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INSIGHTS

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EDITORS' NOTE

In this month's edition of *Insights*, our articles address the following:

- **An American In London: Due Diligence Observations.** Performing due diligence on private companies for a potential merger or acquisition has been described as an exercise in educated guessing. The questionable quality of the target's financial information, potential hidden liabilities, financing, and similar deficiencies may result in a valuation that is neither straightforward nor reliable. When the target is abroad, the culture, language, and business norms may cause the educated guess to be more guess and less educated. Knowing how to overcome this dilemma is a skill set that can be obtained only through experience. Nick Magone, founder of Magone & Company, P.C., in Roseland, New Jersey, shares his experiences in performing due diligence on potential target companies in the U.K. His advice? Numbers are only the beginning.

- **The Changing Face of Service Permanent Establishments.** As governments struggle to adapt the old rules of taxable presence within a jurisdiction to economic activities in the digital age, new concepts have been asserted to impose tax on foreign service providers who are based abroad but regularly furnish services within a country. India is among the global leaders rejecting physical presence in favor of location of the customer. Neha Rastogi and Stanley C. Ruchelman look at the concept of destination based taxation and a recent case, where an Indian Income Tax Appellate Tribunal held that the physical presence of the foreign taxpayer's employees is not relevant for determining the existence of a Service P.E. in the source country.

- **Double Dutch: Dividend Tax Reform Extends Exemption, Yet Tackles Abuse.** This year's budget in the Netherlands contains a legislative proposal that introduces a unilateral exemption applicable to corporate shareholders based in treaty countries, such as the U.S., subject to stringent anti-abuse rules. In addition, it proposes to bring cooperatives used as holding vehicles within the scope of the dividend withholding tax rules. Soon after the proposals were announced, a coalition government was formed and announced a complete elimination of dividend withholding tax. Paul Kraan of Van Campen Liem in Amsterdam explains.

- **The Sharing Economy Part 1: New Business Models + Traditional Tax Rules Don't Mix.** The current international tax system was established on principles dating back to the first half of the 19th century, when a nation's retail economy consisted mostly of brick-and-mortar stores. As the purchase of services and goods was gradually dematerialized and internet giants such as Google or Microsoft appeared, governments struggled adapt tax rules to keep up with new business models. Now, governments around the world have shifted their focus to a relatively new part of the digital economy called the "sharing economy." Fanny Karaman and Beate Erwin look at recent tax developments in the world of Airbnb and Uber.

- **Swiss Federal Council Opens Consultation Process on Tax Proposal 17.** When Swiss voters rejected the Corporate Tax Reform Act III ("C.T.R. III") in a referendum on February 12, 2017, Swiss tax reform was not derailed, only delayed. Events that took place in September have moved the process forward. Existing cantonal tax privileges will be abolished, as agreed with the E.U., and replaced by mandatory introduction of a patent box regime in all cantons, voluntary introduction of additional deductions for research and development ("R&D") expense, and a step-up in basis of hidden reserves created under the old tax regimes or before immigration to Switzerland. Reto Heuberger, Stefan Oesterhelt, and Martin Schenk of Homburger AG, Zurich, explain the most important aspects of these and other aspects of T.P. 17.

- **When Does an Aged Account Receivable Give Rise to a Deemed Repatriation?** One form of taxation under Subpart F is an "investment in U.S. Property." The law treats the investment as a form of taxable repatriation of earnings. Under certain circumstances, aged accounts receivable may be seen as a form of taxable investment in U.S. property. Most U.S. tax advisers look to a 60-day rule under which the account receivable is treated as a loan if not settled by the last day of the second month following a sale. However, that is a safe harbor. I.R.S. private letter rulings and Tax Court cases have addressed fact patterns in which the account receivable remains open for a much longer time. Some taxpayers win and others lose. Elizabeth V. Zanet and Stanley C. Ruchelman explain.

- **Art and the Estate: Why Planning is Important, Part I – U.S. Taxpayers.** Taxpayers holding valuable works of art receive different tax treatment, depending on the characterization of the individual. Is the individual the artist, a dealer, an investor, or a collector? Rusudan Shervashidze and Nina Krauthamer examine various planning tools available, focusing mostly on the collector.

- **O.E.C.D. Receives Public Comments on Proposed Changes to the Model Tax Convention.** In August, the O.E.C.D. released public comments on proposed changes to the Model Tax Convention. Beate Erwin and Stanley C. Ruchelman examines the suggestions received by the O.E.C.D. and provides observations on the interplay between the O.E.C.D. proposed changes and existing U.S. approaches to these issues. Areas covered include whether competent authority agreements can define undefined terms thereby removing the interpretation from local courts, whether a limitation on benefits ("L.O.B.") clause or a principle purpose test ("P.P.T.") is the better approach to limit treaty shopping, and whether a home that is leased to others can be a permanent home for purposes of applying the residence tiebreaker provision in a treaty.

- **Treasury Turns Back the Clock on 2016 Tax Regulations.** On October 4, the "other shoe dropped" on eight regulations issued by the Obama administration in 2016 and January 2017. These eight measures, which were first identified in an interim report to the president as unnecessary, unduly complex, excessively burdensome, or failing to provide clarity and useful guidance, will be withdrawn, revoked, or modified. Stanley C. Ruchelman, Sheryl Shah, and Neha Rastogi identify the targets and explain the plans of the Treasury Department.

- **Updates and Tidbits.** This month, Sheryl Shah, Neha Rastogi, and Nina Krauthamer look briefly at certain timely issues: (i) Swiss nexus requirements to be eligible for treaty benefits, (ii) the impact of technology tax reporting and information sharing, (iii) an I.R.S. pilot program expanding the scope of letter rulings to Code §355 stock and security distributions, and (iv) recent application of the 2016 anti-inversion regulations issued by the Obama Administration under Code §7874.

We hope you enjoy this issue.

- The Editors

AN AMERICAN IN LONDON: DUE DILIGENCE OBSERVATIONS

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Tags
Due Diligence
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INTRODUCTION

U.S. business owners and professionals performing due diligence on potential merger or acquisition candidates are all too familiar with the trials and tribulations of arriving at a fair valuation for the acquirer. They often stress over the quality of the target's financial information, potential hidden liabilities, financing, and the like. Now, imagine that the due diligence exercise is occurring outside of the U.S. because the target is based abroad. Adding to the stress is a different culture as well as different finance and legal terminology, laws, and accounting principles. How is one to manage?

The silver lining, in my experience, is that when the due diligence involves a non-listed (*i.e.*, privately-held) U.K. company, financial information is much more accessible than it is in the U.S. One can purchase information on a possible target and see the reported operating results, ownership group, and directors. The information is provided in a required government format, as will be discussed. However, this does not guarantee that the information is accurate. Normal due diligence skepticism still applies.

This article will provide information on some sources of information, forms of financing, and director responsibilities that are typical in the U.K. This is not a "how to" on M&A due diligence, but rather an overview of the types of financial information, financing, and other business practices relevant to acquiring a privately-held company. It is based on the author's experience garnered from several due diligence exercises in the U.K. for potential acquirers based in the U.S.

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FINANCIAL INFORMATION

In the U.S., we are accustomed to receiving various forms of financial statements in accordance with Generally Accepted Accounting Principles ("G.A.A.P."). In the U.K., there are also Generally Accepted Accounting Principles. However, they are known as U.K. G.A.A.P. Financial statements are often prepared in accordance with these principles. In addition, financial statements may also be prepared pursuant to International Financial Reporting Standards ("I.F.R.S."). The latter is usually reserved for listed (*i.e.*, publicly-traded) companies.

In the U.K., public and private companies are governed by the Companies Act 2006 (the "Act") as amended. The Act sets forth the requirements for operating public and private corporations and limited companies, including director responsibilities and reporting requirements to Companies House, the keeper of all financial statements. Generally, non-listed companies are required to report their financial information within nine[1] months after the fiscal year-end, listed companies within six months.[2] Penalties are assessed for lateness and may indicate financial or operating issues to be cognizant of during the due diligence process.

Now that we have context, the financial information must be acquired from Companies House. The information can be accessed by following this link. Here, one can access free information, select documents, or subscribe to the Companies House information service. Personally, I commence my due diligence with a request for the financial statements.

"Too often we tend to put more credibility in audited financial statements than other levels of financial statement preparation such as internal management reports or tax returns."

Contained in the financial statements are statements and exhibits we, in the U.S., are unaccustomed to seeing for non-public companies. One such exhibit is the section on "Company Information." Company Information contains a listing of the company's directors, registered number (the equivalent of an E.I.N. in the U.S.), registered office business address, auditor, and bankers, if any.

I use this information to begin some of my preliminary due diligence. I call business associates and colleagues to see what I may uncover in casual conversation based on knowing the players. I also conduct internet searches to determine lawsuits, sanctions, or other adverse actions taken against the company or its directors, as well as the professionals retained by the company.

While on the topic of financial and accounting data, I want to emphasize the importance of skepticism when evaluating the data. Too often we tend to put more credibility in audited financial statements than other levels of financial statement preparation such as internal management reports or tax returns. On more than one occasion, my due diligence has uncovered questionable accounting principles. These questionable principles were not developed to facilitate the transaction but rather were used and adopted over years.

As one banker friend once said to me, "I don't understand G.A.A.P., but I know if the business cash flows." This tactic is important when conducting due diligence in the U.K. Americans will not know all of the U.K. G.A.A.P. differences, but we can develop cash flow models proving or disproving the operating results. After all, it is all about business.

BANKING

Banking in the U.K. is vastly different from banking in the U.S., both in process and diversity of product – some better and some worse. For this reason, it is useful to understand the more common forms of bank financing one will encounter in the U.K. In my experience, the most common forms are bank sales financing, overdraft facility, trade financing, and bank guarantees.

Bank Sales Financing ("B.S.F.")

B.S.F. is asset-based financing. Similar to the practice in the U.S., B.S.F. can be secured by accounts receivable ("debtor accounts") or inventory ("stock"). The advance rate will be similar to what we are accustomed to seeing in the U.S. – 80% of eligible accounts receivable. Incorporated into the agreement will also be ineligible

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[1] "Filing Accounts," GOV.UK, last updated July 25, 2017.

[2] *Id.*

accounts (*e.g.*, cross-aged receivables greater than 90 days old, concentrations, or accounts receivable with right of offset). Accounts receivable with right of offset occurs frequently when the business sells to a vendor. The bank is very concerned with not realizing 100% of its collateral in the event of a bankruptcy ("receivership"). The bank therefore limits its exposure through additional advance rate restrictions, perhaps 50% or less for accounts with rights of offset. The disadvantage of this financing vehicle is that the company is limited to the accounts receivable at a given point in time. This means if the business is seasonal, there will be insufficient working capital for the business, and the business may need Trade Financing, discussed below.

Finally, the reporting is more cumbersome than in the U.S. Monies received from customers are immediately swept against the outstanding balance. From my experience, the finance team of the target company must be competent and on the ball with their reporting or this facility will prove to be problematic.

Overdraft Facility

An overdraft facility is known as a line of credit in the U.S. It operates in much the same manner. However, in my experience, banks in the U.K. do not extend this type of financing to privately-held companies, least of all U.K. companies owned by a U.S. entity or individual. There are ways around it, if one is willing to post a Letter of Credit. However, the bank may still refuse overdraft facility in lieu of lending using a B.S.F. secured by a Letter of Credit.

Trade Financing

Trade financing, commonly referred to as import/export financing, enables the business to finance its inventory, thereby overcoming seasonality as it relates to product. The bank will typically request a list of the company's suppliers. If the bank is not comfortable with a supplier, it will not fund the P.O. The terms are typically 120 days from the date of shipment. Upon presentation of appropriate shipping documents, the payment is made to the supplier. Problems do arise when the customers do not pay timely or when there are delays in shipments to customers. In my experience, the bank is usually willing to extend the date of repayment.

Bank Guarantee

A bank guarantee is exactly what it implies. It can be used as a performance bond to ensure the company performs as intended under a contract. It is also used for the Value Added Tax ("V.A.T.") Duty Deferment Scheme when goods are imported to the U.K. It is given to Her Majesty's Revenue and Customs ("H.M.R.C.") – the U.K. equivalent of the I.R.S. – to ensure the company can meet the cost of all duty and V.A.T.

