intermediate entities.

The government has recognized that the exercise will be difficult in certain circumstances, and has published extensive draft guidance. Nonetheless, it advises also that it is likely that companies will require expert advice in difficult cases, particularly given that failure to comply with the legislation can result in fines and imprisonment.

EXEMPTIONS TO MANDATORY DISCLOSURE

Given that the obligations created by the legislation are onerous, the availability of exemptions was fiercely debated at the consultation stage.

Listed companies

A significant number of companies will benefit from the exemption available to listed companies. Broadly, and on the basis that their significant shareholdings are already in the public domain, the following companies are not required to complete and maintain a P.S.C. register:

- Companies that are subject to D.T.R. 5 (Disclosure and Transparency Rules), which includes companies on the Main Market, A.I.M., and I.S.D.X. Growth Market
- Companies that are admitted to trading on a regulated market in an E.E.A. state (other than the U.K.)
- Companies listed on certain markets in Israel, Japan, Switzerland, and the United States

However, these exemptions do not simply flow through to any U.K. subsidiaries. Further, the exemption from these rules for A.I.M. and I.S.D.X. Growth Market companies is likely to fall away in July 2017, when the fourth E.U. anti-money laundering directive comes into force.

Protection Regime

The legislation also provides for a "protection regime," which allows a company to apply to Companies House on behalf of the P.S.C., requesting that Companies House refrain from publicly disclosing information about the P.S.C. if the company reasonably believes that the disclosure will expose the P.S.C. to the risk of violence or intimidation. Thus, there is still a requirement to disclose *vis a vis* Companies House; however, there is no further obligation on the company to make this information publicly available. The draft guidance states that applications will be assessed on a case-by-case basis, and there is no set list of circumstances in which protection will be granted.

INFORMATION THAT MUST BE DISCLOSED ON THE P.S.C. REGISTER

For individuals on the P.S.C. register, certain personal information will need to be disclosed, including name, service address, nationality, date of birth, and usual residential address. The P.S.C. register will also include details of the nature of the control exercised by the P.S.C.

U.K. companies and L.L.P.'s will have to file the information on their P.S.C. registers with an Annual Return (to be renamed as a Compliance Statement). The information must be filed with Companies House at least once every 12 months, from June 30, 2016, and the P.S.C. register must also be made available for inspection at the entity's registered office from April 6, 2016.

TERRITORIAL AMBIT AND ENFORCEMENT

The legislation applies to companies and other bodies corporate incorporated under the U.K. Companies Act and to L.L.P.'s formed under the Limited Liability

Partnerships Act 2000. It does not apply to the overseas subsidiaries of U.K. companies, for example.

The legislation requires an affected company to take reasonable steps to find out if it has any registrable P.S.C.'s and, if so, to identify them. The company must then record the requisite details in its P.S.C. register. Failure to maintain a register or take reasonable steps to find and identify P.S.C.'s will make the company liable to a fine and its director(s) liable to a fine and imprisonment. However, many individuals may be P.S.C.'s in relation to U.K. companies without having ever set foot in the U.K. This raises the following questions of fairness:

- How can a company elicit the required information?

- What are reasonable steps in these circumstances?

The legislation contemplates that the company will submit a notice to the potential P.S.C. requesting the information. It is a criminal offense for a person to fail to comply with a notice sent by a company. Further, the legislation allows the company to impose restrictions on shares or rights held by an individual if he or she does not comply with the terms of a notice.

"Effectively, the register relies on self-reporting only. There are no procedures in place for systematic and objective verification."

But, what if the company receives plainly inaccurate information? Is it under an obligation to investigate further? What steps are "reasonable" steps? And, more importantly, what steps are *not* "reasonable" steps? If a shareholder sent back a return stating that his full name was Mickey Mouse and his address was on Pluto, presumably it would be difficult for the company to claim that it had taken reasonable steps. But where does the boundary lie? What degree of investigation is required?

The government's draft guidance states the following:

> 2.3.1 You must take reasonable steps to determine whether any individual or any legal entity meets the conditions for being a P.S.C. or registrable [relevant legal entity] in relation to your company, and if so, who that person or registrable [relevant legal entity] is. It may be that, having taken these steps, you cannot identify the person or confirm their details, but failure to take reasonable steps is a criminal offence.

The draft guidance does therefore anticipate the possibility that it may not be feasible to identify the control by the company. However, it offers little else by way of guidance.

Further, there is no system for the verification of information. This was one of the objections voiced by a number of commentators during the consultation process. Effectively, the register relies on self-reporting only. There are no procedures in place for systematic and objective verification, which leads to the following two questions:

- Are there enough regulations to ensure that the data reported is reliable?

- Is a system that elicits and stores inaccurate information worse than no system at all?

When this objection was raised during consultation, the response was that if an entry was incorrect, public scrutiny would identify and report it. This seems weak at best and, given that the consequent penalties are criminal in nature, arguably wholly inadequate. Commentators have questioned the propriety of having the accuracy and verification of U.K. government regulation dependent on the N.G.O. community's agenda – a largely unregulated but politically powerful sector.

RECENT (IRONIC) DEVELOPMENTS

Transparency has moved further up the current political agenda with the recent unprecedented leak from Panamanian law firm Mossack Fonseca. The sheer scale of the leak has been dramatic, as has the number of high-ranking government officials that have been implicated. Ironically, given that he has been the prime protagonist in the development of the world's first publicly-available register of beneficial ownership of companies, Prime Minister Cameron has suffered in particular as a result of disclosures about the nature and background of his family's wealth.

As a result of the leak, tax and law enforcement agencies in the U.K., Germany, France, Italy, and Spain have agreed to additional data-sharing arrangements and are now seeking to establish cross-border company register information. However, although this is demonstrative of the continued drive for transparency, this information sharing is still at government level only and, therefore, can be clearly distinguished from the substantive content of the U.K.'s P.S.C. register. The U.K. remains the only jurisdiction to have implemented this type of legislation.

Some will be irritated by the continued assumption by the media (the good and the bad) that "offshore" jurisdictions are all created equal. For a start, the term "offshore" means different things to different people. In this context, "offshore" is widely used as a pejorative shorthand to suggest tax evasion, organized crime, terrorism, arms trade, or drug dealing.

The evidence suggests otherwise. A recent academic study, "Global Shell Games,"[2] looked at compliance with F.A.T.F. guidelines. In summary, the authors posed as consultants wishing to form a shell company. They sent emails asking over 3,500 different incorporation agents in 182 jurisdictions to form companies for them. Overall, 48% of the agents who replied failed to ask for proper identification. Almost half of these did not want any documentation at all.

The authors compiled a table of compliance, ranking jurisdictions in terms of their compliance. It makes for interesting reading. The following is an extract from the authors' conclusions:

> One of the biggest surprises of the project was the relative performance of rich, developed states compared with poorer, developing countries and tax havens.… The overwhelming policy consensus, strongly articulated in G20 communiqués and by many NGOs, is that tax havens provide strict secrecy and lax regulation, especially when it comes to shell companies. This consensus is wrong. The Dodgy Shopping Count for tax havens is 25.2, which is in fact much higher than the score for rich, developed countries at 7.8 – meaning

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2 Michael G Findley, Daniel L Nielson and JC Sharman, *Global Shell Games: Experiments in Transnational Relations, Crime and Terrorism*, (Cambridge: Cambridge University Press: 2014).

it is more than three times harder to obtain an untraceable shell company in tax havens than in developed countries. Some of the top-ranked countries in the world are tax havens such as Jersey, the Cayman Islands and the Bahamas, while some developed countries like the United Kingdom, Australia, Canada and the United States rank near the bottom of the list. It is easier to obtain an untraceable shell company from incorporation services (though not law firms) in the United States than in any other country save Kenya.

THE ROAD AHEAD

Perhaps the most controversial aspect of the new provisions has been the requirement not just to collate information on the ultimate beneficial ownership of companies, but to make it publicly accessible. Recent developments notwithstanding, no other jurisdictions have made firm commitments to introduce equivalent measures.

No doubt the rest of the world will be watching the U.K. with interest over the coming months. The measures will undoubtedly add to the burden of doing business through a U.K. company – in some cases, considerably. Whether the benefits of that burden will be worthwhile remains to be seen. If the data is inaccurate, what will have been achieved but another layer of costly administration and a deterrent to doing business through U.K. entities? Anecdotal evidence suggests that reputable tax advisers try not to associate with criminals, and it seems likely that criminals are not much interested in accurate self-certification for government authorities.

As a final point, the lack of certainty surrounding a company's "reasonable" attempts to obtain information is of particular concern, particularly given that failure to make such efforts carries criminal penalties. In a sense, the requirement to maintain the P.S.C. register is simply an expansion of F.A.T.C.A. and the C.R.S. from financial institutions to everyday companies with an added twist: a failure to comply with an undefined standard of reasonableness elicits criminal penalties for non-performance. In the world of F.A.T.C.A., noncompliance is burdened only with withholding tax.

"Transparency has moved further up the current political agenda with the recent unprecedented leak from Panamanian law firm Mossack Fonseca. . . . Cameron has suffered in particular as a result of disclosures about the nature and background of his family's wealth."

EXCHANGE OF INFORMATION: ISRAEL INCHES TOWARD INTERNATIONAL NORMS

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INTRODUCTION

The State of Israel has always invested a large amount of effort to attract people from around the world to immigrate to Israel and to invest their funds in Israel.

As part of these efforts, Section 14 of the Israeli Income Tax Ordinance stipulates that when a person becomes a new Israeli resident, Israel grants the individual a ten-year exemption from disclosing to the Israeli tax authorities any information regarding non-Israeli assets, sources of income, and capital gains. This tax holiday also applies to senior returning residents who resume Israeli residency after residing overseas for at least ten years.

Some global tax policy officials claim that Israel has blindly accepted the source of funds that were invested in Israel by new immigrants and that it disregarded the possibility that the investments were made with the proceeds of tax evasion in other countries. For this reason, it is claimed that Israel has not been eager to disclose information regarding these funds and assets to other states.

PERSPECTIVE

The lack of willingness to disclose fiscal information between states has been a standard practice among nations, as evidenced in early multilateral conventions. One of the first conventions to deal with legal assistance between countries was the European Convention on Mutual Assistance in Criminal Matters 1959 (the "Strasbourg Convention").[1] The Strasbourg Convention specifically stipulated in Article 2 that any legal assistance may be refused in regard to fiscal offences.

Israel has adopted and ratified the Strasbourg Convention. However, in parallel to this convention, Israel, like many other states, has signed numerous double taxation treaties that call for exchange of information ("E.O.I.") regarding tax matters. In most double taxation treaties, the E.O.I. clause allows each Member State the sovereignty to decide whether or not it wishes to disclose information. Israel generally has preferred to maintain its sovereignty rather than willingly promote E.O.I. regarding assets and income located in Israel.

RECENT DEVELOPMENTS

Recently, Israel has reversed its prior position and has moved to establish an active E.O.I. policy. This is partly due to Israel's desire to obtain information regarding

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1 European Convention on Mutual Assistance in Criminal Matters, CETS No.030, Strasbourg, April 20, 1959.

financial activities of Israeli residents abroad and partly due to the worldwide trend toward breaking all secrecy barriers between tax authorities and financial institutions. As a result, effective January 2016, Israel has instituted new laws that will enable it to join international conventions and treaties relating to the disclosure and exchange of information regarding income and assets in Israel. Consequently, Israel will provide financial information to other foreign tax authorities. In turn, Israel will receive financial information relating to its residents.