Other

Some other terms to be aware of as you go through the due diligence process are "bank support" and "comfort letter." Bank support is a euphemism for work out. This will require more work on the business's part and more monitoring by the bank. If you hear the words "business support," I would not hold out hope that the bank will assign the financing to a new owner. With that said, the bank may be interested in working with the new owner and request a comfort letter that states the foreign owner in the U.S. company will provide resources in support of the U.K. entity. The resources expected will be cash. The bank will present this as a non-binding document, but legal advice I have obtained in the U.K. has always cautioned against signing the comfort letter.

EMPLOYMENT

Perhaps more than any other area of due diligence, U.K. employment norms are difficult for Americans to comprehend.

In the U.S., we are accustomed to employment at will – a concept in employment law whereby an employer can dismiss an employee for any reason without warning. This concept does not exist in the U.K.

Generally, only senior executives have employment agreements in the U.S. This is not true in the U.K. In the U.K., all employees have employment ("service") agreements, which set forth hours of work, vacation time ("holiday"), benefits, grounds for termination, and payment once terminated. It is important to review these agreements carefully, especially for senior executives of the target company.

In my experience, employees in the U.K. can be terminated ("made redundant"). However, one must follow the procedures established in the employment agreement. For example, I was involved in the termination of a senior financial professional. The terms of her employment agreement were such that she was entitled to six months' pay after termination (referred to in the U.K. as "Garden Leave"). For a period of time, this company was paying terminated employees a nice sum while, in some cases, also employing their replacements.

A by-product of having an employment agreement is that U.K. employees take their responsibilities very seriously. They will generally work the hours required in their agreements but not longer, or at least not on a consistent long-term basis, as is common in the U.S.

The mistake many Americans make is to presume that the target company's workforce will abide by American standards – working on weekends, working for more than eight hours daily, limiting vacation time to two weeks. I have unsuccessfully tried to impart this aspect of American work culture. It does not work.

During your due diligence, you must begin to think through which employees you will keep, the cost involved for terminating the others, and how you intend to manage them from 3,000 miles away. A sure-fire way to encourage significant turnover is to have an American present in the U.K. from the onset or to insist on American work habits. If that is the intent of the acquirer, let me save you time, money, and aggravation. Pass up the opportunity. This is the one area that cannot be overcome with money alone. There must be a plan and cultural sensitivity. Even with such a plan, it will not go smoothly and a great deal of patience will be required.

OFFICE LEASES

Office leases in the U.K. operate in a similar fashion to those in the U.S. There is one major difference: the concept of "dilapidations." As many an attorney can attest, dilapidations constitute the disrepair for which a tenant is liable upon vacating the premises (*e.g.*, repairs, redecoration, and reinstatement of alterations). In other words, the tenant must leave the premises as it was provided.

Obtain the target company's leases and review the language. In the U.K., it is unlikely that a lease does not contain language as to dilapidations. Financial Reporting Standard 12 ("F.R.S. 12") and International Accounting Standard 37 ("I.A.S. 37") set forth the requirements to accrue the amount. If you have company with audited financial statements, the financial statements should provide for a dilapidations reserve, which will be described in the footnote under "Provisions for Liabilities." This will indicate the amount included in the financial statements but not the actual total liability, as the accrual usually occurs ratably over the life of the lease. Read the lease agreement carefully and speak with experts. The last thing an advisor or business owner wants to see is a lease expiring in the near term costing the business hundreds of thousands of pounds sterling for the privilege of leaving the premises.

DIRECTOR RESPONSIBILITIES

It may seem odd to include director responsibilities in a document on due diligence. However, this is a serious consideration as it bestows rights, obligations, and liability on an individual.

Prior to becoming a director of a privately-held U.K. company, I had the usual American view when it came to the housekeeping for a corporation. How many of you or your clients maintain corporate minutes, meeting agendas, resolutions, and the like? Most in the U.S. first give consideration of the requirements when the company is put up for sale or when bank financing requires up-to-date resolutions, minutes, etc.

A private company director in the U.K. is expected to follow the rules of the articles of association, keep company records, report changes, and file the company's accounts and tax return. The responsibility is greater, more along the lines of a director of a publicly-held company in the U.S., as can be seen in the following examples.

Example 1

> A director has responsibility if a company overtrades. This occurs where a company requires more resources either in people, working capital, or other circumstances than is available and the company runs the risk of not meeting its obligations. Most people would consider start-ups at risk, but in my experience, most privately-held companies in the U.K. are thinly capitalized. If this is the case, one will hear terms such as "trading within our means."

Example 2

> Another area where a director can be held responsible is with regard to health and safety. Health and safety deals with anything involving the people who work for the company. Examples of health and safety concerns include electrical cords not being properly adhered to the floor causing a danger for falls, employees speeding in company cars, or multiple tickets for speeding received by employees. If there is a serious accident and the company cannot demonstrate that it sent the employee to driver training, the director can be held responsible.

Arguably, these are items where the executives and directors can be held liable in the U.S., as well. But can a director in the U.S. be held criminally responsible? In the U.K., a director most certainly can.

For the reasons mentioned above, it is imperative to determine who will be a director post-closing. It will also be imperative that the entity will be appropriately managed to ensure the various laws and responsibilities are carried out properly to reduce exposure for the individuals involved. As a director, I travel, phone, and review internal financial information to ensure I am carrying out my fiduciary responsibility. In addition, there is an agenda for each board meeting. A standing item on the agenda is health and safety.

"Those that prove successful take the cultural differences seriously and are sensitive and respectful of those differences."

MORE THOUGHTS ON FINANCIAL INFORMATION

As I have covered, U.K. directors have responsibility and liability for their companies. Consequently, the attitude towards financial reporting is more sensitive when it comes to overtrading and profitability. There is a desire to ensure the company is profitable, and accounting principles are often used to achieve this end, especially if there is bank financing involved. Therefore, be wary of significant prepaid assets, or even fixed assets, for that matter.

In the course of a manufacturing company due diligence, I found designs capitalized. I am not referring to molds. I am referring to wages capitalized for designing patterns on the basis the patterns would be reused. As I analyzed the data and recast the capitalized assets as expenses, the company went from marginally profitable to significantly unprofitable. In another due diligence, I was presented with various refinancings of debt through government programs. The U.K. has some interesting programs for small and midsize enterprises ("S.M.E.'s"). However, in this case, the programs were used to mask cash flow problems and kick the repayment problem down the road. Potential buyers beware.

FINAL OBSERVATIONS

The information presented can be considered a quick start as to finding documents, overcoming terminology, and understanding financing.

As professionals, we get too caught up in the data. Keep in mind that the items making due diligence in the U.K. more difficult are not only the regulations and banking, but also the cultural differences. The cultural differences are huge. Do not be surprised if you tell a British manager to stay out of an area and she actually steps aside. Also do not be surprised if this same manager has a solution but does not proactively come forth with it.

Having worked for many years with colleagues in the U.K., there is a saying I have heard time and again: "The Americans have landed." It is not flattering, but meant to imply we are here to save the day and know what to do to save it. Indeed, we have arrived, and bringing this cultural awareness with us is important. After all, the due diligence is being conducted to acquire and/or merge the U.K. operation into the U.S. operations of the acquirer. Significant dollars and effort have been expended, and the difference between success and failure is a simple understanding of what makes us different.

I do not have any empirical data to support the following assertion, only anecdotal evidence in speaking with friends and colleagues who have worked for U.K. companies post-acquisition by American companies. Those that prove successful take the cultural differences seriously and are sensitive and respectful of those differences. Those that are not sensitive and respectful of the cultural differences can expect to waste years trying to get the business to run smoothly and profitably. Remember what George Bernard Shaw said in 1910: “England and America are two countries separated by a common language.” In my experience, what was true then is even more true now.

THE CHANGING FACE OF SERVICE PERMANENT ESTABLISHMENTS

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Place of Performance

INTRODUCTION

Broadly speaking, a Service permanent establishment ("P.E.") is an international tax concept under which services provided by a nonresident may give rise to a P.E. in the source country if the services are provided beyond a certain period of time. The concept was first inserted in the U.N. Model Tax Convention in 1980, and while tax authorities across the world remain split on whether a Service P.E. requires a fixed place of business in the source country, the Indian tax authorities recently introduced a new dimension that is further baffling the tax world.

IS "PHYSICAL PRESENCE OF EMPLOYEES" NO LONGER A PRECONDITION FOR IMPOSING TAX?

India Holds Physical Presence of Employees Not Required

Recently, an Indian Income Tax Appellate Tribunal[1] (the "Tribunal") presided over a matter[2] that addressed whether a Service P.E. existed in India with regard to a business carried on by a U.A.E. L.L.C., ABB FZ.

ABB FZ was engaged in the business of providing regional services to a related party in India. The employees of the L.L.C. were present in India for 25 days, during which services were provided. However, the employees continued to render services on a regular basis from the U.A.E. through emails, video conferencing, and other electronic modes for more than nine months within a 12-month period.[3]

The Tribunal determined that ABB FZ had a Service P.E. in the facts presented and held that the presence of employees is not required in the source country for a Service P.E. to exist. The Tribunal emphasized that it is not the presence of the employees that is important. Rather, it is the furnishing of services for more than the specified period of time (regardless of the place of performance) that determines whether the nonresident employer has a Service P.E. in India. Needless to say, this

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1 An Income Tax Appellate Tribunal is the first judicial appellate authority for trying direct tax matters in India.

2 *ABB FZ-LLC v. Deputy Commr. of Income tax (International Taxation),* [2017] 83 taxmann.com 86.

3 Article 5(2)(i) of the India-U.A.E. tax treaty provides that a non-resident has a Service P.E. in the source country if it furnishes services through its employees in the source country and such services continue for a period of more than nine months in a 12-month period.

approach has shocked tax advisers even more than the decision in the *Formula One* case.[4]

The Tribunal held that in the present age of technology, where the services, information, consultancy, management, etc. can be provided through various virtual modes (*e.g.*, email, internet, video conference, remote monitoring, remote access to desktop), the physical presence of the foreign taxpayer's employees is not relevant for determining the existence of a Service P.E. in the source country.[5]

If the Tribunal's decision is upheld on appeal, almost all income earned by a nonresident from providing services to an Indian affiliate from a base outside India will be taxed in India under the Service P.E. concept as applied. All that is required is for the services to be rendered for more than a specified period of time. Where the Indian company reports to a foreign parent, services likely would be provided through e-mails, teleconferences, and video feed on each working day during the year. Therefore, it is likely that the Indian tax authorities will argue for the existence of a Service P.E.

"The physical presence of the foreign taxpayer's employees is not relevant for determining the existence of a Service P.E. in the source country."

It may be noted that under Indian domestic tax law, fees for technical services provided by a nonresident are taxed in India regardless of whether the nonresident has a place of business in India or the services are rendered in India.[6] It appears that the Tribunal borrowed the logic from that provision and applied it to the requirements of the Service P.E. clause under the India-U.A.E. Tax Treaty. It is noteworthy because there is no "Fees for Technical Service" clause in the treaty, and in the absence of a P.E. in India, the fee would have completely escaped Indian taxation.[7] Thus, it appears that the Tribunal underwent such creative thinking in an attempt to tax the service income in India.

The decision of the Tribunal implies that the place of performance of services is not relevant for determining the source of income. Rather it is the place of final consumption/utilization of such service that determines its source. Instead of an income tax, which compensates a service provider for its actions performed at the location where employees are based, the activity is subject to consumption tax, which is based on the place of consumption. Recent E.U. proposals to tax the income of U.S.-based digital companies, such as Amazon and Google, reflect a similar approach.

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4 *Formula One World Championship Ltd. v. Commr. of Income-tax*, (IT)-3, Delhi, [2017] 80 taxmann.com 347 (SC); judgement dated April 24, 2017. In the case, a U.K. resident licensed the use of certain intangible property to an Indian company that operated a Formula One grand prix race in India. The U.K. resident received a fixed fee of $40 million. The build-up for the race and the race itself took place over a limited period of time using a track facility owned by a third person. Affiliates of the U.K. resident exercised media and title sponsorship rights in India. In broad terms, the limited period leading up to the race represented the entire period during which business was conducted in India. The Indian Supreme Court held that the U.K. resident maintained a P.E. in India and the license fee paid to the U.K. resident was fully taxable.

5 The Tribunal, however, held that this issue will only have any bearing on the issues under considerations if on examination of facts it is concluded that the activities of the taxpayer do not fall under any of the articles of the tax treaty.