The new laws enable Israel to join the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (the "M.L.A.T. Convention").[2] As we will show, joining the O.E.C.D. Convention does not necessarily mean that Israel will in fact abandon its historical position of preferring sovereignty over disclosure.

Israel Joins the M.L.A.T. Convention

As mentioned above, on November 24, 2015, Israel joined the M.L.A.T. Convention, making it the 91st jurisdiction to join.[3]

The M.L.A.T. Convention obligates the Member States to exchange information with each other concerning income and assets of residents of the Member States. The information can be used by the receiving state only for income tax purposes. Information is made available on a reciprocal basis between each of two states under existing Tax Information Exchange Agreements.

The M.L.A.T. Convention applies to a wide range of taxes, including taxes on income; capital gains; net wealth; compulsory social security; estates, inheritances, or gifts; immovable property; and consumption, such as value added tax ("V.A.T."), or sales; etc.[4]

The Israeli State Revenue Administration in the Ministry of Finance has stated that Israel will enforce the M.L.A.T. Convention on direct taxes only, not including social security payments.[5] This means that the Israeli law regarding E.O.I. will not be imposed on indirect taxes, especially V.A.T. Another interesting question is with regard to real estate tax. Israel may claim, that real estate tax is not covered by the M.L.A.T. Convention. This means that Israel may decide not to transfer information regarding the purchase and sale of real estate in Israel. Furthermore, Israel will not enforce the M.L.A.T. Convention's provisions on assistance in tax examinations abroad or on tax collection and service of documents, a decision which will not be addressed in this article.

Under the M.L.A.T. Convention there are five methods of exchanging information: E.O.I. on request, automatic exchange of information ("A.E.O.I."), spontaneous E.O.I., simultaneous tax examinations, and tax examinations abroad. Each Mem

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[2] O.E.C.D. and Council of Europe, *Multilateral Convention on Mutual Administrative Assistance in Tax Matters: Amended by the 2010 Protocol*, (Paris: O.E.C.D. Publishing, 2011), last modified February 2016 (the "*O.E.C.D. Convention*").

[3] O.E.C.D., "Israel Joins International Efforts to Boost Transparency and End Tax Evasion," news release, Nov. 24, 2015; Ministry of Finance, "Israel Signed the Multilateral Convention on Mutual Administrative Assistance in Tax Matters," news release, Nov. 25, 2015.

[4] *O.E.C.D. Convention*, art. 2.

[5] "Israel Signed the Multilateral Convention."

ber State can decide at its sole discretion whether or not to transfer information to other Member States by using one or more of these methods.

E.O.I. on Request

Upon the request of a Member State (the "Applicant State"), the Member State receiving the request (the "Requested State") must provide the Applicant State with any relevant information that concerns particular taxpayers or transactions. In order to comply with the request for information, the Requested State must provide information available in its tax files. It must also take all relevant measures to provide the Applicant State with the information requested.[6]

"Under the M.L.A.T. Convention there are five methods of exchanging information: E.O.I. on request, A.E.O.I., spontaneous E.O.I., simultaneous tax examinations, and tax examinations abroad."

_A.E.O.I._

The M.L.A.T. Convention does not specify the way to conduct A.E.O.I., and in this respect, the O.E.C.D. published the Standard for Automatic Exchange of Financial Account Information in Tax Matters (the "Standard") on July 21, 2014.[7]

The Standard calls for Member States to obtain information from domestic financial institutions and automatically exchange that information with other Member States on an annual basis. The Standard also determines the type of financial information to be reported and exchanged, the different types of accounts and taxpayers covered, and the common due diligence procedures to be followed by domestic financial institutions.

According to the Standard, financial institutions (*e.g.*, banks and insurance companies) will determine a process for identifying account owners that are residents of foreign countries. The financial institutions will then collect information with respect to such account holders and transfer that information to the relevant tax authorities in the other Member State. This information will include balances and financial revenues of foreign account holders.[8]

Given the importance of implementing A.E.O.I., competent authorities from over 79 jurisdictions have signed the Common Reporting Standard Multilateral Competent Authority Agreement (the "C.R.S. M.C.A.A."), which implements the Standard and specifies the details of what information will be exchanged and when. While the C.R.S. M.C.A.A. is multilateral, the actual A.E.O.I. will be implemented bilaterally.[9]

Israel has yet to join the C.R.S. M.C.A.A. However, on October 27, 2014, the Israeli Ministry of Finance notified the O.E.C.D. that it will adopt the procedure for the automatic exchange of financial account information for tax purposes (referred to as the "Common Reporting Standard" or the "C.R.S.") by the end of 2018. The procedure will be implemented via an agreement between the relevant authorities in countries complying with the procedure.[10]

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6 *O.E.C.D. Convention*, art. 5.

7 *Id.*, art. 6; O.E.C.D., *Standard for Automatic Exchange of Financial Account Information in Tax Matters*, (Paris: O.E.C.D. Publishing, July 21, 2014) ("*The Standard*").

8 *The Standard*.

9 *O.E.C.D. Convention*; O.E.C.D., "The CRS Multilateral Competent Authority Agreement (MCAA),"

10 Ministry of Finance, "Israel to Adopt OECD Procedure for the Automatic Exchange of Financial Account Information," news release, Oct. 27, 2015.

Spontaneous E.O.I.

A party can spontaneously forward information to another party in the following circumstances:[11]

- A party concludes that there may be a loss of tax in the other party jurisdiction.
- A taxpayer obtains a reduction or exemption from tax in a party jurisdiction, which may result in an increase in tax or liability to tax in the other party jurisdiction.
- Business dealings between two taxpayers from different party jurisdictions are conducted through one or more countries in a way that may result in tax savings in one of the party jurisdictions, or in both.
- A party concludes that tax savings may result from artificial transfers of profits within a group of enterprises.
- Information forwarded to a party by the other party may be relevant in assessing the tax liability in the latter party jurisdiction.

Simultaneous Tax Examinations

Two or more parties shall consult with each other and determine cases and procedures for simultaneous tax examinations. During these examinations, two or more parties are each conducting domestic investigations into the tax affairs of a taxpayer or taxpayers in which they have common or related interest. The purpose of these examinations is that each state will exchange any relevant information it obtains during the examinations.[12]

Tax Examinations Abroad

The competent authority of the Applicant State can request to be present in tax examinations conducted by the competent authority of the Requested State. The Requested State can refuse to include the Applicant State in its examination, and even if it decides to allow the request, all decisions with respect to the conduct of the tax examination shall only be made by the Requested State.[13]

Israel Amends Tax Laws Regarding E.O.I. with Certain Reservations

On November 19, 2015, a week before joining the M.L.A.T. Convention, the Israeli parliament, the Knesset, approved a bill to increase enforcement of the M.L.A.T. Convention against tax evaders (the "Bill").[14] As of January 1, 2016, the Bill enables the director of Israeli Tax Authority (the "I.T.A.") to transfer information to a foreign country according to an international treaty for enforcement under the tax laws of that country.[15]

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11 *O.E.C.D. Convention*, art. 7.

12 *Id.*, art. 8.

13 *Id.*, art. 9.

14 The Law of Amending the Income Tax Ordinance (No. 207) - 2015.

15 Ministry of Finance, "The State of Israel Increases Enforcement Ability Against Tax Evaders," news release, Nov. 22, 2015.

The main goal of the Bill was to enable Israel to join the M.L.A.T. Convention. However, the Bill stipulates additional conditions that allow Israel to disregard provisions of the M.L.A.T. Convention. These additional conditions give precedence to the sovereignty of the I.T.A. (which may decide whether or not to transfer information) over the promotion of E.O.I. with other Member States.

"The Bill stipulates additional conditions that allow Israel to disregard provisions of the M.L.A.T. Convention. These additional conditions give precedence to the sovereignty of the I.T.A."

According to the Bill, the director of the I.T.A. (the "Director") may transfer information to a "Foreign Tax Authority" according to an international agreement, subject to the following conditions:

1. If the information is transferred at the initiative of the Director, it should be verified that the requested information is needed for the enforcement of the domestic tax law of the foreign Member State.[16]

2. If the information is transferred at the request of the Foreign Tax Authority, the Director should be convinced that the foreign requesting country requires the requested information in order to enforce its domestic tax law.[17]

3. The I.T.A. is allowed to use the requested information in order to enforce its domestic tax law.[18]

4. The foreign country is committed to the confidentiality and safekeeping of the requested information, as determined by an international agreement.

5. The Foreign Tax Authority uses the information solely for the purpose of enforcement of its domestic tax law.

6. The Foreign Tax Authority will transfer the information to other institutions in the foreign country solely for the purpose of enforcing its domestic tax law.

7. The Foreign Tax Authority will not transfer the information to other countries.[19]

8. The I.T.A. is allowed (under current Israeli tax law) to decide to withhold information from a country that does not keep up with international standards of E.O.I.

9. The I.T.A. will notify an Israeli resident, in the case of a request for information, at least 14 days before transferring the information, unless the requesting country has asked for secrecy.

10. No information will be transferred to a Foreign Tax Authority according to an international agreement if such transfer of information could harm Israel's national security, public safety, pending investigations, public policy, or any other matters that are vital to the State of Israel.[20]

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[16] It remains to be seen how Israel will interpret this provision.

[17] This provision may also be widely interpreted by Israel and may result in the refusal of an information disclosure to another country.

[18] "Tax law" is defined as a law that deals with the imposition of tax or with a mandatory payment that it is the responsibility of the Finance Minister to execute.

[19] It is interesting to see that sections 5, 6, and 7 only apply to Foreign Tax Authorities and the I.T.A. is not subject to these provisions at all.

[20] This provision may also be widely interpreted and may lead to the refusal to transfer information to other countries.

CONCLUSION

Today, even after Israel has amended its domestic law and joined the M.L.A.T. Convention, Israel's intention seems to remain the same – to obtain information with respect to its residents but not to allow for disclosure of any information to other countries where such disclosure fails to meet protective provisions under Israeli domestic law. It seems that both the new law and the provisions of the M.L.A.T. Convention do not damage the sovereignty of Israel to deny any disclosure of information.

There is no question that as long as Israel does not amend the provisions of the tax holiday given to new immigrants and senior returning residents, these individuals will be allowed to deny the I.T.A. any information regarding their foreign assets and income, and Israel will thus be unable to disclose information it does not possess.

The one exception that may have a crucial effect on the balance between sovereignty and disclosure relating to Israeli-based assets and income is the A.E.O.I. procedure, under which a Member State truly loses its ability to decide what information is disclosed to other Foreign Tax Authorities. Israel has not established a plan to implement A.E.O.I. procedures and so far has not changed its laws in this respect. According to the current Israeli law, the I.T.A. is not entitled to receive any kind of information from Israeli banks and such information can only be obtained from individual taxpayers or by a court order in connection with an on-going criminal investigation. However, it is expected that Israel will adopt A.E.O.I. procedures by the end of 2018.

Although A.E.O.I. has yet to be implemented in Israeli law, this procedure has definitely changed the way Israeli banks operate – and did so long before Israel even joined the M.L.A.T. Convention. Today, all domestic Israeli banks require that information regarding the tax residency of the account owner must be provided at the time of account opening. In addition, each account owner must sign a waiver in order to protect the bank in the event it discloses information relating to the account to the I.T.A. or to any Foreign Tax Authority.

The interesting question remains whether Israel will truly agree to relinquish its sovereignty and its historical objective of promoting immigration from around the world and allowing immigrants to bring funds with them under assurance of confidentiality.

INDIA BUDGET 2016-17

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Tags
2016 Budget
B.E.P.S.
Dividend Declaration Tax
India

INTRODUCTION

The Indian Finance Minister presented the Union Budget for 2016-17 (“Budget 2016-17”) and Finance Bill, 2016 in Parliament on February 29, 2016. Along with proposed amendments to the tax law, key economic figures (as per the annual economic survey) and policy proposals were also announced.

The proposals indicate that India is poised to experience sustainable growth, owing to favorable macro-economic factors and demographics, rising income, greater urbanization, and increasing focus on manufacturing activities. The positive domestic outlook is offset by turmoil in the global economic climate, characterized by uncertainty, low growth, and turbulent financial markets. For financial year (“F.Y.”) 2016-17, the International Monetary Fund (“I.M.F.”) projects 7.5% growth in India, while the estimates for global economic growth plummeted from 3.4% for 2014 to 3.1% for 2015. The negative Wholesale Price Index (“W.P.I.”) of -2.8% and a reduction in the Consumer Price Index (“C.P.I.”) from 5.9% in F.Y. 2014-15 to 4.95% in F.Y. 2015-16 highlight the stability of the Indian economy. Adherence to the fiscal deficit target of 3.5% is a sign of the Indian government’s commitment to fiscal discipline.

Budget 2016-17 places an emphasis on infrastructure development, financial sector reforms, ease of doing business, education and skill development, and job creation.

This article focuses on key proposals of Finance Bill, 2016.

POLICY ANNOUNCEMENTS

Infrastructure and Investment

- Total outlay of I.N.R. 2.18 trillion (approximately $32.5 billion) is proposed for roads and railways.
- A bill is to be introduced regarding resolution of disputes in infrastructure-related construction contracts and Public Private Partnership (“P.P.P.”) and public utility contracts. Guidelines will be issued for renegotiation of P.P.P. Concession Agreements.
- A dedicated fund is to be set up by the Life Insurance Corporation of India (“L.I.C.”) to provide credit enhancement to infrastructure projects.
- A new credit rating system is to be set up for infrastructure projects.

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Fiscal Discipline

- The fiscal deficit will be set as a target range rather than a fixed number, by way of an amendment to the Fiscal Responsibility and Budget Management Act, 2003 ("F.R.B.M. Act").

Relaxation of Foreign Direct Investment ("F.D.I.") Policy

- 100% F.D.I. will be allowed in marketing of food products produced and manufactured in India under the Foreign Investment Promotion Board ("F.I.P.B.") approval route.
- Investment in insurance and pension sectors will be allowed up to 49% under the automatic route for government approval.
- 100% investment in asset reconstruction companies will be permitted under the automatic route for government approval.
- The investment limit by foreign entities in Indian financial exchanges will be increased from 5% to 15%, which is on par with domestic institutions.
- The investment limit for Foreign Portfolio Investors ("F.P.I.'s") investing in listed central public sector enterprises (other than banks) will be increased to 49%.
- F.D.I. will be allowed in additional activities beyond the 18 Non-Banking Financial Company activities specified under the automatic route for governmental approval.
- Hybrid instruments will be included among eligible F.D.I. instruments.

Financial Sector

- A comprehensive code on the resolution of bankruptcy situations of financial firms will be introduced.
- New derivative products are to be developed by the Securities and Exchange Board of India ("S.E.B.I.") in the commodity derivatives market.
- A proposed I.N.R. 2.50 billion (approximately $37.5 million) will be devoted to recapitalization of public sector banks.

Governance and Ease of Doing Business

- Amendments will be made to the Companies Act, 2013 to improve ease of doing business and to enable the registration of companies in a single day.

INCOME TAX PROPOSALS

Most direct tax proposals in Finance Bill, 2016 are effective from F.Y. 2016-17, *i.e.*, from April 1, 2016 unless otherwise specifically stated.

Tax Rates

The basic tax rates for domestic and foreign companies will remain unchanged, at

30% and 40%, respectively. Separately, for companies having turnover or gross receipts not exceeding I.N.R. 50 million (approximately $750,000) in F.Y. 2014-15, the basic rate of tax will be reduced to 29%.

Newly-established[1] domestic companies engaged in the business of manufacturing will have an option to pay tax at a reduced basic rate of 25%. Companies that exercise this option will not be eligible for deductions and reliefs that are otherwise allowable, except for the deduction for compensation paid to additional workmen employed.

"Newly-established domestic companies engaged in the business of manufacturing will have an option to pay tax at a reduced basic rate of 25%."

The basic rate of tax for individuals will remain unchanged. However, the rate of surcharge that is levied on the amount of income tax will be increased to 15% for individuals earning income in excess of I.N.R. 10 million (approximately $150,000) in any financial year.

The basic rates of tax for Minimum Alternate Tax ("M.A.T.") and Dividend Distribution Tax ("D.D.T.") will remain unchanged, at 18.5% and 15%, respectively.

Taxation of Dividend Income Exceeding I.N.R. 1 Million

Under existing domestic tax law, where a dividend is paid by an Indian company, the Indian company is required to pay 15% D.D.T. on the amount of the dividend, plus a surcharge and education cess.[2] Once these amounts are paid, the dividend is exempt from further tax in the hands of the recipient, whether resident or nonresident ("N.R.").

It is now proposed that dividends received by resident individuals and firms in excess of I.N.R. 1 million (approximately $15,000) will be taxed at 10%, on a gross basis. If implemented, this proposal will have numerous adverse consequences. Most notably, it will amount to the same income being taxed three separate times:

- Corporate tax imposed on the corporation
- D.D.T. imposed on the corporation
- Proposed tax of 10% on the shareholder

This provision also has the effect of discriminating between residents and N.R.'s. Further, it will adversely affect promoters holding shares directly and may lead to disputes over the taxability of dividends in the case of taxable non-business trusts that receive dividends exceeding I.N.R. 1 million, even if the shares of individual beneficiaries are less than I.N.R. 1 million.

Provisions Relating to N.R.'s

Equalization Levy to Tax B2B E-commerce Transactions

It is proposed that a 6% "equalization levy" will be charged on the gross amount of consideration for specified services received or receivable by an N.R. that does not have a permanent establishment ("P.E.") in India when the consideration is received from residents carrying on a business or profession in India or N.R.'s having a P.E. in India.

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1 *I.e.*, incorporated on or after March 1, 2016.

2 A cess is a type of tax levied by the Indian Tax Authorities, which must be used for a particular purpose, here education.

No levy will be charged in any of the following fact patterns:

- The N.R. providing the specified service has a P.E. in India and the specified service is connected with the P.E.
- The total consideration received/receivable by the N.R. does not exceed I.N.R. 100,000 (approximately $1,500) in any F.Y.
- The services are not provided for the purpose of carrying on a business or profession.

Income on which the equalization levy is charged will be exempt from income tax.

The payer of a consideration that is subject to the equalization levy will be required to deduct the levy from the amount payable to an N.R. If no deduction is made by the payer, a deduction for the entire consideration will be disallowed in computing the income of the payer.

Procedures for collection of the levy, interest, penalties, and prosecution are in *pari materia* with withholding tax provisions under the domestic tax law.

This provision has been introduced to extend the scope of taxation to transactions relating to the digital economy and is based on the recommendations of the O.E.C.D. committee on base erosion and profit shifting ("B.E.P.S."). At present, income from digital economy transactions is not taxable in India, in accordance with India's Double Taxation Avoidance Agreements ("D.T.A.A.'s"), since the relevant foreign entities do not maintain a P.E. in India. However, these transactions are intended to be brought under the ambit of taxation by way of introduction of the equalization levy.

"It may be noted that the amount of equalization levy paid in India may not be available as a credit in the home country of the N.R., as this amount is per se not a 'tax' under the domestic tax law."

However, it may be noted that the amount of equalization levy paid in India may not be available as a credit in the home country of the N.R., as this amount is *per se* not a "tax" under the domestic tax law. For U.S. companies that provide services to Indian clients from locations in the U.S., the income is domestic-source income. Consequently, even if the tax is an income tax under U.S. concepts, it cannot be used to offset U.S. income tax on the consideration received.

The proposed amendment will be effective from a date to be stipulated by the Indian government.

Tax Incentives for International Financial Services Centers ("I.F.S.C.'s")

Various incentives are proposed with regard to entities set up in an I.F.S.C. to enable the I.F.S.C.'s to become international financial hubs.

Securities Transaction Tax ("S.T.T.") will not be payable on transactions in securities undertaken on a recognized stock exchange located in an I.F.S.C. In addition, the existing exemption from Long Term Capital Gains ("L.T.C.G.'s") will be extended to transactions undertaken in foreign currency on a recognized stock exchange by an entity located in an I.F.S.C., even if no S.T.T. is paid on such transactions.

Companies located in an I.F.S.C. will be entitled to pay M.A.T. at a reduced rate of 9%, if the income of such companies is derived solely in foreign exchange.

Further, no tax will be levied on distributions of profits by a company located in an I.F.S.C. that derives income solely in foreign exchange, and such dividend income will also not be taxable in the hands of the recipient.

These are welcome measures to promote the growth of I.F.S.C.'s.

Application of M.A.T. to Foreign Companies for the Period Prior to April 1, 2015

The issue of the application of M.A.T. on foreign companies has been a matter of long-standing debate.

It has been now clarified that M.A.T. will not be applicable to foreign companies with effect from F.Y. 2000-01, if

- the foreign company is a resident of a country or specified territory with which India has a D.T.A.A. and such company does not have a P.E. in India, or
- the foreign company is a resident of a country with which India does not have a D.T.A.A. and such company is not required to seek registration under the Companies Act in India.

This clarification will be greatly appreciated by foreign companies.

Rationalization of Withholding Tax Provisions for Categories I and II Alternative Investment Funds ("A.I.F.'s")

Income of the fund that is not business income will be exempt in the hands of the fund. In addition, income received by the investor from the investment fund, other than specified income that is taxed at the fund level, will be taxable in the hands of investor in the same manner as if the investment were made directly by investor.

The person responsible for making the payment to the investor will be required to withhold tax at 10% where the payee is a tax resident. If the payee is an N.R., the rate will be specified and may change from time to time. A certificate for deduction of tax at a lower rate may also be obtained from a tax officer.

This proposed amendment will be effective from June 1, 2016.

Country-by-Country ("CbC") Reporting

It is proposed that a three-tier structure will be implemented for transfer pricing documentation and CbC reporting, in accordance with the recommendations of the O.E.C.D. committee on B.E.P.S. Specified information will be required to be reported in the prescribed formats, if the consolidated revenue of the multinational enterprise ("M.N.E.") group exceeds the specified threshold.

- CbC reporting would involve the following:
- Local file – containing material transactions of the local taxpayer
- Master file – containing standardized information relevant to all M.N.E.'s in the group
- CbC reporting – containing information about global allocation of the M.N.E. group's income and taxes along with the location of economic activity within the M.N.E. group

> *"Certain incentives will be provided to eligible, certified, start-up companies to promote the growth of entrepreneurship and start-ups."*

Exemption of Income of a Foreign Company Accruing from the Storage and Sale of Crude Oil

Income accruing or arising to a foreign company from the storage of crude oil in a facility in India and the sale of the stored crude oil to any person resident in India will be exempt, provided that such storage and sale by the foreign company is made pursuant to an agreement entered into and/or approved and notified by the Indian government.