6 Explanation after section 9(2) of the Income-Tax Act, 1961.

7 The Tribunal, however, ultimately held that consideration for services is in the nature of Royalties under the India-U.A.E. Tax Treaty.

The rationale behind the Tribunal's decision appears to be contrary to the concept of tax neutrality between a sale of goods and provision of services. Profits arising from a transaction that involves a simple sale of goods from a nonresident is not taxable in the source country in the absence of a P.E. of such nonresident seller. By similar reasoning, services performed outside India for an Indian resident should also be free of tax in India, if only to preserve similar treatment for sales and services.

U.N. Maintains Traditional Approach but Concedes to Minority

Although the existence of a Service P.E. without the physical presence of employees in the source country is an enormous deviation from generally accepted international tax standards, it is not totally unheard of.

In its 10^{th} and 11^{th} sessions, in 2014 and 2015 respectively, the U.N. Committee of Experts on International Cooperation in Tax Matters (the "U.N. Committee") agreed that the traditional interpretation of the Service P.E. requires the physical presence in the source country of individuals, being employees or personnel of the nonresident furnishing services in order for a P.E. to exist in source country. However, a minority emphasized the term "furnishing" as used under Article 5(3)(b) of the U.N. Model tax Convention and contended that the furnishing of services does not require a physical presence. As the term furnished suggests the place where the customer benefits from the service, physical presence of employees in the country of consumption becomes irrelevant as long services are furnished for more than 183 days (*i.e.*, the threshold specified under Article 5(3)(b) of the U.N. Model Tax Convention).

The U.N. Committee acknowledged that the growth of technology has made it possible to furnish services without any physical presence in the source country and, for that reason, did not reject outright the minority view. Rather, the U.N. Committee required countries adopting the minority view to seek agreement through a mutual agreement procedure under Article 25 (Mutual Agreement Procedure) when the treaty partner followed the majority view of physical presence.

In 2016, Saudi Arabia adopted the minority view and formally implemented guidelines to recognize the existence of a Service P.E. without the presence of employees in Saudi Arabia. Under the Saudi guidelines, a nonresident is deemed to have a Service P.E. in Saudi Arabia if

- it furnishes services to a person in connection with the latter's activity in Saudi Arabia, and
- under the contract, the duration of services rendered exceeds the threshold period under the applicable tax treaty (predominantly a 183-day limit).

In effect, Saudi Arabia does not require the physical presence of employees to establish a Service P.E. with respect to the provision of cross-border services. The validity of such internal guidelines may be questionable in a treaty context, since they reflect a unilateral interpretation of that tax treaty whereas the provisions of the entire treaty represent the benefit of a bargain.

WHAT WOULD HAPPEN IF *ABB FZ* WAS TRIED IN THE U.S.?

The Service P.E. concept, which was conceived by the U.N. Model Tax Convention, has also appeared in U.S. tax treaties with Canada and certain developing countries. Thus, it is interesting to examine how U.S. courts may rule on a transaction like the one in the *ABB FZ* case, where services are provided in a foreign jurisdiction and consumed in the country.

Under current U.S. domestic law, it is likely that U.S. courts would emphasize the place of performance of services instead of the place of consumption to determine the source of income.

In a landmark case, *Piedras Negras Broadcasting Co. v. Commr.*,[8] the U.S. Court of Appeals for the Fifth Circuit addressed the source of income arising from the sale of radio time and the dissemination of advertisements by a radio station located in Mexico. Despite the fact that 90% of the station's listener response came from U.S. and 95% of its income came from U.S. advertisers, the court held that a nonresident is not considered to have performed services in the U.S. without some physical presence in the U.S. and made the following observations:

> We think the language of the statutes clearly demonstrates the intendment of Congress that the source of income is the situs of the income-producing service. The repeated use of the words within and without the United States denotes a concept of some physical presence, some tangible and visible activity. If income is produced by the transmission of electromagnetic waves that cover a radius of several thousand miles, free of control or regulation by the sender from the moment of generation, the source of that income is the act of transmission.
>
> All of the respondent's broadcasting facilities were situated without the United States, and all of the services it rendered in connection with its business were performed in Mexico. None of its income was derived from sources within the United States.

The Court of Appeals emphasized the situs (*i.e.*, the place of performance) of the services to determine the source of income. For services provided via e-mail, video conferencing, or other digital medium, it may be argued that the source of income arising from that service is its situs (*i.e.*, the place of performance). If other U.S. courts follow the rationale of the Court of Appeals, then it is likely that services provided electronically from outside the U.S. would not be taxed in the U.S.

In any event, this is the current state of U.S. domestic law. Since an income tax treaty generally cannot increase tax, a treaty resident presumably always maintains the right to elect to apply U.S. domestic law instead of a treaty. However, since the I.R.S. generally does not permit "cherry picking" of provisions, the treaty resident must choose between applying the treaty in its entirety or not at all.

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[8] 127 F.2d 260.

DOES A SERVICE P.E. REQUIRE A FIXED PLACE OF BUSINESS?

Proving that ABB FZ had a fixed place of business in India seemed to be the least of the Tribunal's concerns since it was already of the view that ABB FZ had a Service P.E. by reason of providing services to a party inside India beyond the specified period of time. Nonetheless, the Tribunal observed that Article 5(2) of the India-U.A.E. tax treaty, which, inter-alia, includes the concept of Service P.E., broadens the scope of Article 5(1), which defines P.E. as a fixed place of business in the source country. Therefore, Article 5(2) was not a prerequisite to fulfilling the requirement of Article 5(1), as Article 5(2) is independent of Article 5(1) and the condition of fixed place of business is not attached.

The Johannesburg Tax Court reached a similar conclusion, albeit along a different path, in a case[9] that addressed a matter involving a U.S. service provider. While, the Tax Court held that the two comparable subparagraphs of the U.S.-South Africa tax treaty cannot be read disjunctively or treated separately, it nonetheless held that a Service P.E. does not require a fixed place of business in the source country.

In the Johannesburg case, the employees of the U.S. taxpayer visited South Africa to provide consulting services to South African airlines, and the days of presence in South Africa exceeded 183 days in a 12-month period. Article 5(2)(k) of the U.S.-South Africa tax treaty provides that employees must be present in the source country for more than 183 days in any 12-month period for the nonresident employer to have a Service P.E.:

> The term 'permanent establishment' includes especially: * * * (k) the furnishing of services, including consultancy services, within a Contracting State by an enterprise through employees or other personnel engaged by the enterprise for such purposes, but only if activities of that nature continue (for the same or a connected project) within that State for a period or periods aggregating more than 183 days in any twelve-month period commencing or ending in the taxable year concerned. (emphasis added)

The issue in this case was whether, once the requirements of Article 5(2)(k) are met, the U.S. service provider must also have a fixed place of business in South Africa for it to have a Service P.E.

The Johannesburg Tax Court emphasized the phrase "includes especially" appended to Article 5(2), and observed that, by using this phrase, the drafters of the treaty intended that the factors referred to in Article 5(2)(k) be made part of the definition referred to in Article 5(1); otherwise, they would not have used the words "includes especially." The Tax Court, therefore held that the contents of Article 5(2)(k) must be read as an integral part of Article 5(1).

Based on this analysis, an enterprise becomes liable for taxation in the nonresident country as soon as its activities fall within the ambit of Article 5(2)(k). There is no need to examine whether a fixed place of business exists under Article 5(1). The definition is composite by virtue of the bridging phrase "includes especially." To

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[9] *AB LLC and BD Holdings LLC v. Commr. SARS*, (13276) [2015] ZATC 2.

break it up and treat the two articles separately would be to ignore the natural and ordinary meaning of the phrase.

CONCLUSION

"With advances in technology, the concept of a fixed base seems to be out of touch with today's business practices."

The Service P.E. clause was first inserted in the U.N. Model Tax Convention in 1980, when electronic commerce was unheard of. It is therefore understandable that the drafters did not intend to impose tax on services provided with no physical presence in the source country. However, with advances in technology, the concept of a fixed base seems to be out of touch with today's business practices. Jurisdictions such as India, Saudi Arabia, and South Africa are changing the face of the old provision. Soon it may no longer be recognizable.

DOUBLE DUTCH: DIVIDEND TAX REFORM EXTENDS EXEMPTION, YET TACKLES ABUSE

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INTRODUCTION

In the Netherlands, the third Tuesday of September is known as Princes' Day (*Prinsjesdag*). This event clearly has two sides: Traditionally, it is the annual occasion for the Dutch to show their loyalty to the monarchy (and for the ruling family of Orange to show its royalty to the people in return). Politically, it marks the opening of the new parliamentary year, with the presentation of the budget proposals for the next year. In this regard, it is the Dutch equivalent of the U.K.'s Budget Day.

In line with this double-sided character, this year's budget contains a proposed dividend tax reform that has two sides as well. First, the legislative proposal provides for a significant extension of the existing exemption from withholding tax by introducing a unilateral exemption applicable to corporate shareholders based in treaty countries, such as the U.S. At the same time, it tightens the current system by bringing cooperatives used as holding vehicles within the scope of the dividend withholding tax rules and making the new exemption subject to stringent anti-abuse rules.

These new rules are scheduled to enter into force as per January 1, 2018. When effective, the Dutch government aims to reinforce the position of the Netherlands as the jurisdiction of choice for setting up holding companies that function within business structures with genuine economic activities. In taking these steps, the Dutch government must heed the calls coming from Paris, where the O.E.C.D. is rolling out its B.E.P.S. Action Plan, and Brussels, where the European Commission continues to pursue E.U. Member States that grant illegal State Aid. Together, they bode ill for structures set up primarily for tax reasons. As will be discussed in this article, the proposed legislation attempts to forge an attractive holding company tax system without creating harmful tax regimes. Finding the right balance will require a deft touch by the Dutch government.

EXTENSION OF DIVIDEND AND GAIN EXEMPTIONS

Historically, the Dutch dividend withholding tax regime provides for exemptions in certain domestic situations. Where one Dutch company owns at least 5% of the nominal share capital of another Dutch company, the shareholder is eligible, in principle, for benefits granted under the Dutch participation exemption. The exemption applies to dividends received from a 5% or greater subsidiary. Where the exemption is applicable to the shareholder, a subsidiary distributing a dividend is not required to withhold tax.

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

The proposed legislation extends the scope of the existing exemption for corporate shareholders based within the E.U./E.E.A. to any jurisdiction that has concluded a tax treaty with the Netherlands containing a clause governing taxation of dividends. Consequently, a tax information exchange agreement ("T.I.E.A.") that merely provides for exchange of tax information is not covered by the proposed legislation. The contents of the applicable dividend clause are not relevant. The new unilateral exemption will apply where the treaty provides for a reduction of the statutory domestic withholding rate.

"The proposed legislation extends the scope of the existing exemption or corporate shareholders . . . to any jurisdiction that has concluded a tax treaty with the Netherlands containing a clause governing taxation of dividends."

As an example, the unilateral exemption will apply to qualifying Canadian-resident companies under the Netherlands-Canada Income Tax Treaty even though the treaty provides only for a reduced withholding tax rate of 5%. Similarly, the unilateral exemption will apply to qualifying Chinese-resident companies under the Netherlands-China Income Tax Treaty that reduces withholding rates on dividends to 5% in some circumstances and 10% in others. It will apply also to qualifying U.S.-resident companies under the Netherlands-U.S. Income Tax Treaty when those companies do not qualify for the exemption provided under the treaty.

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

With a view on the simultaneous introduction of a withholding obligation for "holding" cooperatives (see below), going forward the exemption will also be applicable to distributions to "qualifying members" of such cooperatives. In other words, while the new rules may bring holding cooperatives within the scope of the dividend tax, in principle these cooperatives should not be affected if and to the extent their members are corporations established in a treaty country. That said, in these situations normally there would be no Dutch tax benefit in using a cooperative anymore, meaning that existing holding cooperatives might just as well be converted into companies.

Lastly, the new unilateral exemption will apply subject to domestic anti-abuse rules. These rules are discussed in greater detail below. Essentially, they codify the principle purpose test ("P.P.T.") as laid down in the new multilateral instrument ("M.L.I."), which has been developed by the O.E.C.D. within the context of the B.E.P.S. Action Plan. As the M.L.I. is adopted worldwide, it may be expected that the P.P.T. will gradually become part of bilateral tax treaties, meaning that more and more tax treaties will contain similar anti-abuse rules. While dividend clauses in tax treaties currently may overrule anti-abuse rules as codified in domestic legislation, over time anti-abuse rules laid down in domestic law and relevant tax treaty provisions will merge in scope for countries that have signed the M.L.I. and revised treaties with other countries.