The proposed amendment will be effective retrospectively from F.Y. 2015-16.

Relaxation of the Conditions of the Special Taxation Regime for Offshore Funds

The provision dealing with certain activities that are not considered to constitute a business connection in India has been relaxed to include funds established, incorporated, or registered in a country or a specified territory that is identified by the Indian government. Also, the existing requirement preventing funds from controlling and managing any business in or from India has been diluted so that only activities carried on in India are subject to the prohibition.

Place of Effective Management ("P.O.E.M.") and the General Anti-Avoidance Rule ("G.A.A.R.")

Implementation of a P.O.E.M.-based residency test for foreign companies will be deferred to April 1, 2016. Under these rules, a foreign company is treated as being resident in India if its P.O.E.M. is in India; this means that key management and commercial decisions that are necessary for the conduct of its business, as a whole, are made in substance in India.

For G.A.A.R., the scheduled effective date of April 1, 2017, remains unchanged.

Exemption from the Requirement to Furnish a Permanent Account Number ("P.A.N.")

The higher rate of withholding tax in the absence of a P.A.N. will not apply to N.R. or foreign companies for payments of interest on long-term bonds or any other payments, subject to prescribed conditions.

Tax Incentives for Start-ups

Certain incentives will be provided to eligible, certified, start-up companies to promote the growth of entrepreneurship and start-ups. A 100% deduction of profits will be available to an eligible, certified, start-up company that is

- incorporated after March 31, 2016 but before April 1, 2019, and
- engaged in the business of innovation, development, deployment, or commercialization of new products, processes, or services driven by technology or intellectual property.

The deduction will be available for any consecutive three-out-of-five F.Y.'s after the date of incorporation of the start-up.

L.T.C.G. will be exempt if it is invested after March 31, 2016 in units of a fund that is identified by the Indian government as a qualified fund. The exemption is capped at

I.N.R. 5 million (approximately $75,000). Further, exemption will be provided if the L.T.C.G. is invested in the subscription of shares of a company that qualifies as an eligible start-up, subject to certain conditions.

Taxation of Income from Patents

A new section will be introduced to tax gross royalty income, at a concessional rate of 10%, arising from a patent developed and registered in India. However, M.A.T. provisions will be applicable to such companies. This provision will apply to a person resident in India, who is the true and first inventor.

D.D.T. on Distributions Made by a Special Purpose Vehicle ("S.P.V.") to a Business Trust

D.D.T. will not be imposed on distributions made by an S.P.V. to Real Estate Investment Trusts ("R.E.I.T.'s") or Infrastructure Investment Trusts ("Inv.I.T.'s") holding prescribed shareholdings. In addition, dividends received by R.E.I.T.'s or Inv.I.T.'s and their investors will be exempt from tax. The exemption is allowed only in respect of dividends paid out of current income generated after the date of purchase of shares of the S.P.V. by a R.E.I.T. or Inv.I.T. This proposal is expected to have a positive impact on the establishment of R.E.I.T.'s and Inv.I.T.'s. These collective investment vehicles have not been widely utilized by investors since their enactment.

Amortization of Spectrum Fees

A new provision is announced to provide for amortization of the amount actually paid to acquire rights to use radio frequency spectrum for telecommunication services. The amortization will be allowed in equal installments over the license period.

Disallowance of Expenditures Incurred in Connection with Exempt Income

Currently, under the domestic tax law, no deduction is allowed for expenses incurred in connection with earning income that is exempt from tax. In the absence of a one-to-one correlation between exempt income and the expenditure specifically incurred to earn such income, tax officers generally disallow a part of the total expenses claimed as a deduction by the taxpayer based upon a formula for computing the disallowance. In certain fact patterns, the amount of the disallowance can be greater than the actual expenditure incurred. This has been a long standing topic of dispute between taxpayers and tax examiners in India.

The budget announces provisions redressing the problem. The disallowance will be computed at 1% of average monthly value of investments yielding exempt income and will be capped at the amount of the actual expenditure. Implementation rules will be announced in coming months.

Phasing out of Deductions and Incentives

Certain profit-linked deductions and exemptions, included weighted deductions, will be phased out under the budget. In addition, the highest rate of depreciation will be restricted to 40% with effect from April 1, 2017.

Tax Dispute Resolution Scheme

In order to reduce the huge backlog of pending appeal matters, a new scheme for resolution of disputes will be introduced. The scheme relates to "tax arrears" in respect of matters pending before the first level appellate authority and "specified taxes" in respect of pending matters relating to retrospective amendments, as of February 29, 2016, and provides as follows:

Tax Arrears

- If the declarant pays the entire disputed tax demand plus interest up to the date of the scrutiny order, it will be deemed that the appeal has been withdrawn, and the taxpayer will be granted immunity from penalty and prosecution, subject to exceptions in the following paragraphs.
- If the disputed tax liability exceeds I.N.R. 1 million (approximately $15,000), a 25% minimum penalty will be due in addition to tax and interest.
- In the case of pending appeals against a penalty order, a 25% minimum penalty will be due in addition to tax and interest payable.

Specified Taxes

- The taxpayer will be required to pay the amount of disputed tax and will be granted immunity from interest, penalty, and prosecution.
- The taxpayer will be required to withdraw the relevant appeals, notices, or claims filed with an authority.

The proposed dispute resolution scheme will be effective from June 1, 2016.

Income Declaration Scheme, 2016

A new scheme will be introduced to provide an opportunity for taxpayers to disclose previously undisclosed domestic income, pertaining to the period up to F.Y. 2015-16. Tax will be payable at 30% on such income along with a 7.5% surcharge and a 7.5% penalty, resulting in an effective tax rate of 45%.

The proposed amendment will be effective from June 1, 2016, and the scheme will remain open till a date that will be notified subsequently.

Various other measures are proposed with a view to rationalize and simplify the taxation system and to transition toward a non-adversarial tax regime.

INDIRECT TAX PROPOSALS

Service Tax

- The 0.5% *Krishi Kalyan* cess has been introduced with effect from June 1, 2016 on all taxable services. Thus, the effective tax rate on services will be 15% considering the basic rate of service tax as well as the *Swachh Bharat* cess of 0.5%, which was introduced from November 15, 2015.
- Service tax exemptions in respect of the following services are withdrawn:
    - Construction services in respect of monorail and metro projects, to be taxed at a basic rate of 5.6% after abatement

- Air conditioned stage carriages, to be taxed at a basic rate of 5.6% (in line with service tax on contract carriages)
- Transport by cable car, ropeway, and tramway, to be taxed at 14%[3]

- Exemptions are given to the following services:
  - Housing projects under affordable housing schemes (*i.e.*, 30m^2 in four metropolitan areas and 60m^2 in other areas) are exempt as of March 1, 2016.
  - Services rendered by Pension Fund Regulatory and Development Authority/Employees Provident Fund Organization/Insurance Regulatory and Development Authority of India and S.E.B.I. are exempt as of April 1, 2016.[4]
  - Government-sponsored cold chain, biotechnology, and vocational training and cultural projects are exempt as of April 1, 2016.

"The 0.5% Krishi Kalyan cess has been introduced with effect from June 1, 2016 on all taxable services. Thus, the effective tax rate on services will be 15% considering the basic rate of service tax as well as the Swachh Bharat cess of 0.5%."

- A single premium insurance policy will attract service tax at 1.4%, rather than the existing 3.5% rate, from April 1, 2016.
- Service tax is levied on Indian shipping lines along with the full input tax credit ("I.T.C.") available, so as to ensure parity with foreign shipping lines.
- Service tax is levied on a receipt basis and payment of service tax is made on a quarterly basis for One Person Companies ("O.P.C.'s") and Hindu Undivided Families ("H.U.F.'s").
- The C.E.N.V.A.T. credit rules have been amended to give an option to banks and financial institutions to either reverse 50% of I.T.C. or reverse only part of the credit in proportion to exempt service turnover *vis a vis* total turnover.
- A clarification had been made that the allocation of radio frequency spectrum by the Indian government will be a taxable service and not a sale of intangible goods.
- Further clarifications include mutual exclusivity of application of service tax and excise duty on one taxable event.
- Interest rates and abatements have been rationalized in line with those applicable to customs duty and excise duty payments, except when the taxpayer has collected and not paid the service tax, in which case the rate of interest is increased to 24% per annum.
- The limit for prosecution for wrongful withholding of service tax has been increased to I.N.R. 20 million (approximately $300,000), from I.N.R. 10 million (approximately $150,000) under prior law.
- The limitation period for under-collection or underpayment of service tax has been extended from 18 months to 30 months when not attributable to fraud, collusion, or misrepresentation.

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[3] This will increase costs for tourists and hence may be a retrograde step, in so far as promoting India as a tourism destination is concerned.

[4] Previously only services rendered by the R.B.I. were exempt.

Excise Duty

- An infrastructure cess in the range of 1% to 4% will be levied on all motor vehicles, depending on the length of the motor vehicle, engine capacity, etc.
- The clean environment cess will be increased from I.N.R. 200 (approximately $3) per ton to I.N.R. 400 (approximately $6) per ton.

SUMMARY

Budget 2016-17 demonstrates the government's intent to promote balanced, long-term growth in India through fiscal discipline, infrastructure development, job creation, and tax and financial sector reforms. In particular, the focus on infrastructure projects has been praised by IMF chief Christine Lagarde.[5] Although Budget 2016-17 does not contain broad provisions aimed at attracting large multinational enterprises, it offers a number of more modest proposals, such as tax incentives to encourage investment through R.E.I.T.'s and Inv.I.T.'s, easing of restrictions on foreign direct investment, and benefits for start-ups and manufacturing businesses, which will strengthen the private sector and position India for sustainable, high growth rates on par with major global economies such as the U.S. and China.

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5 "India's Fiscal Stance Sensible: IMF's Christine Lagarde," NDTV, March 13, 2016, where Ms. Lagarde is quoted as saying:

> We consider that the fiscal stance adopted by India is exactly appropriate and a very sensible objective that has been set. It's just the right one that has been set under the given circumstances.

B.E.P.S. INITIATIVE SPAWNS UNFAVORABLE PERMANENT ESTABLISHMENT COURT DECISIONS

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Tags
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INTRODUCTION

Over the past few months, two court decisions in different parts of the world found that a permanent establishment ("P.E.") existed in structures that appeared to be risk free. These decisions serve as warnings that reliance on the business profits and P.E. articles of an income tax treaty may have to be rethought. The provisions may not provide benefits when most needed: during the course of a tax examination abroad.

TOKYO DISTRICT COURT JUDGED PRODUCT SHIPPING FACILITY FOR ONLINE SHOPPING SERVICES AS A P.E.

Background

Sometimes, it is dangerous to anticipate that a standard provision of an income tax treaty will be applied in a straightforward way to achieve a desired goal. This was recently illustrated by a Tokyo district court case that was asked to apply one of the more prevalent provisions of an income tax treaty.

The case apparently ignored the plain meaning of the of the Japan-U.S. Income Tax Treaty ("the Treaty"), and expanded its interpretation to conclude that a storage facility for inventory could rise to the level of a P.E. The case involved the following fact pattern:

- A U.S. resident operated an online shopping service directed to Japanese customers. It rented an apartment and warehouse in Japan (hereinafter the "Japanese Facilities") in order to store products prior to their shipment to Japanese customers. All orders were placed through the internet.
- The Japanese tax authorities asserted that the U.S. resident was taxable on the resulting business income because the Japanese Facilities qualified as a P.E. under the Treaty.
- The taxpayer asserted that the Japanese Facilities used for storage and delivery purposes could not qualify as a P.E. because they were maintained for preparatory or auxiliary purposes.