The key likely will not be in the standard that is adopted but in the application of that standard. It may turn out that the Dutch application of the P.P.T. may not be sufficiently rigid to satisfy the European Commission. As further discussed below, Dutch anti-abuse rules are not just meant to codify the P.P.T. as laid down in the M.L.I. but also to implement the G.A.A.R. as included in the recently amended P.S.D. Any perceived failure to implement the P.S.D. in a correct manner may lead the European Commission to take legal action against the Netherlands.

INCLUSION OF HOLDING COOPERATIVES

Under current law, as a rule, cooperatives are not within scope of Dutch dividend tax. This has been a deliberate choice; in fact, today's government policy in the Netherlands still maintains that "real" cooperatives must not be bothered with an obligation to withhold dividend tax when distributing profits to their members. As a result, the Dutch legislator has created a clear distinction between a cooperative and other business entities or arrangements such as a public company ("N.V."), a private company ("B.V."), the contractual form of an "open" limited partnership that is not transparent ("C.V."), and a mutual fund ("F.G.R."). In principle, the latter group of business entities or arrangements are obliged to withhold dividend tax on their profit distributions.

The background to this distinction is that the cooperative is traditionally used for certain collective activities (*e.g.*, purchases or sales) that are closely connected with – and supportive to – the individual businesses of its members. For this reason, it is felt that no fiscal obstacles should hinder the distribution of profits to members of cooperatives.

Pursuant to the Dutch Civil Code, the legal purpose of a cooperative is "to serve the economic interests of its members." This definition is generally accepted as being rather broad and is not restricted to any specific activities or industries. Even though cooperatives are traditionally used for collective activities within the agricultural and banking sectors, nothing on the face of the law prevents investors or companies from using cooperatives for other purposes, as long as the relevant activities serve the economic interest of a member. Consequently, holding and finance activities qualify just as well from a legal point of view.

In the course of the past decade, the use of Dutch cooperatives became quite popular within the domain of international tax planning. Although it goes without saying that such popularity was mainly caused by the absence of an obligation to withhold tax on distributions at source, it follows from the above that this was not caused by any change of law. The law always provided for that treatment. Rather, the sudden rise of the Dutch cooperative as an international holding vehicle resulted when tax advisers "discovered" the cooperative as an appropriate vehicle for structuring international investments. Particularly in relation to private equity, using a cooperative did not just create a tax benefit. It offered a nice "add-on" by reason of the flexibility it provides from a legal point of view in structuring the arrangement. This is because a cooperative is much less governed by mandatory provisions of law than a company.

Inevitably, systems in nature tend to revert to stasis, and the rise of the cooperative lead to its partial downfall once its popularity attracted the attention of the tax authorities, both in the Netherlands and abroad. It became clear that Dutch cooperatives could be used as an exit route from the E.U. to tax haven jurisdictions. This is generally considered undesirable, particularly where membership interests are held as a passive investment and members are not actively involved in the management of the cooperative and its investments, as is normally the case with private equity funds.

Under some pressure from the international community, the Netherlands introduced a withholding obligation for cooperatives in 2012 that was designed to be applicable in specific circumstances. This provision however was formulated as an exception to the rule. Hence, it was aimed at certain abusive structures only. With a view to implementing the general anti-avoidance rule ("G.A.A.R."), as laid down in the amended P.S.D., into Dutch law, the wording of the relevant legislation was amended with effect from 2016, but nothing of substance changed.

Then, in July 2016, the European Commission published a notice on illegal State Aid that set the stage for the present change in law. In its notice, the European Commission reasoned that where cooperatives are used for similar purposes and activities as companies, there would be no justification for a difference in tax treatment and any deviation from the general legal framework as it applies to companies might be construed as offering a selective advantage, which in turn may result in illegal State Aid. Considering the broad definition of their statutory purpose, Dutch cooperatives can be used for similar purposes and activities as companies, from a legal point of view. Apparently, the European Commission expressed the view that, from an illegal State Aid perspective, cooperatives should be subject to the same type of taxation as companies.

Essentially, this is what the proposed legislation aims to achieve. By introducing the concept of a holding cooperative that differs from other types of cooperatives, a cooperative that is predominantly engaged in holding and group finance activities will be brought within scope of collecting dividend withholding tax and therefore become – more or less – subject to the same type of taxation as other entities and arrangements that are customarily required to withhold tax on dividend distributions. This treatment will apply when holding and group finance activities comprise at least 70% of all activities engaged in by a cooperative. Where a cooperative is significantly engaged in activities other than holding and group finance, it remains outside the scope of the dividend tax. This will occur when other activities comprise more than 30% of the total activities of a cooperative. Consequently, cooperatives with real economic activities should not be affected by the new rules, except in unusual circumstances. Accordingly, for dividend withholding tax purposes, a cooperative will be afforded comparable treatment to a company if it is predominantly engaged in holding and finance activities.

Whether a cooperative qualifies as a holding cooperative depends on its activities over the financial year preceding a profit distribution. While in principle the composition of its balance sheet should be decisive, other factors may also be taken into account – such as allocation of turnover and the type of activities carried on by its employees. Even though the aggregate book value of participations in group companies and group loans may comprise over 70% of the asset side of a balance sheet, a cooperative may still not be regarded as a holding cooperative if it performs a headquarter function with active involvement in the management of its participations, provided that a sufficient number of employees perform management tasks of substance.

Where a cooperative has a significant number of members based in non-treaty jurisdictions such as the British Virgin Islands or the Cayman Islands, it cannot rely on the new domestic exemption from dividend withholding tax in relation to profit distributions to those members. Particularly in those situations, it seems worthwhile to consider a restructuring (*e.g.*, by making the cooperative sufficiently active through hiring employees, renting office space, and the like. Also, private equity structures with sufficient employees at the level of the cooperative and active involvement at the level of its portfolio companies may be out of the scope of withholding tax obligations. Again, the substance of the employee activities will likely be determinative, not titles and activities that occur sporadically.

Pursuant to the legislative proposal, the dividend withholding tax treatment of cooperatives remains different from companies where profit distributions are made to a member owning an interest of less than 5% in the cooperative. The withholding tax obligation on dividend distributions applies solely to qualifying members that are entitled to at least 5% of either annual profits or liquidation proceeds. For this purpose, membership interests that are directly or indirectly held by related parties or by a "cooperating group" must be aggregated. Since "real" cooperatives often have many members, this provision effectively functions as an "escape clause" since it ensures that even though they may qualify as holding cooperatives, these cooperatives are not affected – and thus bothered – by the new rules.

INTRODUCTION OF ANTI-ABUSE RULES

As already mentioned above, application of the new domestic exemption is subject to anti-abuse rules. These rules are basically a combination of the P.P.T. as advocated by the O.E.C.D. in B.E.P.S. Action 6 and the G.A.A.R. as recently inserted in the P.S.D.

The wording of the new anti-abuse rules is essentially based on existing Dutch domestic corporate income tax rules. Under specific circumstances, dividends distributed to members and capital gains from the sale or other disposition of a membership interest may be taxed in the hands of a foreign shareholder or member. Under the legislative proposal, this provision will be aligned with the new dividend tax provisions. Consequently, the exemption is denied if the following conditions are met:

- The shareholder or member (the "direct owner") holds its participation in the company or holding cooperative (the "Dutch entity") and one of the main purposes of that holding is the avoidance of Dutch dividend tax (the "subjective test").
- The shares or membership rights (the "participation") are part of an artificial structure or the profit is distributed through an artificial transaction or a series of artificial arrangements or transactions that lack valid business reasons reflecting economic reality (the "objective test").

Thus, the new legislation establishes the following obligations:

- Under the subjective test, management of the company or the cooperative must determine whether the direct shareholder or member has a main purpose of avoiding Dutch dividend tax. This is generally the case if the Dutch entity would be required to withhold more dividend tax on its distributions had the direct owner not been inserted into the structure, meaning that one must be able to rely on the objective test, as discussed below, in the event the subjective test produces negative results. Note that Dutch dividend tax avoidance need not be the main purpose for the investment under the subjective test.

- Under the objective test, one must assess whether the structure is artificial by itself or in conjunction with a series of artificial arrangements or transactions that lack valid business reasons reflecting economic reality. Essentially, this the mantra formulated by the European Court of Justice in its ruling in the *Cadbury Schweppes* case.

Where the direct owner conducts an active business to which its participation in the Dutch entity is attributable, valid business reasons reflecting economic reality are generally present. In comparison, if the direct owner is considered to hold its participation as a passive portfolio investment rather than an active business asset, profit distributions by the Dutch entity would be subject to withholding tax.

Where the direct owner is merely an intermediary holding company, the assessment is more complicated. In any event, its shareholder (*i.e.*, the indirect owner of the Dutch entity) must conduct an active business enterprise, whilst the intermediary holding company must function as a link (*schakelfunctie*) between its shareholder and the Dutch entity. In that case, "valid business reasons reflecting economic reality" are still considered to be present if the intermediary holding company meets a number of the new relevant substance requirements in its own jurisdiction. Most of these criteria resemble existing minimum substance requirements applicable to certain Dutch-based entities and are rather straight forward. However, with the new anti-abuse rules, two additional substance requirements are introduced for intermediary holding companies:

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

- The intermediary holding company must also have its own office space at its disposal and that space must be equipped and actually used for the performance of such activities for at least 24 months.

Since it is recognized that time will be required to meet the two additional requirements, a three-month window is provided for identifying employees and arranging facilities. Everything must be in place by April 1, 2018.

OTHER MATTERS

Existing structures with intermediary holding companies may run afoul of the new domestic anti-abuse rules if the relevant substance requirements are not met, *“Current dividend tax provisions would remain in force until the date of abolition, albeit the contemplated withholding tax exemption for distributions to treaty country residents may still be implemented.”*

notably the requirements to (i) pay at least €100,000 annually in salaries and (ii) rent and equip office space for at least 24 months. This would also apply to intermediary holding companies established within the E.U./E.E.A. or in a treaty jurisdiction such as Luxembourg. Even though, in these situations, Dutch dividend tax may currently still be mitigated under an applicable tax treaty, this might change once the P.P.T. is inserted in the treaty at the time of implementation of the M.L.I.

Tax rulings will terminate as from January 1, 2018, if the intermediary holding company does not meet the relevant substance requirements in a timely manner. In certain situations, having an intermediary holding company in place may no longer be necessary, as a result of the introduction of the domestic exemption.

CONCLUSION

In recent years, the Netherlands has relinquished its historic role as the premier location for a European holding company for a multinational group based in Canada, China, Japan, and the U.S. With the adoption of an exemption from withholding tax for Dutch entities, business arrangements, and cooperatives, the “bloom” may be returning to the “tulip.”

P.S. – NEW COALITION GOVERNMENT INTENDS TO ABOLISH DIVIDEND TAX

On Tuesday October 10, 2017, following a negotiation period of almost seven months (a new record) from the date of the last general elections, it was announced that a coalition of four political parties will form a new Dutch government. That same day, the new coalition presented their political agreement to the Dutch Parliament. Amongst other (tax) topics, the agreement addresses the coalition’s intention to completely abolish the Dutch dividend withholding tax, effective January 1, 2019, or ultimately by January 1, 2020.

In light of this outcome, the recent legislative proposal that is the subject of this article may not pass after all. This would imply that current dividend tax provisions would remain in force until the date of abolition, albeit the contemplated withholding tax exemption for distributions to treaty country residents may still be implemented, effective January 1, 2018. More clarity on this topic is expected in the coming weeks.

THE SHARING ECONOMY PART 1: NEW BUSINESS MODELS + TRADITIONAL TAX RULES DON'T MIX

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Digital Economy
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WHAT IS THE SHARING ECONOMY?

The current international tax system was established on principles dating back to the first half of the 19th century, when the internet did not exist and the economy mostly consisted of brick-and-mortar stores. Back then, a foreign entity would generally have a taxable presence in a host country if the entity had a certain level of physical presence in that country to which income generation could be linked. Such taxable presence is referred to as a "permanent establishment." But with the advent of the internet came the rise of the digital economy, and what has evolved is a mix of brick-and-mortar and online stores.