The court affirmed the position of the Japanese tax authorities and held that the Japanese Facilities amounted to a P.E. under the Treaty.

Treaty Provisions

Article 7 (Business Profits) of the Treaty addresses the threshold of contact with Japan that must exist before a U.S. tax resident may be taxed on its business profits. Paragraph 1 provides as follows:

> The profits of an enterprise of a Contracting State shall be taxable only in that Contracting State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in that other Contracting State but only so much of them as is attributable to the permanent establishment.
>
> Article 5 (Permanent Establishment) of the Treaty addresses facts that must exist in order for a U.S. resident to be considered to maintain a P.E. in Japan. The starting point is the general rule in paragraph 1: For the purposes of this Convention, the term 'permanent establishment' means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Paragraph 2 contains specific examples of facts that would be considered to comprise a P.E.:

> The term 'permanent establishment' includes especially
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> a) a place of management;
>
> b) a branch;
>
> c) an office;
>
> d) a factory;
>
> e) a workshop; and
>
> f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

Paragraph 4 contains express exclusions from P.E. status for certain places of business that are used for preparatory and auxiliary purposes. It provides as follows in pertinent part:

> Notwithstanding the preceding provisions of this Article, the term 'permanent establishment' shall be deemed not to include
>
> a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
>
> b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
>
> * * *

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

The Technical Explanation prepared by the Treasury Department in connection with the approval process in the Senate explains the exception in the following way:

> This paragraph contains exceptions to the general rule of paragraph 1, listing specific activities that may be carried on through a fixed place of business, but which nevertheless do not create a permanent establishment. The use of facilities solely to store, display or deliver merchandise belonging to an enterprise does not constitute a permanent establishment of that enterprise. The maintenance of a stock of goods belonging to an enterprise solely for the purpose of storage, display or delivery, or solely for the purpose of processing by another enterprise does not give rise to a permanent establishment of the first-mentioned enterprise. * * * Subparagraph 4(f) provides that a combination of the activities described in the other subparagraphs of paragraph 4 will not give rise to a permanent establishment if the combination results in an overall activity that is of a preparatory or auxiliary character. This combination rule, derived from the OECD Model, differs from that in the U.S. Model. In the U.S. Model, any combination of otherwise excepted activities is deemed not to give rise to a permanent establishment, without the additional requirement that the combination, as distinct from each constituent activity, be preparatory or auxiliary. If preparatory or auxiliary activities are combined, the combination generally also will be of a character that is preparatory or auxiliary. If, however, this is not the case, a permanent establishment may result from a combination of such activities.

Issue Presented

The issue presented to the court was whether the Japanese Facilities have a "preparatory or auxiliary character." Presumably, that was because both a stock of goods and a storage facility were maintained. The court held that the Japanese Facilities were not of a "preparatory or auxiliary character" based on the following facts:

- The U.S. resident conducted sales activities in the Japanese Facilities as sales offices, even though all sales were placed on the U.S. entity's website.
- Employees actually performed important operations of the online shopping service in the Japanese Facilities, such as the storing, wrapping, and shipment of products and the receipt of returned products.[1]

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[1] Judged on May 28, 2015.

Analysis

Critical to the judge's ruling was the fact that the U.S. resident emphasized on its website, which was written entirely in Japanese, that the U.S. business could deliver goods imported from the U.S. soon after a purchase order was placed. The judge acknowledged that such quick delivery was possible because the Japanese Facilities stored goods imported from the U.S. beforehand. In order to fulfill one of the conditions of the service's contract with their customers, *i.e.*, that they would deliver goods quickly, the Japanese Facilities were playing an important role for the online shopping service provided by the U.S. resident, and as such, their character was beyond preparatory or auxiliary.

The logic of the court is somewhat unique. The Treaty does not limit the exclusion for storage facilities that are slow, or that ship goods in unwrapped condition, or only in packages with delivery addresses written in English. Yet the court seemed to distinguish storage facilities that are effective and that store inventory prior to sale to Japanese customers from other storage facilities. Presumably, efficiency is the enemy of preparatory or auxiliary activity. U.S. businesses are cautioned that neither the Japanese tax authorities nor the courts are willing to allow competition from businesses designed to be efficient, and nothing in the Treaty will be applied to the contrary.

BROADCASTER'S TAX LIABILITY IN INDIA BASED ON P.E. RULES

An Indian tax court, the Mumbai Bench of the Income Tax Appellate Tribunal ("I.T.A.T."), held that a U.S. broadcaster owes tax to India on the income generated from the independent sale of advertising airtime by its Indian network subsidiary because such subsidiary is considered a dependent agent and constitutes a P.E. of the broadcaster. Despite the existence of principal-principal contractual provisions and arm's length payments, the court in *NGC Network Asia LLC v. Joint Director of Income Tax*[2] found that the entities had a principal-agent relationship. The tax liability created by this principal-agent characterization is expected to impact how foreign broadcasters enter into contracts and advertise in India.

The case involved NGC Network Asia LLC Co. ("NGC Asia"), which is a Delaware subsidiary of U.S. Fox Entertainment Group, Inc., and the Indian tax authority. NGC Asia owns the television channels National Geographic and Fox International, which the company broadcasts in India as well as other countries. NGC Asia entered into an advertisement sales agreement with one of its subsidiaries, NGC Network (India) Private Limited ("NGC India"), in which NGC Asia sold to NGC India the rights to distribute its two television channels and to sell advertising airtime in exchange for a lump sum. Under the agreement, NGC India made arm's length payments to NGC Asia for the income derived from the distribution rights and from the advertising profits. The agreement provided that NGC India bear all the risks for the sale of advertising airtime as well as determine the terms of the airtime sales to advertisers. NGC Asia and NGC India intended to establish a principal-principal arrangement and viewed NGC India as an independent agent.[3]

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2 *NGC Network Asia LLC v. Joint Director of Income Tax*, ITA No. 7994/Mum/2011.

3 Amrit Dhillon, "Foreign Broadcasters Risk PE Findings After Indian Ruling," *BNA International Tax Monitor*, January 15, 2016.

NGC Asia did not regard NGC India as a P.E. and therefore considered its income from the sale of distribution rights and airtime to NGC India to be excluded from tax. However, the Indian tax authority determined that NGC India is a dependent agent P.E. of NGC Asia and, as such, NGC Asia's income from the sale of distribution rights and advertising airtime was taxable in India. The tax authority also determined that "advertisement airtime" does not constitute goods that can be sold because "time" cannot be stocked or delivered in advance, or in this case, cannot be separated from the channel airing the advertisement.[4] NGC Asia challenged the determination and the case went up to the I.T.A.T. in Mumbai.

"The tax liability created by this principal-agent characterization is expected to impact how foreign broadcasters enter into contracts and advertise in India."

The I.T.A.T. agreed with the Indian tax authority, and on December 16, 2015, it that since the agreements NGC India entered into in India were binding on NGC Asia, NGC India is a dependent agent P.E. of NGC Asia.[5]

The court affirmed that airtime is not capable of sale and that NGC India is an agent dependent on NGC Asia because NGC India cannot use the advertising airtime without NGC Asia's transfer of rights.[6] Thus, the court held that NGC Asia and NGC India have a principal-agent relationship, despite the fact that the advertising sales agreement intended to establish a principal-principal relationship between the companies.

The I.T.A.T. further refuted NGC Asia's reliance on *DIT v. Morgan Stanley & Co.*[7] and its argument that the arm's length payments by NGC India did not trigger a tax obligation for NGC Asia, even if NGC India is a P.E. The I.T.A.T. stated that *DIT v. Morgan Stanley & Co.* is limited to the situation in which a foreign company makes payments to its associated entity or P.E. in India – it does not apply to an entity in India making payments to an associated entity abroad.[8]

NGC Asia will probably appeal the I.T.A.T.'s decision in the Mumbai High Court. In the meantime, however, the tax court's decision creates uncertainty about tax liability for foreign broadcasters selling advertising airtime in India and concerns that a contractual principal-principal relationship will be viewed as principal-agent with an Indian P.E.

CONCLUSION

Emboldened by the O.E.C.D.'s attack on base erosion and profit shifting ("B.E.P.S."), tax authorities are looking at new ways to assert the existence of a permanent establishment. In the Japanese case, it was web-based advertising in the Japanese language, combined with a local delivery service. In India, it was furnishing media content to a local subsidiary. Tax advisers who remember the world before the B.E.P.S. initiative are likely surprised by these cases. Nonetheless, in a post-B.E.P.S. world, they may represent the new normal.

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4 *Id.*

5 *Id.*

6 *Id.*

7 *DIT v. Morgan Stanley & Co.*, (2007) 292 ITR 416 (SC).

8 Dhillon, "Foreign Broadcasters Risk PE Findings After Indian Ruling."

THE MEANDERINGS OF THE TAXATION OF U.K. REAL ESTATE: WHERE ARE WE GOING?

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INTRODUCTION

A striking feature of the U.K. tax landscape has been the recent introduction of significant changes to the taxation of real estate. Residential property in particular (as opposed to non-residential or "mixed" property – see further below) has borne the brunt of the attack.

Where governments make choices about who, what, and how much to tax, tax policy becomes an emotive issue, never more so than now. It is the area of a government's political strategy that has the most direct and immediate effect on a citizen's pockets. These decisions tend to have a rather focusing effect – an effect that is compounded in this case because the tax in question is on an Englishman's home (or a Welshman's, etc. – you get my drift), which is his castle, as the adage goes. It also affects the desirability of local real estate to foreign investors, whether considering it for personal use or as investment real property.

THE FISCAL SIGNIFICANCE OF PROPERTY

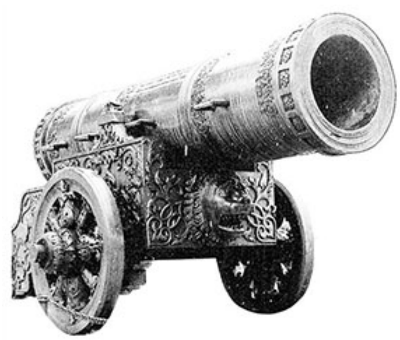
The U.K. housing market is one of the key barometers of the country's economic health. Over the long term, capital growth in real estate can be counted upon to outstrip many other forms of investment. Land is one of the few commodities that is genuinely finite in nature. We cannot produce more of it, and in the U.K., it is in relatively short supply. We Brits have enjoyed an enduring love affair with property ownership, in particular since the 1980's and the introduction of the "right to buy."

One feature that has become increasingly significant for governments seeking to raise funds in the current climate is that real estate is immoveable. This is hugely significant in a world that has seen exponential growth in international mobility, both in terms of persons and assets.

The global environment is increasingly mobile, yet taxing rights are fundamentally territorial in nature. Governments therefore compete with each other to attract mobile capital with occasionally aggressive competitive tax regimes and beneficial economic environments. The initiatives of supranational organizations, such as the E.U. and O.E.C.D., that look to provide for a fair allocation of taxing rights are increasingly important. However, the internal infrastructure and processes of these organizations are necessarily cumbersome, and the results, although astonishing under the circumstances, lag behind the changing economic landscape. In the interim, each government does what it can to tax what it perceives to be its fair share of the global tax base.

In this context, real estate is the dream asset – it is by its very nature immoveable. If an investor wants U.K. real estate, he or she will have to succumb to the U.K. tax authorities. It is perhaps not surprising that the U.K. government wants to cash in on gains arising from this immovable asset.

THE GROWING TAX ARSENAL



What follows in this section is a gallop through some of the recent changes to the taxation of U.K. property, in chronological order (according to the date of entry into force of each). Although not exhaustive, the discussion addresses some of the more significant measures.

March 2012: S.D.L.T. on Enveloped Dwellings

The first of the recent fiscal assaults began in March 2012 with the higher rate of stamp duty land tax ("S.D.L.T.") for "enveloped" dwellings. Very broadly, S.D.L.T. is the tax that is paid by a purchaser on the acquisition of interests in property. It is payable at various rates on the "chargeable consideration" (generally equal to the purchase price).

At the time of the reform, the U.K. Conservative-Liberal Democrat coalition government was (and it appears the Conservative Party government still is) concerned with dissuading the acquisition and holding of real property by non-natural persons. In significant part, this was because the stamp taxes attributable to a transfer of shares in a company holding property (for example) are likely to be considerably less than the S.D.L.T. attracted by a transfer of the underlying property itself.

The effect of the changes was to increase the rate of S.D.L.T. to a flat 15% on the acquisition of residential property by a non-natural person. By comparison, the rates of S.D.L.T. for residential property at the time ranged from 0% to 7%. In the context of commercial or "mixed" property, the rate was (and still is) a flat 4%.[1] At the time that the changes were introduced, the provisions applied only to purchases where the chargeable consideration exceeded £2 million. The government could therefore assure its public that the measure would affect only the very wealthy.

Inevitably, however, the enemy settled in and spread out – mission creep. The threshold has now been significantly reduced so that the inflated rate applies to non-natural persons acquiring residential property with a value of £500,000 and over. In many parts of the U.K., £500,000 is a depressingly insignificant trigger point. Although there are a series of exemptions to the increased S.D.L.T. charge for acquisitions by non-natural persons, they are often complex and in some cases produce anomalous results.

APRIL 2013: A.T.E.D. AND A.T.E.D.-RELATED CAPITAL GAINS

A further attack came in April 2013 with the introduction of the Annual Tax on

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1 These rates are quite high when compared to the acquisition of a comparable residential property in New York City. There, the city imposes a comparable tax of 1% of the value of the property (1.45% if the value exceeds $500,000), and the state imposes one tax on the seller of $2 for each $500 or fractional part thereof (essentially a tax of 0.4% of value) and a second tax on the purchaser of 1% when the value of the residential property exceeds $1 million.

Enveloped Dwellings ("A.T.E.D."). Again, the intention was to dissuade individuals from holding high-value residential property within a corporate structure. The effect of the A.T.E.D. is to impose an annual charge on enveloped dwellings, the quantum of which is linked to the value of the property. As above, although initially the charge applied only to properties worth in excess of £2 million, this threshold was soon reduced, and with effect from April 2016, it will be £500,000.

Although the introduction of the A.T.E.D. was intended to dissuade certain behaviors, the measure proved to be a far greater revenue generator than the government had anticipated. This seems extraordinary, given that the compelling but non-verified, anecdotal evidence indicates that the vast number of non-U.K. companies holding residential property knew nothing about the charge and non-deliberate non-compliance has been widespread. If government statistics are to be believed, the well of potential tax collections runs quite deep once the A.T.E.D. requirements are more widely known.

"The effect of the A.T.E.D. is to impose an annual charge on enveloped dwellings, the quantum of which is linked to the value of the property."

Alongside the A.T.E.D., its brother was introduced – the A.T.E.D.-related capital gains charge. This is an extended capital gains tax on disposals of high-value residential property made on or after April 6, 2013 where the property is held in a corporate wrapper and is within the A.T.E.D.

December 2014: Overhaul of S.D.L.T. for Residential Property

In December 2014, the government announced a further package of reforms to the S.D.L.T. for residential property. The measures included some welcome simplifications (the end of the "slab" system of taxation, which resulted in unnecessary market distortions, was to be replaced by a progressive "slice" system), but also some less-welcome and eye-watering tax hikes, including a new top rate of 12% for acquisitions by individuals (the rate applicable to acquisitions by companies remains 15%). Again, the measures applied (and continue to apply) only to residential property.

April 2015: Capital Gains Tax on Residential Property for Non-U.K. Residents

In April 2015, the U.K. government introduced capital gains tax ("C.G.T.") for non-residents in respect of gains realized on U.K. residential property. This measure in particular represented a very significant shift in U.K. tax policy. Until then it had been a significant (and relatively unusual) feature of the U.K. tax system that it did not seek to impose capital gains tax in respect of U.K. property on non-U.K. tax residents. This had undoubtedly contributed to the popularity of the U.K. real estate market with offshore investors. However, the prevailing political climate meant that the economic clout of foreign investors (inevitably also non-voters) was easily eclipsed by political expedience.

April 2016: Additional 3% S.D.L.T. Rate for Second Homes

The most recently announced development (November 2015) has been the rather extraordinary and generally unforeseen announcement that the U.K. government would introduce an additional 3% S.D.L.T. surcharge on the purchase of additional residential properties (such as second homes and buy-to-let properties) for considerations exceeding £40,000, with effect from April 2016.

The announcement has been met with predictable outrage from the long-suffering property industry, together with a series of specific criticisms (not least in relation to the very rushed nature of the consultation), which has required a significantly shortened consultation period and a delay in the usual timetable for publishing the draft legislation.

Clearly the intention of the measure is to curb the rise of holiday home and buy-to-let properties. The proliferation of these properties is perceived to have caused damage to the local communities of certain areas. However, the measure goes much farther and has some rather surprising consequences. In particular, the government has confirmed that it is intended that the surcharge will apply to purchases by non-U.K. residents of a first home in the U.K. where that nonresident owns other homes worldwide. This is a pretty bold move in terms of the territoriality of a domestic tax measure. How the government intends to police this provision is unclear.

The government has also stated that married couples will be treated as a "unit" for the purposes of the legislation. Commentators have argued that this effectively penalizes married couples over cohabiting couples, since married couples will be treated as acquiring a second home and taxed accordingly, while unmarried couples may simply acquire a property each. The measure may also deter parents co-purchasing property with their children. This is an odd result for a Conservative Party measure and one which has inflamed the suggestion that the ill-thought-out consequences of some of the recent measures demonstrates a lack of coherent policy in this area. Certainly, the piecemeal and fragmented approach of recent announcements is unfortunate. Many of the measures have been forward-looking in any event, and it is not clear why the measures could not have been announced together.

"Clearly the intention of the measure is to curb the rise of holiday home and buy-to-let properties. The proliferation of these properties is perceived to have caused damage to the local communities of certain areas."

Predictably, there is some vigorous lobbying underway. It remains to be seen what form the draft legislation will be in when it is published in due course.

April 2017: Extension of I.H.T. to Indirectly Held U.K. Residential Property

Finally, as part of the 2015 Summer Budget, the government announced a number of significant reforms to inheritance tax ("I.H.T.") and the concept of domicile. Broadly, I.H.T. is a charge to tax primarily on an individual's estate on death. The rate is 0% on the nil rate band, 20% for any taxable lifetime gifts, and 40% on death. An individual who is domiciled in the U.K. is subject to I.H.T. on his or her worldwide estate. An individual who is not domiciled in the U.K. is subject to I.H.T. only in respect of his or her U.K. estate. Under current rules, U.K. property does not include shares in a foreign registered company, even where that company's only asset is U.K. land. However, with effect from 2017, "U.K. property" will include U.K. residential property, even where it is indirectly held through a foreign-registered and -resident company.

As was true for the extension of C.G.T. to non-residents, the change represents a very fundamental policy shift in the U.K.'s approach to the taxation of certain foreign nationals. Historically, the U.K. has provided an extremely hospitable economic climate to the foreign investor. The sands now appear to be shifting but only in respect of residential property, at least for the current time.

Residential vs. Non-residential: Why?

As is abundantly clear, a key feature of a number of the more penal tax developments is that they apply only to "residential" property. The economic consequences of finding that a property is residential in nature are therefore very significant. Not only will it dramatically affect the rates of S.D.L.T., it can also affect the incidence of the A.T.E.D., C.G.T., and I.H.T. Clearly, this puts huge pressure on the distinction.

So what does the term "residential property" mean? The definition largely turns on whether or not the land includes buildings suitable for use as a "dwelling." Specifically, property is regarded as residential if it comprises land and/or buildings

- used as a dwelling,
- suitable for use as a dwelling, or
- in the process of being constructed or adapted for use as a dwelling.

Note that for S.D.L.T. purposes, the higher rates apply only where the land transaction is comprised "entirely" of residential property. Where the property is mixed use (that is, it includes residential and non-residential property), the lower non-residential S.D.L.T. rates will apply.

However, the fact that part of what is otherwise a dwelling is used for business purposes does not necessarily result in a finding that the property is not residential. The key question is whether the building is suitable for use as a dwelling. The distinction is not always an easy one to make. By way of example, a five-bedroom farm house with 20 acres used for commercial agricultural purposes would be mixed use and would qualify for the lower rates. On the other hand, the same house with 20 acres of parkland and the neighbor's chickens on the field at the bottom of the drive might not.

Inevitably, a number of so-called "tax planning" schemes (some more accurately described as fairytales) seek to exploit this distinction. Some of the schemes are eye-wateringly creative and undoubtedly ineffective. We can expect increasing H.M.R.C. scrutiny in this area.

What is not clear is why the U.K. government has chosen to impose such different fiscal treatment on the basis of a distinction that is in some cases both arbitrary and esoteric, and more importantly, difficult to predict. What is it about residential property that justifies this disadvantageous treatment? Many other jurisdictions do not make the distinction at all in terms of tax treatment.

THE LAFFER CURVE

Tax specialists are sometimes reputed to be inaccessible and nerdy. (I believe my U.S. friends refer to this as "dweeb-like.") This is plainly an absurd proposition, and one which I am loathe to promote by including abstract references to academic constructs without practical purpose. Instead, I will refer simply to the Laffer Curve.

The Laffer Curve demonstrates, in diagrammatic form, the behavioral economics principle that increasing the rate of tax does not continue to result in higher tax yield; indeed, the converse is true. Although increases in rates of tax at certain levels may increase total tax take, at some point, an increase in the rate will dis-incenti*vize* the activity producing the asset. At one end of the spectrum (the beginning of the curve), the tax rate is zero, as is tax take. There may be plenty of economic activity, but no tax is levied on it. On the other side of the curve (the end), the tax rate is 100%, and the tax take is also zero. The tax rate has extinguished economic activity. This is referred to, at times, as making others pay their "fair share" of tax.

The peak of the curve is the holy grail of good tax policy. It represents the maximum level at which a government can tax any particular activity before dis-incenti*vizi*ng it to levels at which tax yields decrease. In other words, it is important to tax (in this case) property investors until Lord Healy's pips squeak, but not to continue to do so to the point of a thermonuclear explosion.

Clearly, the U.K. government feels that the U.K. real estate sector is sufficiently robust to withstand the recent fiscal assaults. In other words, it believes that the Laffer Curve applicable to residential property is still in its ascendancy. However, at some point, the zenith will be reached. What then? And who will benefit at that time? Most likely, it will be the ultra, ultra-wealthy, as only they will be immune from the tax increase.