As the purchase of services and goods was gradually dematerialized and internet giants such as Google or Microsoft appeared, governments struggled to keep up. The growth of digital economy brought increased scrutiny of tax structures[1] set up under laws designed for brick-and-mortar stores. Most recently, governments around the world have shifted their focus to a relatively new part of the digital economy called the "sharing economy." The I.R.S. describes it as follows:

> The sharing economy typically describes situations where the Internet is used to connect suppliers willing to provide services or use of assets — apartments for rent, cars for transportation services, etc. — to consumers. These platforms are also used to connect workers and businesses for short-term work.[2]

Well-known examples of companies that utilize the sharing economy are Uber or Airbnb.

Uber is an electronic platform that is linked to an app. This app connects independent drivers with potential customers, by enabling customers to request a car and using geolocation to pair them with nearby drivers. Once a driver accepts the request and completes the ride, the customer's bank card, which is registered on the application, is immediately charged.

Like Uber, Airbnb is also an electronic platform linked to an app. Customers can use both the app and the Airbnb website to find a host who will rent them an apartment, room, or other accommodation to use while they are travelling. Hosts receive payment for the accommodation through the Airbnb platform.

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1 These structures were for instance attacked on an E.U. level under E.U. State Aid rules, see the examples of Apple and Starbucks described in "Treasury Attacks European Commission on State Aid – What Next?" *Insights* 8 (2016).

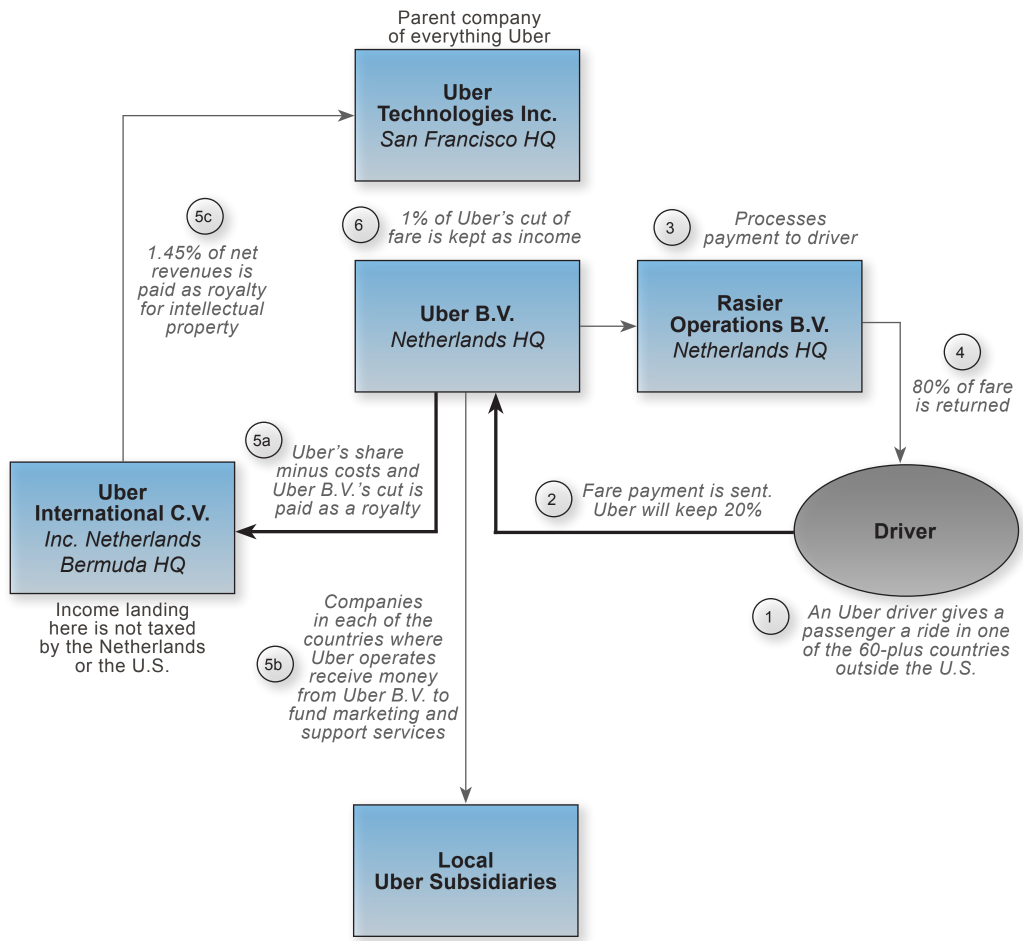
2 "IRS Launches New Sharing Economy Resource Center on IRS.gov, Provides Tips for Emerging Business Area," news release, August 22, 2016.

Both Uber and Airbnb have worldwide operations and use a similar international tax structure. And both companies are dipping deep into the market shares of traditional businesses in the transportation and hospitality industries, respectively.

THE CHALLENGE OF TAXING THE SHARING ECONOMY

The Uber Structure

Uber's structure is comprised of a dense worldwide network of holding companies, limited partnerships, and local operating companies. Since Uber's is a privately held company, details of the exact structure are not publicly available. To the extent it is understood, the international structure can – in a simplified form – best be illustrated as follows:[3]



- Uber Technologies Inc. ("Uber U.S.") is a Delaware corporation with over 135 direct or indirect subsidiaries, both inside and outside the U.S.

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3 "How Uber Plays the Tax Shell Game," *Fortune*, October 22, 2015. Note that this assessment is based on the author's research and may contain inaccuracies. Please further note that the structure will lose major benefits once the E.U. Anti-Tax Avoidance Directive and the amendments to the Directive are implemented into Dutch law.

- Among these subsidiaries is Uber International C.V. ("Uber C.V."), an entity with no employees, formed in the Netherlands, that has its headquarters in Bermuda. It is not considered taxable in the Netherlands, and Bermuda has no corporate income tax.

- Uber C.V. holds the non-U.S. subsidiaries of Uber U.S.[4] As of 2014, these local operating companies have been held by Uber C.V. via two Netherlands-based holding companies organized in the form of private partnerships, Uber International Holdings B.V. and Uber International B.V.[5]

- In 2013, Uber C.V. and Uber U.S. entered into an agreement pursuant to which Uber C.V. paid a one-time fee of approximatively $1 million to Uber U.S., along with a royalty of 1.45% of future net revenue, for the right to use Uber U.S.'s intellectual property ("I.P.") outside the U.S.

- Uber C.V. and Uber U.S. also entered into a cost-sharing agreement pursuant to which they agreed to share the costs and benefits of I.P. developed in the future.

- Another Uber subsidiary, Uber B.V. (also a Dutch entity), processes the worldwide payments of all Uber rides. Every ride payment is sent to this entity. After deducting payouts to the local drivers (generally, 80% of the ride fare), the balance of revenues is kept by Uber B.V.

- Uber B.V. then pays the local Uber (operating) company a small fee for its services, including marketing. The fee is determined based on costs of the local operating company plus a mark-up (*e.g.*, 8.5%). The mark-up is effectively the profit that is taxed in the local jurisdiction.

- Pursuant to an I.P. licensing agreement between Uber C.V. and Uber B.V., Uber B.V. also pays a royalty fee to Uber C.V. for the use of the I.P. This leaves Uber B.V. with an effective 1% of revenue. (Remember, Uber C.V. holds the I.P. it received in 2013, plus its share of any I.P. developed in collaboration with Uber U.S.)

By using low-tax jurisdictions and having transferred its I.P. out of the U.S., Uber is able to generate substantial profits and pay very little tax. Under current law, the tax effect of the structure for the various jurisdictions may be summarized as follows:

- Under the agreement between Uber C.V. and Uber U.S., the latter's income consists of the (minimal) 1.45% royalty fees it receives from Uber B.V. This amount is then subject to U.S. income tax.

- The timing of the two arrangements between Uber C.V. and Uber U.S. was prior to Uber's substantial increase in value (allegedly $330 million rather than $3.5 billion), which effectively allowed Uber to shift the I.P. out of the U.S. at as low a cost as possible. Under the same agreement, future profits

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4 It cannot be verified whether this holds true for *all* foreign operating companies. As of 2014, Uber France, for example, was reported to be owned directly by Uber U.S. This may, however, have changed. ("Uber's Tax-Avoidance Strategy Costs Government Millions. How's that for 'Sharing?'," *48 Hills*, July 10, 2014.)

5 *Id.*, with reference to records held by the Registrar of Companies in England and Wales in the case of the London-based operating company.

from the exploitation of the Uber I.P. outside the U.S. will be non-U.S. source and thereby sheltered from U.S. Federal income taxation under current rules.

- The royalty payments pursuant to the agreement between Uber C.V. and Uber B.V. are not taxable under Dutch tax laws.
- On a local level, 80% of the ride fares are ultimately earned by the independent Uber drivers. The local Uber operating company receives only a small percentage of income, which is then subject to tax. Furthermore, local tax authorities are potentially subject to substantial losses should the drivers not comply with local income reporting obligations.

The Airbnb Structure

Airbnb uses a similar structure. However, instead of using Dutch subsidiaries, it channels its income through Ireland and Jersey.

Airbnb's European headquarters is located in Ireland. The concept is similar to the one Uber applies, a minimum profit is left in the local operating countries and profits are "bundled" in Ireland via royalty payments to the I.P. company located there. Only residual fees are ultimately paid by the Irish subsidiary to its U.S. parent.

Playing the System: Putting the Traditional Tax Framework on the Spot

From a business perspective, the services offered by Uber and Airbnb are not new: In some areas, brokers have operated as intermediaries between producers and customers for hundreds of years. The difference is that new technology is facilitating this brokerage business to the tune of an estimated $6 billion in revenue for Uber in 2016 (after payouts to its drivers)[6] and nearly $3 million in short-term Airbnb rentals in more than 34,000 cities.

While, conceptually, the brokerage business model is not new, Uber and Airbnb share another characteristic that significantly deviates from the tax structures of traditional (brick-and-mortar) businesses: They are highly tax efficient. More specifically, from a direct tax perspective, the structures used by Uber and Airbnb benefit from tax arbitrage – known in a post-B.E.P.S. world as "base erosion."

The majority of profits are shifted to low-tax jurisdictions while only minimal profit is left in the high-tax source jurisdiction. This is achieved by what these companies may deem a smart use of existing tax rules. In the view of local governments and institutions such as the O.E.C.D. and the E.U. Commission, they are clearly qualified as tax abusive. However, these companies find themselves mostly well within the framework of current tax rules.

- **Local Presence of an "IPCo" in the Operating Jurisdiction – Permanent Establishment ("P.E.") Exposure:**

  As explained above, under the Uber and Airbnb structures, the local jurisdiction is left only with a residual profit from a services fee. The majority of the

[6] See "Pipsqueak Lyft Could Reach Profitability Before Giant Rival Uber," CNBC, January 12, 2017. Uber is allegedly the largest transportation network company in the U.S., claiming between 84% and 87% of the U.S. ride-hailing market ("Uber Loses at Least $1.2 Billion in First Half of 2016," *Bloomberg Technology*, August 25, 2016).

profits end up in the hands of an IPCo (*i.e.*, the subsidiary holding the group I.P.) located outside the operating jurisdictions. Under current income tax treaty principles, foreign taxpayers are typically only subjected to the source country's tax regime if they have either a physical presence or a dependent agent negotiating contracts on their behalf in the source country. In comparison, Uber and Airbnb operate via local subsidiaries. Most income tax treaties concluded by the U.S., for example, include a clarification that if a foreign company carries on business in the source state via a subsidiary, it shall not of itself constitute a P.E. A similar provision can be found in income tax treaties based on the O.E.C.D. Model Tax Convention. From a U.S. tax perspective, a number of P.E. authorities illustrate that the separate status of affiliated corporations generally is respected.[7] Tax authorities in the subsidiary's jurisdiction may take a deviating view if the local subsidiary is deemed a dependent agent. This would, however, require additional facts, such as legal or economic dependence upon the parent (other than solely by reason of share ownership) and entering into contracts on the account of the parent. Under current treaty rules, a subsidiary, however, cannot be a P.E. if its activities would be merely ancillary in character if performed directly by the parent.[8]

"In the absence of an L.O.B. clause, the royalties could be paid by the local operating countries with zero, or significantly reduced, withholding tax under an applicable income tax treaty, even if the recipient lacks substance."