THE REAL, IMPRECISE, AND IMPERFECT WORLD

However, economics is not the only driving force behind tax policy. Tax policy does not operate in an academic vacuum. Rather, it is formed in a rather more real, imprecise, and imperfect world, in which rather more real, imprecise, and imperfect politicians (with varying degrees of intellect, personality, and competing motives) jostle for power and position, and the maximum length of fiscal foresight tends to be pretty much around the five-year mark.

In this rather more real, imprecise, and imperfect world, tax policy makers must make decisions about who, what, and how much to tax in response to any number of domestic and global economic, social, and natural events. They must then defend these positions to the media, the lobbyists, and the ever-powerful court of public opinion. Budget Day announcements undoubtedly often owe more to extravagant political posturing than to the Laffer Curve.

As mentioned above, one of the more frequent criticisms of the recent changes has been their fragmented and piecemeal development. Where is the reasoned and coherent tax policy? However, it may be that in this rather more real, imprecise, and imperfect world, it is unrealistic and even undesirable for governments to impose rigid long-term fiscal policies. Instead, it may be that an iterative approach is the ideal. It allows policymakers to respond to the changing economic and social factors and the vagaries of the tax take. Which is not to say that policymakers should abandon efforts to design and pursue a careful and coherent tax policy, but neither should they be restricted from reacting appropriately to necessity and expedience.

The U.K. enjoys a hugely successful property industry. Under the circumstances, perhaps it is not surprising that the U.K. government has sought to exploit that fact.

WHERE TO NOW?

How is the market to make sense of it all? Clearly, the taxation of real estate in the U.K. is a fast-moving and increasingly specialized area. The intricacies of many of the relevant taxes proliferate, and their interactions can be difficult to quantify in advance. Who should invest, in what form, from what jurisdiction, and in accordance with what terms? How should the property be used? The tax practitioner may find that it is best to be agile in planning, including flexibility in that investment structures so that they may be modified on the fly in response to changes of policy.

It remains to be seen whether some of recent residential property developments will be extended to commercial and mixed property. It is also possible – maybe even likely – that the government will seek to tinker with the definition of residential property or remove it entirely.

Meanwhile, it is perhaps not surprising that we are seeing an increased appetite for investment in commercial property.

THE COMMON REPORTING STANDARD – A GLOBAL F.A.T.C.A.?

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Tags
Automatic Exchange of Information
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O.E.C.D.
Transparency

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STANDARD FOR AUTOMATIC EXCHANGE OF FINANCIAL ACCOUNT INFORMATION IN TAX MATTERS

The Standard for Automatic Exchange of Financial Account Information in Tax Matters (also known as the "Common Reporting Standard" or "C.R.S.")[1] is a global system of automatic exchange of information for tax purposes ("A.E.O.I."). As of January 1, 2016, financial institutions ("F.I.'s") in jurisdictions that have signed up as members of the Early Adopters Group ("E.A.G.")[2] of the C.R.S. are obligated to gather identification and residence information from new account holders to pass it to their jurisdictions' reporting authority in order to enable reporting of the accounts. By 2018, the 96 jurisdictions[3] that have adopted the C.R.S. will be exchanging information on those account holders identified as reportable between their respective reporting authorities. F.I.'s and tax authorities still need to work through all the details, but below is a brief introduction to the system, how it is expected to work, and some potential pitfalls.

What Countries Does It Affect and When?

Those jurisdictions that have adopted the C.R.S. include most of the world's major economies and financial centers, with the notable exception of the U.S. The earliest date for information exchange under the C.R.S. will be 2017[4] (for information gathered in 2016) for the 56 jurisdictions that make up the E.A.G. The remaining 40 jurisdictions are committed to commence exchange by 2018. The process starts with F.I.'s collecting information on new account holders and then expands to include information on relevant existing account holders. The system was developed by the Organization for Economic Co-operation and Development ("O.E.C.D.") and the Global Forum on Transparency and Exchange of Information for Tax Purposes ("Global Forum") to combat tax evasion in response to a request by the G-20. The aim was to build on the systems and agreements put in place to comply with the Foreign Account Tax Compliance Act ("F.A.T.C.A.") and to create a comprehensive global standard for A.E.O.I.

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1 "Standard for Automatic Exchange of Financial Information in Tax Matters." O.E.C.D. Automatic Exchange Portal - Common Reporting Standard (C.R.S.). July 21, 2014.

2 "Joint Statement by the Early Adopters Group." O.E.C.D. October 1, 2014.; "CRS by Jurisdiction." O.E.C.D.: C.R.S. Implementation and Assistance.

3 "A.E.O.I.: Status of Commitments." O.E.C.D. Global Forum on Transparency and Exchange of Information for Tax Purposes.

4 "C.R.S. by Jurisdiction." O.E.C.D.: C.R.S. Implementation and Assistance.

The U.S. is already receiving information on U.S. persons ahead of these C.R.S. deadlines. The first information exchange under its own A.E.O.I. system took place at the end of September 2015.[5] Under the U.S. system – operating under F.A.T.C.A. – the U.S. Internal Revenue Service ("I.R.S.") is provided with information on financial accounts of U.S. persons, either from F.I.'s directly or from the relevant tax authority of those foreign tax jurisdictions that have appropriate Intergovernmental Agreements ("I.G.A.'s") with the U.S. The U.S. has committed to implement a level of reciprocity under the Model 1 I.G.A.'s rather than signing up to participate in the C.R.S., but political stalemate has prevented the legislative changes necessary to make that work in practice. Among other consequences, if a jurisdiction participating in the C.R.S. deems the U.S. as non-participating, then most U.S. trusts, as well as F.I.'s that are investment entities (*e.g.*, a managed investment entity like a mutual fund), with accounts in the participating jurisdiction will have to provide information on their controlling persons, which otherwise is only required for more limited types of F.I.'s in participating jurisdictions.

How Does It Work?

The C.R.S. sets out the information that reporting authorities in participating jurisdictions should gather from F.I.'s located in those jurisdictions and that should be automatically exchanged on an annual basis with other participating jurisdictions. This information broadly consists of details of financial assets that are held by the F.I.'s on behalf of taxpayers that are resident in other participating jurisdictions, provided that the reporting authority has in place an agreement for the exchange of tax information. F.I.'s report to the reporting authority in the participating jurisdiction in which they are located. The consequences of non-compliance are left to the participating jurisdictions to specify in domestic legislation.

The Documentation

The system is made up of components. First, there is the 'Model' Competent Authority Agreement ("C.A.A.")[6] (a bilateral and reciprocal agreement based on the F.A.T.C.A. Model 1 I.G.A.), which provides the international legal framework[7] for A.E.O.I. under the C.R.S. The Common Reporting and Due Diligence Standard[8] sets out the reporting and due diligence requirements, and is known as the Common Reporting Standard or "C.R.S." This can cause confusion because the acronym C.R.S. is also commonly used to refer to the Common Reporting Standard as a whole. Finally, there is a "User Guide"[9] for the C.R.S. XML Schema and Commentaries.[10] The Schema may need to change in the future as the system evolves. To overcome the potential legal difficulties this would create, in December 2015, the O.E.C.D. agreed on a plan to work out a system for adopting future changes (see below).

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5 The first information exchange under reciprocal I.G.A.'s, took place by the September 30, 2015 deadline.

6 "Commentaries on the Common Reporting Standard." O.E.C.D.

7 "The C.R.S. Multilateral Competent Authority Agreement." O.E.C.D.: International Framework for the CRS.

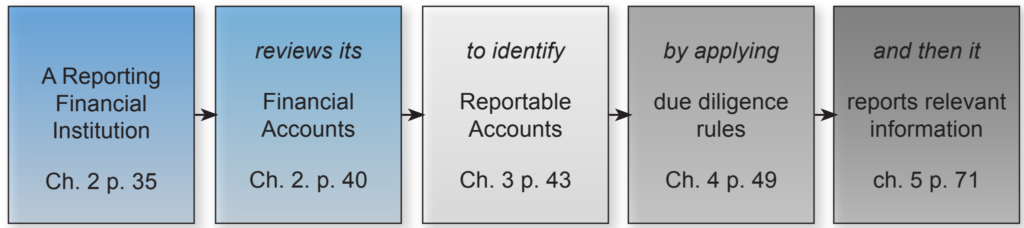
8 "Commentaries on the Common Reporting Standard." O.E.C.D.

9 "Common Reporting Standard User Guide and Schema." O.E.C.D.

10 "Commentaries on the Common Reporting Standard." O.E.C.D.

What Is Required of F.I.'s?

The A.E.O.I. process for the C.R.S. is set out in the component documents above, but the O.E.C.D. has also prepared the C.R.S. *Implementation Handbook*[11] (the "Handbook"), which explains the basics simply and clearly in "Part II: Overview of the C.R.S. and Due Diligence Rules."[12] Put simply, F.I.'s in jurisdictions that participate in the C.R.S. will need to follow the steps in the diagram below.



Guidance on exactly how to implement these steps may be found at each chapter of the Handbook referenced in the diagram above, with step-by-step flow charts on identifying Reporting Financial Institutions, Financial Accounts, and Reportable Accounts as well as the various due diligence rules to be applied depending on the nature of the account as new or pre-existing (open before January 1, 2016) and the nature of the holder as an entity or individual.

"F.I.'s should advise clients and account holders that they must provide their details to the F.I. and that data will be made available to tax authorities in the client's jurisdiction of residence."

F.I.'s should advise clients and account holders that they must provide their details to the F.I. and that data will be made available to tax authorities in the client's jurisdiction of residence. While there is considerable overlap between F.A.T.C.A. and the C.R.S., information, systems, and processes that F.I.'s have established to comply with F.A.T.C.A. will need to be adapted if they are to be used for the C.R.S. The C.R.S. covers more accounts and entities than F.A.T.C.A., and there is some flexibility on which accounts are included (*e.g.*, individual jurisdictions can define which accounts are low-risk) so there is a real possibility of jurisdictional variations for reporting. Also, jurisdictions are free to decide the format by which F.I.'s will report information. Although the Handbook suggests jurisdictions use the C.R.S. Schema (which is virtually identical to the F.A.T.C.A. XML Schema) to avoid the need for significant additional investment on the part of governments or F.I.'s, it is not mandatory and F.I.'s will need to confirm the approach taken by the appropriate jurisdiction.

Timetable

F.I.'s in E.A.G. countries will have prepared their I.T. and administrative systems to deal with the requirements for new account-opening procedures from January 1, 2016. For E.A.G. jurisdictions, the timetable is as follows:

1. F.I.'s will be required to have account-opening procedures in place to record tax residence for all new accounts opened from January 1, 2016.

2. Pre-existing accounts are those already open on December 31, 2015.

3. Due diligence identifying high-value, pre-existing individual accounts must be

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11 "The C.R.S. Implementation Handbook," O.E.C.D.

12 *Id.*, p. 34.

complete by December 31, 2016.

4. Due diligence for low-value, pre-existing individual accounts and entity accounts must be complete by December 31, 2017.

5. First reporting of information gathered in 2016 is expected in 2017.

As an example of the preparations being made in E.A.G. countries, in the author's jurisdiction of the Cayman Islands (which is a founding member of the E.A.G.) the Cayman Islands Department of International Tax Co-operation of the regulatory authority, the Cayman Islands Monetary Authority, has introduced regulations[13] and set up an A.E.O.I. Portal[14] to allow F.I.'s to monitor progress.

For jurisdictions that are not in the E.A.G., the timetable for collecting the same information is extended through 2017, with reporting scheduled to commence in 2018.

What Is the Domestic Legal Basis of the C.R.S.?

To create any global standard, the information gathering and exchange mechanisms need to be incorporated into the legal system of each participating country. This means that the jurisdictions that have signed up to participate in the C.R.S. have been bringing in new or adapting existing legislation to ensure that F.I.'s report the required information on the relevant financial assets that are held. The four core requirements for governments to implement the C.R.S. are as follows:

1. Translating the reporting and due diligence rules into domestic law, including rules to ensure their effective implementation (including penalties and sanctions)

2. Selecting a legal basis for the automatic exchange of information

3. Putting in place I.T. and administrative infrastructure and resources

4. Protecting confidentiality and safeguarding data

The approach to protecting the confidentiality and integrity of the data being exchanged may differ for each jurisdiction. There is non-mandatory guidance offered by the O.E.C.D. in its guide *Keeping it Safe*[15] from July 2012. In it, the O.E.C.D. sets out best practices and gives practical guidance (including a checklist) on what steps jurisdictions should take to protect the confidentiality of tax information. This protection is important, as jurisdictions can withhold information based on the fact that they consider it will not be safe in the destination jurisdiction.

What Is the International Legal Basis?

To reduce the number of F.I.'s providing information to the I.R.S. directly, the U.S.

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13 "The Tax Information Authority (International Tax Compliance) (Common Reporting Standard) Regulations, 2015." Cayman Islands Department for International Tax Cooperation. October 16, 2015.

14 "AEOI News & Updates." Cayman Islands Department for International Tax Co-operation.

15 "Keeping It Safe: The O.E.C.D. Guide on the Protection of Confidentiality of Information Exchanged for Tax Purposes." O.E.C.D.

developed Model I.G.A.'s, which allowed governments to collect information from the F.I.'s that is then provided to the U.S. in bulk. The C.R.S. provides for an alternative to multiple bilateral tax information exchange agreements. The O.E.C.D. and Global Forum drafted a Multilateral Convention on Mutual Administrative Assistance in Tax Matters ("M.A.C.") that jurisdictions may sign. This provides a legal gateway for the exchange of tax information between all countries and jurisdictions that have signed up for the C.R.S. As of October 29, 2014, 51 jurisdictions signed the Model C.A.A. for A.E.O.I. based on Article 6 of the M.A.C. – there are now 89 jurisdictions covered by the M.A.C. and 74 by the Model C.A.A.[16] To help F.I.'s understand how far along a jurisdiction is in the implementation of the C.R.S., the O.E.C.D.'s A.E.O.I. Portal has an overview of the current state of implementation for all committed G-20/O.E.C.D. member countries, which is contained in a single table.[17]

Future Changes to the C.R.S. XML Schema

On December 1, 2015, the O.E.C.D. agreed[18] to plan to consider, review, and adopt future changes to the C.R.S. XML Schema that would allow it to evolve over time. This came after the European Commission asked for the inclusion of three additional fields and a value in the C.R.S. XML Schema, which highlighted the potential legal issues involved in making such a change (*e.g.*, changes to the C.A.A.). The plan is for a substantive review of the experiences of tax authorities during the first exchange and use of the C.R.S. information in 2017 and 2018 (as well as the early exchanges of information under the F.A.T.C.A. I.G.A.'s) in order to see what other technical changes to the C.R.S. XML Schema might be needed.

"The C.R.S. asks for different data and will affect significantly more accounts than F.A.T.C.A., as it has no universal minimum level of pre-existing individual account holding below which due diligence by F.I.'s is not required."

So, Is It Really Any Different from F.A.T.C.A.?

The C.R.S. was designed to build on the agreements and systems put in place by governments and F.I.'s to comply with F.A.T.C.A. The goal was to create an effective new international standard at a minimal cost to F.I.'s and governments.

However, F.A.T.C.A. is U.S.-specific and its I.G.A.'s were unsuitable for a global standard, so changes were made.[19] The use of citizenship as an indication of tax residence and references to U.S. domestic law were changed, as were approaches that were more suited to the bilateral context of F.A.T.C.A. I.G.A.'s rather than the multilateral context of the C.R.S. The use of F.A.T.C.A. regulation definitions in the C.R.S. should help those working with both systems, but not all definitions are the same. This will create practical problems and operational challenges for F.I.'s. These include identifying which entities need further investigation for the C.R.S. and reporting entities with controlling persons that have a different tax residency than the entity.

The C.R.S. asks for different data and will affect significantly more accounts than F.A.T.C.A., as it has no universal minimum level of pre-existing individual account

16 "Statement of Outcomes." O.E.C.D.: Global Forum on Transparency and Exchange of Information for Tax Purposes. October 30, 2015.

17 "C.R.S. by Jurisdiction." O.E.C.D.: C.R.S. Implementation and Assistance.

18 "Statement of Outcomes by Working Party No. 10 on the EU Proposal on the Addition of Fields to the CRS XML Schema." O.E.C.D. December 1, 2015.

19 The Handbook offers detailed comparisons at p. 84, "Part III: The Standard compared with F.A.T.C.A. Model 1 I.G.A.," and p. 22, ¶36, "Differences to F.A.T.C.A."

holding below which due diligence by F.I.'s is not required. Regarding non-compliance, the F.A.T.C.A. threat of withholding from a non-compliant F.I.'s own money does not apply, but each participating jurisdiction will legislate its own non-compliance penalties.

The C.R.S. covers accounts held by individuals and entities, including trusts and foundations, and the information it covers includes balances, interest, dividends, and sales proceeds from financial assets. Some C.R.S. due diligence procedures will require manual checks to confirm information with paper-based documentary evidence. Without an agreed, standard form of self-certification, each jurisdiction is free to ask F.I.'s for more information than the minimum, causing duplication in the preparation of information on account holders in order to meet the information and presentation requirements of different jurisdictions.

Further Help from the O.E.C.D. and Global Forum

To back up the formal documentation of the C.R.S., the O.E.C.D. recently launched a new A.E.O.I. Portal[20] to give tax administrations and F.I.'s the information and legal, administrative, and I.T. tools that may be needed. It has published detailed F.A.Q.'s[21] and a second edition of its *Offshore Voluntary Disclosure Programmes*[22] with updated guidance on the design and implementation of voluntary disclosure programs based on the practical experience of 47 countries, including the views of private client advisers. The Global Forum has also been monitoring how jurisdictions that have signed up for the C.R.S. are implementing the commitments they have undertaken.

Beneficial Ownership Registers and the C.R.S.

There has been much discussion of beneficial ownership public registers, and it is significant that the Global Forum will include in its next round of peer reviews the examination of a jurisdiction's ability to provide beneficial ownership information.[23] This is not something that arises from the C.R.S. In fact, the C.R.S. does not actually refer at all to beneficial ownership, but rather to controlling persons. There is nothing in the C.R.S. that requires the setting up of a register, public or otherwise, for any of the information collected by F.I.'s and passed to the relevant reporting authority.

The driver for establishing beneficial ownership registers comes from the G-20 High-Level Principles on Beneficial Ownership Transparency,[24] which includes the provision that

20 "A.E.O.I. Portal." O.E.C.D.

21 "C.R.S.-related F.A.Q.'s." O.E.C.D.

22 "Update on Voluntary Disclosure Programmes: A Pathway to Tax Compliance." O.E.C.D. August 1, 2015.

23 "Statement of Outcomes." O.E.C.D.: Global Forum on Transparency and Exchange of Information for Tax Purposes. October 30, 2015.; "Global Forum on Tax Transparency Pushes Forward International Co-operation against Tax Evasion." O.E.C.D. Newsroom. October 30, 2015.

24 "G20 High-Level Principles on Beneficial Ownership Transparency." G-20.: 2014.; "Update to Article 26 of the O.E.C.D. Model Tax Convention and Its Commentary." O.E.C.D. July 17, 2012.

> [c]ountries should ensure that competent authorities (including law enforcement and prosecutorial authorities, supervisory authorities, tax authorities[,] and financial intelligence units) have timely access to adequate, accurate[,] and current information regarding the beneficial ownership of legal persons. Countries could implement this, for example, through central registries of beneficial ownership of legal persons or other appropriate mechanisms.

"A global system of A.E.O.I. to attempt to defeat tax evasion is an ambitious idea, which goes far beyond F.A.T.C.A."

The Global Forum is the premier international body for ensuring the implementation of the internationally agreed upon standards of transparency and exchange of information in tax matters. Through an in-depth peer review process, it monitors its members to ensure that they fully comply with the standard of transparency and exchange of information to which they have committed. This monitoring covers C.R.S. compliance as well as other commitments, such as those under a Tax Information Exchange Agreement ("T.I.E.A."). Under T.I.E.A.'s, there is an exchange of information on request ("E.O.I.R.") mechanism. At a meeting[25] held at the end of October 2015, the Global Forum created a new framework for the second round of Phase 2 peer reviews on exchange of information. The new 2016 terms of reference[26] include a requirement that

> [j]urisdictions should ensure that ownership and identity information, including information on legal and beneficial owners, for all relevant entities and arrangements is available to their competent authorities.

The U.K. and the E.U. have chosen to meet their commitment to ensure "timely access to adequate, accurate[,] and current information regarding the beneficial ownership of legal persons" by implementing public registers. Other countries, such as the Cayman Islands, meet the same obligation by ensuring their regulatory bodies have the information available from the formation of the relevant entities, and valid requests for such information can be, and are, responded to in a timely fashion. The C.R.S. will not require any change to this commitment or the way it is met by participating jurisdictions. It will, in fact, require assessment of slightly different criteria to identify controlling persons for some entities.

CONCLUSION

A global system of A.E.O.I. to attempt to defeat tax evasion is an ambitious idea, which goes far beyond F.A.T.C.A. It remains to be seen whether, and how, the dual F.A.T.C.A. and C.R.S. systems for A.E.O.I. will continue on their parallel paths. It will be interesting to see whether or not the two systems will gradually converge, and how the fact that the U.S. is not a participating C.R.S. country and isn't legally able to require U.S.-based F.I.'s to collect the relevant information on account holders will play out in practice.

With 96 jurisdictions committed to A.E.O.I. through the C.R.S. system, it is a certainty

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25 "Statement of Outcomes." O.E.C.D.: Global Forum on Transparency and Exchange of Information for Tax Purposes. October 30, 2015.; "Global Forum on Tax Transparency Pushes Forward International Co-operation against Tax Evasion." O.E.C.D. Newsroom. October 30, 2015.

26 "Tax Transparency 2015: Report on Progress." O.E.C.D.: Global Forum on Transparency and Exchange of Information for Tax Purposes. 2015, p. 33.

that F.I.'s will be asking their clients for more information in order to establish the clients' residence and then report their account information to the tax authority of their residence (through the F.I.'s tax authority). This will happen in every jurisdiction where the client has a reportable account and, as what is asked may differ slightly from jurisdiction to jurisdiction, it will be difficult to apply a "one size fits all" approach to due diligence/"know your client" requirements. These are early days for the C.R.S., but like F.A.T.C.A., it is here to stay in one form or another, and it is already operating in E.A.G. jurisdictions. Even though the U.S. is not a participating jurisdiction, the C.R.S. will still have an impact on some F.I.'s located there and it must still be taken it into account.

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