- **Lack of Substance in an IPCo – Treaty Abuse Exposure:**

Current income tax treaties that follow the O.E.C.D. Model Tax Convention (*i.e.*, treaties between O.E.C.D. countries other than the U.S.) do not require that the corporate recipient of royalty income has substance. In particular, these treaties do not contain the so-called Limitation on Benefits ("L.O.B.") clause, which subjects the reduced withholding tax rate (in this case, for royalties on I.P.) to certain conditions.[9] *Inter alia*, these requirements provide that the ultimate beneficial owner must be a qualified individual resident in one of the contracting countries, the recipient or related companies based in the recipient's jurisdiction must meet a certain degree of substance (the "active trade or business test"), or the company must be listed on a recognized stock exchange. In the absence of an L.O.B. clause, the royalties could be paid by the local operating countries with zero, or significantly reduced, withholding tax under an applicable income tax treaty, even if the recipient lacks substance.

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7 See, *e.g.*, Rev. Rul. 76-322 1976-2 CB 487 (consignment sales through U.S. subsidiary); Private Letter Ruling (P.L.R.) 8715037 (U.S. marketing cooperative); P.L.R. 8131059 (U.S. marketing cooperative); P.L.R. 7923075 (U.S. subsidiary formed to provide certain services in connection with French parent corporation's and unrelated U.S. corporation's manufacturing operations).

8 Pursuant to the B.E.P.S. initiative, the O.E.C.D. Model Convention includes changes to the definition of *commissionaires* as well as limitations on ancillary activities. France appears to be pushing in the same direction, expanding the P.E. definition in a draft legislation issued in 2016.

9 Changes to the O.E.C.D. Model Convention, including the addition of an L.O.B. provision, were presented for public comment. The changes are subject to approval by the Fiscal Committee, which is expected by the end of this year. For details, see "O.E.C.D. Receives Public Comments on Proposed Changes to the Model Tax Convention," *Insights* 10 (2017).

- **Intercompany Arm's Length Payments – Transfer Pricing Exposure:**

  As long as the royalty paid by the local operating company conforms with the arm's length standards under its local jurisdiction's transfer pricing rules, local tax authorities will find it difficult to successfully challenge these payments to an IPCo. The same holds true for the service fee paid by Uber B.V. However, the buy-in payment from Uber C.V. to Uber U.S. may not withstand scrutiny by the tax authorities given the significant increase in value that followed the transfer.

- **I.P. Services v. Transportation and Hospitality Businesses – V.A.T. Exposure:**

  Uber argues that from a V.A.T. perspective it acts as a mere agent of self-employed drivers rather than a service provider. As a result, it deems itself not subject to V.A.T., and in most instances, the drivers will stay below the V.A.T. registration threshold (*e.g.*, £85,000 in the U.K.).

WHERE DO GOVERNMENTS GO FROM HERE?

Globally, tax authorities have become wary of this type of set up, which deprives them of substantial tax revenues at the business entity level. In addition, tax authorities have noticed that independent contractors, such as Uber's drivers and Airbnb's hosts, are not always aware of their tax reporting and filing obligations, which also leads to a substantial loss in tax revenues. On August 22, 2016, the I.R.S. attempted to resolve this issue when it launched the Sharing Economy Tax Center. The site provides education and resources relevant to the taxation of the sharing economy, so that individuals earning income through platforms like Uber and Airbnb can comply with their U.S. filing obligations.

As we have noted, by utilizing technology and the brokerage business model, sharing economy companies are able to generate substantial profits while paying very little tax. With these structures cutting deep holes in source jurisdictions' tax revenues, governments are now taking various approaches to attempt to obtain their fair share. These local initiatives, which can be characterized as income tax, indirect tax, or regulatory focused, will be addressed in the next edition of Insights along with international efforts at the level of the O.E.C.D. and the E.U.

SWISS FEDERAL COUNCIL OPENS CONSULTATION PROCESS ON TAX PROPOSAL 17

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INTRODUCTION

Swiss voters rejected the Corporate Tax Reform Act III ("C.T.R. III") in a referendum on February 12, 2017. But Swiss tax reform was not derailed, only delayed. This article addresses events that took place in September of this year that are intended to move the process forward. This article provides an overview of the most important aspects of tax reform that are under consideration currently.

T.P. 17

Recommendations regarding the implementation of a modified corporate tax reform were presented to the Swiss Federal Council on June 1, 2017, under the title Tax Proposal 17 ("T.P. 17"). At its meeting on September 6, 2017, the Federal Council presented a new version of the project.

The proposal provides for the abolishment of existing cantonal tax privileges, as agreed with the E.U. Additionally, the Federal Council proposes the following compensation measures: (i) mandatory introduction of a patent box by all cantons and (ii) voluntary introduction of additional deductions for research and development ("R&D") expenses by the cantons. Further, the proposal provides for the possibility of a tax-neutral realization (*i.e.*, a step-up in basis) of hidden reserves that were created under the old tax regimes or before immigration to Switzerland. The previously-proposed notional interest deduction is no longer part of the reform package. In order to finance T.P. 17, the privileged taxation of dividends from qualifying participations will be limited to 30% (currently: 40% on the Federal level and usually up to 50% on the cantonal level).

General reductions to cantonal corporate income tax rates are not part of the proposal because the cantons may independently decide on reductions. In order to provide the cantons with more fiscal flexibility, the proposal provides for an increase of the canton's share in income from the direct Federal tax.

ABOLITION OF CANTONAL TAX PRIVILEGES

With the Federal Act on T.P. 17, the existing legal basis for cantonal tax privileges available to holding, domicile, and mixed companies will be abolished. As soon as it is definitive that T.P. 17 will be implemented (*i.e.*, once it is clear that there is no referendum against T.P. 17 or once T.P. 17 has been accepted in a referendum by the Swiss voters), the cantons will have until the time T.P. 17 comes into force to adapt the cantonal tax laws to the new Federal requirements. The cantons are free to abolish the cantonal tax privileges before the whole T.P. 17 comes into force.

When the cantonal laws come into force, companies that benefit from cantonal tax privileges will be subject to ordinary taxation. T.P. 17 provides for a five-year transition period during which the realization of hidden reserves established during the old regime are taxed separately. Alternatively, hidden reserves of a tax-privileged company may also be realized tax-neutrally in the course of giving up the privileged tax status before the new rules come into force. Such realization of hidden reserves may then be amortized over the following years (the so-called previous-law step-up). Further, special practices regarding the tax allocation of principal companies and finance branches will be abolished by the Swiss Federal Tax Administration.

Pursuant to a statement by Federal Counselor Maurer, Switzerland agreed to abolish cantonal privileges by 2019. Since the Dispatch for T.P. 17 will only be provided to the Federal Council by the Federal Department of Finance in the spring 2018, the new law may not come into force until 2020 at the earliest, and therefore, abolishment of the tax privileges by 2019 is impossible. It is conceivable that this may entail sanctions by the O.E.C.D. or unilateral anti-avoidance measures by individual states.

"Abolishment of the tax privileges by 2019 is impossible. It is conceivable that this may entail sanctions by the O.E.C.D. or unilateral anti-avoidance measures by individual states."

Further, it should be noted that information on tax rulings regarding privileged tax regimes that are still applicable on January 1, 2018 may be spontaneously exchanged with other jurisdictions in the course of the spontaneous exchange of information.[1] Even if the respective rulings are retracted before January 1, 2018, the privileged taxation may still be claimed by the taxpayer until the cantonal tax laws are changed or until tax-privileged status is given up by the taxpayer, provided that the requirements for the privileged tax status are still fulfilled.

PATENT BOX

A patent box will be introduced under T.P. 17 and will be mandatory for all cantons. This patent box provides that taxable income derived from patents and comparable rights is taxed with a reduction of up to 90% upon request. At the Federal level, such profits are taxed without a reduction.

The patent box regime fulfills the requirements provided by the O.E.C.D. (the so-called modified nexus approach). Pursuant to this modified nexus approach, income from qualifying rights may only be subject to a privileged regime in proportion to the extent overall R&D expenses are allocable to the taxpayer. Allocable R&D expenses consist of expenses for R&D performed by the taxpayer in Switzerland, expenses for R&D performed by third parties, and expenses for R&D performed by group companies in Switzerland.

ADDITIONAL R&D DEDUCTIONS

The cantons are authorized in T.P. 17 to provide an additional deduction from the cantonal corporate income tax base for R&D that is performed in Switzerland. This additional deduction must not exceed 50% of the qualifying R&D expense.

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1 See "Spontaneous Exchange of Tax Rulings – The Swiss Angle," *Insights* 9 (2017).

LIMITATION ON TAX RELIEF

As was the case with C.T.R. III, T.P. 17 proposes the introduction of a limitation on tax relief. The limitation on tax relief provides that at least 30% of the taxable profit of a company must be subject to tax before the application of any special regimes, such as the patent box and the additional R&D deductions. In addition, no losses may result from the application of the special regimes.

INCREASED DIVIDEND TAXATION

T.P. 17 proposes that dividend taxation for individuals with qualifying participations should be increased to at least 70% at the Federal and cantonal levels. Currently, only up to 60% of such dividends is taxed on the Federal level and only up to 50% is taxed in most cantons. This measure is intended to finance the tax deficits connected with T.P. 17 and the cantonal tax rate reductions.

INCREASED CANTONAL SHARE IN DIRECT FEDERAL TAX

To the extent possible, T.P. 17 aims at keeping Switzerland fiscally attractive for mobile activities. However, the tax incentives of T.P. 17 affect only certain kinds of mobile income. The profits not covered by these incentives are subject to the ordinary corporate income tax rate after the abolishment of the current tax privilege system. In order to prevent Swiss companies that currently enjoy tax privileges from moving aboard, the cantons must reduce – in certain cases drastically – their corporate income tax rates. This is illustrated in the chart at the end of the article. In order to provide the cantons with more flexibility in this regard, T.P. 17 provides for an increase of the cantonal share of income from direct Swiss Federal tax. The reduction of the cantonal corporate income tax rates, which is made possible by this measure as well as the revision of the inter-cantonal financial equalization, is by far the most important part of T.P. 17.

RELIEF FOR CAPITAL TAXES

Companies benefitting from a privileged tax regime currently pay capital tax at a reduced rate. T.P. 17 proposes that the cantons should provide appropriate compensation measures to maintain their attractiveness once the privileged tax regimes are abolished.

REALIZATION OF HIDDEN RESERVES

T.P. 17 provides for a tax-neutral realization of hidden reserves upon relocating to Switzerland and tax-effective amortization in the following years. This produces a symmetry with the tax treatment of a relocation abroad, which triggers the taxation of hidden reserves.

It should be noted that the hidden reserves are not realized on the tax balance sheet but are instead determined by the tax administration through decree.

CANTONAL TAX RATE REDUCTIONS

The reduction of cantonal corporate income tax rates is not directly part of T.P. 17. With regard to the planned implementation under C.T.R. III, most of the cantons that did not already have low tax rates planned to implement rate reductions. Various cantons developed different strategies based on facts and circumstances unique to each canton. The cantons of Vaud and Geneva, for example, propose to implement compensation measures only to a limited extent while substantially reducing the general tax rates. Other cantons, like Zurich, would reduce the tax rate by a relatively small amount and make more extensive use of compensation measures.

It is assumed that the announced proposals at the cantonal level will not fundamentally differ at the time of implementation of T.P. 17. Furthermore, with an increase in the cantonal share in the income from the direct Swiss Federal tax and changes in the inter-cantonal financial equalization, cantons will be able to proceed with tax rate reductions in a more or less fiscally neutral manner.

TRANSPOSITION

T.P. 17 further provides that all sales of participation rights to a company in which the seller holds an interest of at least 50% will be subject to tax, to the extent the consideration for such transfer exceeds the sum of share capital and capital contribution reserves. This applies also if several people act in concert with regard to the transfer and collectively fulfill the 50% requirement.

A tax-free private capital gain is therefore no longer possible under T.P. 17 with regard to a transfer of participation rights to a controlled company. This is to be compared to the current provision, which provides that only transfers of at least 5% to a controlled company are subject to taxation.

TIMING FOR IMPLEMENTATION

The Federal Council's Dispatch on T.P. 17 is expected in the spring of 2018, hence the new provisions cannot come into force before 2020. Afterwards, the cantons must adapt their cantonal tax laws to the new provisions of the Federal Act on the Harmonization of Cantonal Taxes. Current tax privileges are therefore expected to continue for several years.

CONCLUSION

Within a relatively short period of time, a compromise has been achieved politically regarding tax reform. T.P. 17 contains the most important points of the C.T.R. III in a hopefully majority-backed proposal. Nonetheless, the absence of a notional interest deduction in T.P. 17 is troubling. It would have been an important tool for Switzerland to attract group financing activities. Whether this will be corrected in the course of parliamentary consultation remains to be seen.

CHART

Standard Corporate Income Tax Rates by Canton (incl. Federal)		
Canton	**Current**	**Under T.P. 17**
Aargau	18.6%	Open
Appenzell Ausserrhoden	13.0%	Open
Appenzell Innerrhoden	14.2%	Open
Basel Country	20.3%	14.0%
Basel City	22.2%	13.0%
Berne	21.6%	16.4 – 17.7%
Fribourg	19.9%	13.7%
Geneva	24.2%	13.5%
Glarus	15.7%	14.2%
Grisons	16.1%	Below 15%
Jura	20.9%	Open
Lucerne	12.3%	No Reduction
Neuchâtel	15.6%	Open
Nidwalden	12.7%	No Reduction
Obwalden	12.7%	Open
St. Gall	17.4%	14.0%
Schaffhausen	16.0%	12 – 12.5%
Schwyz	15.3%	Open
Solothurn	21.5%	12.9%
Thurgau	16.4%	13.0%
Ticino	20.7%	17.5%
Uri	15.1%	Open
Valais	21.6%	15.6%
Vaud	22.1%	13.8%
Zug	14.6%	~ 12%
Zürich	21.2%	18.2%

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WHEN DOES AN AGED ACCOUNT RECEIVABLE GIVE RISE TO A DEEMED REPATRIATION?

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Ownership of a "controlled foreign corporation" ("C.F.C.") by a "U.S. shareholder" presents the potential for imputed income, that is, income treated as received from the C.F.C. and recognized as income to the U.S. shareholder in a current tax year. Under certain circumstances, aged accounts receivable may be seen as an investment in U.S. property and treated as a deemed repatriation, therefore constituting imputed income of the U.S. shareholder.

BACKGROUND

A C.F.C. is a foreign corporation in which U.S. shareholders (defined below) directly, indirectly, or constructively own more than 50% of either: (i) the total combined voting power of all classes of stock entitled to vote or (ii) the total value of the stock, on any day during the foreign corporation's tax year.[1]

A U.S. shareholder is a U.S. person,[2] such as a U.S. citizen or U.S. corporation, that owns (or is considered as owning) 10% or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation. Voting power generally means the votes inherent in the shares held to elect members of the board of directors or its equivalent under the laws of the jurisdiction where the entity is formed. That is, if the voting shares grant the power to elect, appoint, or replace the body of persons exercising the powers ordinarily exercised by the board of directors of a domestic corporation.[3]

Arrangements to shift formal voting power away from U.S. shareholders are not given effect if voting power is retained in reality.[4] Consequently, the mere ownership of stock entitled to vote does not by itself mean that the shareholder owning the stock has the voting power inherent in the stock for purposes of determining whether a foreign corporation is a C.F.C. This rule covers agreements by non-U.S. shareholders to refrain from voting with respect to shares actually owned and corporate structures in which two or more classes of shares exist and the class or classes with voting power are separated from the class that is entitled to substantially all of the earnings.

One type of imputed income is Subpart F income, which includes the C.F.C.'s

- investment income (*e.g.*, dividends, interest, rents, royalties),
- income (*e.g.*, profits, commissions, fees) from certain sales or purchases of

1 Code §957(a).

2 As generally defined under Code §7701(a)(30).

3 Treas. Reg. §1.957-1(b)(1)(i).

4 Treas. Reg. §1.957-1(b)(2).

personal property in transactions involving a related party as a supplier or purchaser in which the personal property is manufactured or produced in a jurisdiction outside the C.F.C.'s country of incorporation and the property is sold or purchased for use outside that country of incorporation,

- income (*e.g.*, compensation, fees) from rendering services for or on behalf of a related person outside the C.F.C.'s country of incorporation.[5]

Another situation in which a U.S. shareholder will have imputed income with respect to a C.F.C. arises when the C.F.C. makes an investment in "U.S. property," as discussed in detail below. Under certain circumstances, an investment in U.S. property may include accounts receivable in favor of the C.F.C. for which the obligor is a U.S. person.

"A U.S. shareholder generally must increase its gross income by its pro rata share of the increase in the earnings invested by the C.F.C. in U.S. property for the tax year. Thus, the C.F.C.'s investment in U.S. property is treated as a deemed repatriation."

INVESTMENT IN U.S. PROPERTY

Code §956 provides the rules that govern the taxation of U.S. shareholders in the case of an investment in U.S. property by the C.F.C. Code §956(c)(1) defines U.S. property as

- tangible property located in the U.S.,
- stock of a domestic corporation,
- obligations of U.S. persons, or
- any right to use certain items in the U.S. (*e.g.*, patents and copyrights, acquired or developed by the C.F.C. for use in the U.S.).

Code §951(a)(1)(B) states that a U.S. shareholder generally must increase its gross income by its *pro rata* share of the increase in the earnings invested by the C.F.C. in U.S. property for the tax year. Thus, the C.F.C.'s investment in U.S. property is treated as a deemed repatriation.

The original rationale for this provision is that the earnings of the C.F.C. are effectively repatriated to the U.S. in a transaction that is not otherwise taxable.[6] This may be accompanied by a deductible expense, for example, if the investment is in the form of an interest-bearing loan to a U.S. parent company. The loan is not taxable and the interest may be deductible.

EXCEPTION AND SAFE HARBOR

Code §956(c)(2) provides exceptions to the definition of U.S. property for certain accounts receivable of a U.S. person. Under the exception, the account receivable is not an item of U.S. property if, *inter alia*, it reflects:

> any obligation of a U.S. person[7] arising in connection with the sale or processing of property, if the amount of such obligation outstanding

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5 Code §954(a).

6 H.R. Rep. No. 1447, 87th Cong., 2d Sess. 58, 1962-3 C.B. 405, 462 (1962).

7 As defined in Code §957(c), which refers to the definition in Code §7701(a)(30), which includes a U.S. corporation.

> at no time during the tax year exceeds the *amount which would be ordinary and necessary to carry on the trade or business* of both the other party to the sale or processing transaction and the U.S. person had the sale or processing transaction been made between unrelated persons.[8] (emphasis added)

Under the Treasury Regulations, the term "obligation" specifically includes an account receivable in which the obligor is a U.S. person.[9] In accordance with the exception under Code §956(c)(2), the regulations provide an exclusion from the definition of an obligation for any obligation of a U.S. person that arises in connection with the provision of services by a C.F.C. to that U.S. person if the amount of the obligation outstanding at any time during the tax year of the C.F.C. does not exceed an amount that would be ordinary and necessary to carry on the trade or business of the C.F.C. and the U.S. person if they were unrelated.[10]

The regulations add a safe harbor, which states that the amount of the obligation is considered to be "ordinary and necessary" to the extent of such receivables that are paid within 60 days.[11] Whether the amount of an obligation is ordinary and necessary to carry on a trade or business is to be determined from all the facts and circumstances in each case.[12]

At least two Tax Court cases and two I.R.S. private letter rulings ("P.L.R.'s") apply the ordinary and necessary standard to the length of time an account receivable remains unpaid. The Tax Court cases each involve a C.F.C.'s prepayment for goods or services provided by the U.S. parent corporation. They indicate that the analysis is not limited to a factual inquiry into the duration of the obligation. The private letter rulings involve sales of goods by the C.F.C. to its U.S. parent corporation, with the obligation arising as a result of delayed payment. Though they also indicate that the analysis is not limited to a factual inquiry into the duration of the obligation, they provide some guidance on how the I.R.S. might analyze the length of time of an obligation.

Amount Ordinary and Necessary to Carry on a Trade or Business

In *Sherwood Props., Inc. v. Commr.*,[13] the U.S. parent corporation was a supplier of steel to the C.F.C. The taxpayers argued that advances, in the amount of $500,000, made by the C.F.C. to the U.S. parent corporation were to be used by the U.S. parent corporation to purchase steel allocations in the U.S. on behalf of the C.F.C. The allocations guaranteed that if steel were ever in short supply, the steel mill would sell to the U.S. parent corporation a certain amount of steel, which it could then resell to the C.F.C. The taxpayers argued that the advances arose in connection with the sale or processing of property and were in an amount that was ordinary and necessary to carry on the trades or businesses of both the U.S. parent corporation and the C.F.C. The Tax Court stated that although there may have been a business reason for the C.F.C. to advance funds to the U.S. parent corporation, the record did not

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8 Code §956(c)(2)(C).

9 Treas. Reg. §1.956-2T(d)(2).

10 Treas. Reg. §1.956-2T(d)(2)(i)(B).

11 *Id.*

12 Treas. Reg. §1.956-2(b)(1)(v).

13 89 T.C. 651 (1978).

show specific factors considered in calculating the amount necessary to maintain the steel allocations. Further, the court found that there was no objective evidence to establish that the advances were actually used for the purpose of maintaining the steel allocations. In essence, the funds advanced were not encumbered at the level of the parent and served the same purpose as a loan.

In *Greenfield v. Commr.*,[14] two sister corporations, one domestic and the other a C.F.C., had an agreement under which the domestic corporation would supply materials needed for the C.F.C.'s operations on a cost-plus basis. The C.F.C. typically advanced funds to the domestic corporation so that the domestic corporation could take advantage of discounts for cash purchases, prepay freight charges, and pay customs duties in order to receive materials from the docks. The Tax Court acknowledged that there were business reasons for the C.F.C. to advance funds to the domestic corporation. However, it could not conclude that those business reasons made it ordinary and necessary to the C.F.C.'s business to provide funds in such amounts that there was always a substantial balance in favor of the C.F.C. at the end of each tax year. Again, the advances made to the domestic corporation served the same purpose as a loan.

Time During Which Aged Accounts Receivable May Be Outstanding

In P.L.R. 8114032,[15] the I.R.S. determined that extended payment terms as long as four years were ordinary and necessary. Under the facts of the ruling, N was a domestic corporation in the business of aging and distilling alcohol. R was its Canadian subsidiary, which supplied N with aged alcohol known as "base." At one point, continued inflation made the last in, first out ("L.I.F.O.") accounting method the only practical way to value R's inventory, but Canadian law prohibited the use of L.I.F.O. as long as the inventory was owned by R. As a result, it was decided that N would own the inventory of base at the time that it was first placed by R in the aging barrel, so that L.I.F.O. could be used by N in computing income for U.S. tax purposes without causing N to have a permanent establishment in Canada. N bought R's existing inventory for a note, which was to be paid down as base was blended with other alcohols and shipped to N. Pursuant to this payment method, it was expected that 85% of the note would be paid within three years and that 100% would be repaid within four years. The I.R.S. determined that the entire amount of the note at any time during the tax years in question was ordinary and necessary to effectuate the purchase by N and the sale by R of base because the amount of the outstanding note was reduced on a monthly basis as base was shipped to N.

A similar result arose in P.L.R. 200519005,[16] in which the taxpayer represented that, due to long manufacturing lead times and the delicate and unique nature of the product manufactured, it was necessary to store "M" months of inventory supply with the U.S. distributor. M was not identified by a number in the private letter ruling. The taxpayer represented that due to the low margins typical of a distributor, it was both ordinary and necessary to provide M-month payment terms to correspond with the actual sale of the product. The I.R.S. determined that, based on the taxpayer's representations, the M-month obligations obtained by the C.F.C. supplier in exchange for the sale of its products to the U.S. distributor did not constitute an investment in U.S. property to the extent that (i) the amount of such obligations did not exceed the

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14 60 T.C. 425 (1973).

15 P.L.R. 8114032, Dec. 30, 1980.

16 P.L.R. 200519005, May 13, 2005.

amount of inventory held in the U.S. at the end of each month when the U.S. distributor closed its books and (ii) such obligations were not outstanding for a period exceeding M months.

WHEN DO AGED ACCOUNTS RECEIVABLE BECOME INVESTMENTS IN U.S. PROPERTY?

If an account receivable is older than the 60-day safe harbor, the U.S. shareholder must determine whether the length of time during which the account receivable is outstanding is ordinary and necessary the business of the C.F.C. and its U.S. shareholder.

Since the ordinary and necessary test involves a facts and circumstances analysis, the case law and private letter rulings discussed above may be instructive as to how the courts and the I.R.S. may view the standard in certain circumstances, even if they are not determinative.

The private letter rulings are instructive in evaluating the business needs of the purchaser and seller in a case in which the C.F.C. is a supplier and the U.S. shareholder is a distributor. In P.L.R. 8114032, the entire amount of the note at any time during the tax years in question was ordinary and necessary to effectuate the purchase by N and the sale by R of base because the amount of the outstanding note was reduced on a monthly basis as the product was shipped from the supplier to the distributor. In P.L.R. 200519005, the ordinary and necessary standard was met, in part, because the amount of the obligations did not exceed the amount of inventory held in the U.S. at the end of each month when the U.S. distributor closed its books. In both private letter rulings, there was a correlation between the amount of the obligation and the inventory held in the U.S. Thus, based on these private letter rulings, in order to meet the ordinary and necessary standard, it may be important that an aged account receivable is in an amount that correlates with the inventory that has not yet been sold to, or paid for by, the third-party customers.

The Tax Court cases are less instructive because they do not involve accounts receivable but rather C.F.C.'s that advanced money to U.S. corporations. In each case, there was evidence that the U.S. corporation needed the advance to finance its operations. Therefore, the cases illustrate that an advance needed to finance the operations of the U.S. shareholder generally will not be considered an amount ordinary and necessary to carry on the trades or businesses of the C.F.C. and the U.S. corporation.

CONCLUSION

In sum, the cases are both set in fact patterns where the C.F.C. advanced excess cash to the related U.S. company without any objective trigger as to the time of payment. The absence of any indication that the funds advanced were "impressed" at the level of the U.S. shareholder suggests that the "prepayment" or "deposit" was a disguised loan. In comparison, the facts in the private letter rulings suggest that the time of the settlement of the account receivable was triggered by the U.S. shareholder's receipt of payments from third-party customers. Consequently, it was clear that the accounts receivable remained open until the inventory was sold, generating cashflow with which to the U.S. shareholder could make payment.

ART AND THE ESTATE: WHY PLANNING IS IMPORTANT, PART I – U.S. TAXPAYERS

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Tags
Artwork
Estate Planning

"I'm not afraid to die, I just don't want to be there when it happens."

– Woody Allen

The painting you bought when you were a student may worth something today. Or maybe you have accumulated a collection of artwork that has a significant value. If you acquired the artwork for your living room, you should be aware of the consequences of having such valuable assets in your estate. In this article, we will outline various options available to deal with expensive artwork in the family, mostly concentrating on the rules applicable to collectors and the relevant planning tools.

WHO ARE YOU?

Taxpayers that hold valuable art receive different tax treatment depending on their characterization: artist, dealer, investor, or collector. The difference is not always clear; each case must be carefully analyzed.

Simply put, an "artist" is an individual who creates the artwork. When any artist sells his or her work, it is taxed as an ordinary income. This ordinary income treatment is not limited to the artist. If the artist gifts the art, the art will be ordinary income property in the hands of the donee.

A "dealer" is someone who engages in the trade or business of selling works of art, primarily to customers. "Trade or business" means an activity that is conducted with continuity and regularity and with the primary purpose of making a profit. If a dealer sells artwork it is treated as ordinary income and not as capital gain. Even though the dealer does not get to use the preferred capital gains rate, he or she has the advantage of deducing all ordinary and necessary expenses related to the dealing. [1]

An "investor" is someone who buys, sells, and collects the artwork primarily for investment, rather than for personal use and enjoyment (or as a trade or business). The key is whether the taxpayer is engaged in the investment activity with the primary objective of making a profit.[2] When the artwork is sold, the investor has a capital gain. In addition, an investor can qualify for a like-kind exchange and also deduct ordinary and necessary expenses related to the art investment.[3]

And finally, a "collector" is a someone who buys and sells art primarily for personal pleasure or recreation. Similar to the investor, a collector's gain on a sale of artwork is treated as capital gain. While collectors can deduct ordinary and necessary

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1 Code §§162, 165(c)(1).

2 Treas. Reg. 1.183-2(2)(b).

3 Code §212.

expenses attributed to the artwork as miscellaneous itemized deductions, the deduction is limited to the profits generated from the artwork.[4]

HOW DO YOU PLAN?

No matter who you are and what your goals are, careful planning is very important. If you are a collector and hold expensive artwork at the time of your death, its full fair market value will be included in your estate and a 40% Federal estate tax will be levied on the amount above the lifetime gift amount ($5.49 million in 2017). Here are a some of the planning options available to collectors:

Sale of Artwork During Lifetime

As mentioned above, collectors can benefit from capital gains treatment when selling artwork. It is important to know that the I.R.S. does not treat capital assets all the same. Artwork is considered to be a "luxury asset" that is considered to be a collectible. The I.R.S. defines "collectible" as any work of art, any rug or antique, any metal or gem, any stamp or coin, any alcoholic beverage, or any other tangible personal property specified by the Secretary.[5] Net capital gain from selling collectibles is taxed at a maximum rate of 28%.

Gift or Bequest

Another strategy available to collectors is to gift the artwork. Taxpayers may lower the value of their estates without realizing gain on the gift. Generally, taxpayers have an annual gift exclusion amount that can be gifted to each donee each year. In the 2017 calendar year, the annual gift exclusion is $14,000 (or $28,000 for a married couple). If the value of the artwork is higher than the gift exclusion amount, the difference will be counted toward the lifetime gift amount. The basis of the donee is the same as in the hands of the donor. Nevertheless, the transaction may still be beneficial if the donee is in a lower tax bracket than the collector.

Collectors can also transfer the ownership of artwork by bequest. A bequest involves property given by will or estate plan. If a collector makes a bequest of artwork, it will be included in his or her estate at the time of the death. This may be beneficial if the estate is below the lifetime exclusion amount. Generally, artwork bequeathed to a beneficiary will receive a step-up basis, and if the artwork is below the exclusion amount, it can be transferred without estate tax while receiving a step-up basis. However, if the estate is above the exclusion amount, the estate will have to pay the 40% Federal estate tax and state estate tax on the full value of the artwork.

Alternatively, the collector can utilize the unlimited marital deduction when leaving artwork to a surviving spouse. The property can either be given directly or through a qualifying trust. The art will then receive a step-up basis in the hands of the surviving spouse.

Donation to a Charitable Organization

Taxpayers can receive a deduction on their tax returns for artwork donated to a charity. The amount of the deduction varies depending on the type of taxpayer.

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[4] Code §§67(a), 183(b).

[5] Code §408(m)(2).

A collector can deduct the full fair market value ("F.M.V.") of the donated artwork as long as it is (i) donated to a charitable organization and (ii) the charitable organization uses the artwork for a purpose related to its tax-exempt status.[6] This deduction is limited to 30% of the collector's adjusted gross income ("A.G.I."). If the charitable organization does not use the artwork for a related purpose, the collector is limited to the adjusted basis of the donated artwork, and the deduction is limited to 50% of A.G.I. When the value of the donated artwork exceeds the amount deducted, the remaining value can be carried forward up to five years.[7] When artwork is donated to the charity at death, the full value of the art can be deducted on the estate's tax return without any percentage limitation.

Bear in mind that if a public charity sells the artwork within three years of its receipt, the collector must amend the tax return to reflect the cost base value as a deduction and not the full value of the property at the time of donation. It is important, therefore, to restrict the charity from making such a sale.

In addition, the other drawback of donating artwork to a charitable organization is that the collector is permanently giving up the ownership. In such cases, it is important to choose the right charity to donate that artwork. Alternatively, some collectors choose to retain partial possession of the artwork and delay the transfer of full title to the charitable organization. A collector can transfer a fractional interest in artwork to a charitable organization, retaining the remainder interest that will be transferred over time. The transfer of the remaining interest must be completed within ten years.[8] The transfer provides an F.M.V. deduction at the time of the transfer for an undivided interest that was transferred. If the value of the artwork increases over the ten-year period, the deduction value is capped at the time of the initial donation.

Formation of an Art Foundation

In theory, for a very large collection consideration can be given to create an art foundation (*i.e.*, museum). An art foundation is a private operating foundation described under Code §4942(j)(3). The foundation has to dedicate the majority of its resources to conducting tax-exempt activities. There are certain benefits associated with this transaction. A collector can retain control over the artwork, making sure the donated artwork is used for purposes related to the art foundation's tax-exempt activity. This will provide an F.M.V. deduction to the donor, which will still be limited to the 30% of A.G.I. If the artwork is later sold by the art foundation, it does not pay capital gains tax for any gains realized. Furthermore, an art foundation is not subject to state and local tax.

CONCLUSION

It is often the case that a person may be unaware of the full value of artwork. Don't be that person that forgets about the art on the walls, only to discover its real value when it is too late to implement an estate plan. Find out the value or your work, and plan accordingly. Understanding the rules associated with the sale or donation of artwork is an important key.

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6 Code §170(b).

7 Code §170(d).

8 Code §170(o).

O.E.C.D. RECEIVES PUBLIC COMMENTS ON PROPOSED CHANGES TO THE MODEL TAX CONVENTION

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Tags
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On August 11, 2017, the O.E.C.D. released comments on the draft 2017 updates (the "Draft Contents") to the O.E.C.D. Model Tax Convention (the "O.E.C.D. M.C.") prepared by the Committee's Working Party 1 and published on July 11, 2017. The comments relate to O.E.C.D. proposals that were not previously subject to consultation. They were submitted by the B.E.P.S. Monitoring Group ("B.M.G."), the Business and Industry Advisory Group ("B.I.A.C."), the International Chambers of Commerce, and other interested parties.

Other proposed amendments in the Draft Contents were approved under the O.E.C.D.'s B.E.P.S. consultations. They have been released for information only. These provisions mainly relate to Article 5 (Permanent Establishment) and the B.E.P.S. Action 7 Final Report on Preventing the Artificial Avoidance of Permanent Establishment Status.

This article summarizes the changes to the O.E.C.D. M.C. that were open for public comment and the suggestions received and provides additional observations, including an examination of the interplay between the Draft Contents and existing U.S. approaches to these issues. Amendments to the O.E.C.D. M.C. that were approved under the B.E.P.S. consultations were discussed in a previous edition of *Insights*.[1]

PARAGRAPH 2 OF ARTICLE 3 AND THE COMMENTARY – TREATY INTERPRETATION

Proposal and Public Comments

The Draft Contents provide that if the competent authorities agree to an interpretation of a treaty provision that is not defined in the treaty under a mutual agreement procedure, this interpretation should override domestic law. Under prior regulations, absent a definition in the treaty, a term was to be construed under the domestic law of the taxing state.[2] The proposed amendment of paragraph 2 of Article 3 and the Commentary was included as a result of follow-up work on B.E.P.S. and intended to clarify the legal status of a mutual competent authority agreement.

In the B.M.G.'s view, however, this change would go far beyond a mere clarification. To the contrary, it raises policy issues concerning the agenda of creating a supranational resolution of tax treaty disputes. Tax treaties are generally incorporated directly into domestic law. Consequently, their provisions are subject to interpretation

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

2 O.E.C.D. M.C., Article 3, paragraph 2.

by domestic courts. Notwithstanding a certain weight courts would normally give to the views of the administrative authorities, they are typically reluctant to accept that those views could override their jurisdiction to interpret domestic law. However, this could be the result of including the provision in a tax treaty. Accordingly, this proposed amendment could be the source of confusion rather than clarification. Moreover, the B.M.G. points out that the provision is being included without adequate public discussion. Based on the foregoing, it thus recommends that countries should not include this provision in their tax treaties.

Observations

In a U.S. context, the suggested deference to mutual agreements by the competent authorities for interpretation purposes is not new. Nearly every U.S. income tax treaty contains a section authorizing the competent authorities of the contracting states to resolve by mutual agreement any difficulties or doubts arising as to the interpretation of the treaty.[3] Do U.S. courts follow these interpretations? This is a separate issue.

Treaty interpretation is a sensitive topic. Like the Code, U.S. income tax treaties are subject to judicial interpretation, and U.S. courts generally follow established norms of statutory interpretation in resolving treaty disputes. It has been generally accepted that the starting point for interpreting a U.S. income tax treaty is the language of the treaty itself. Only if a term lacks a definition in the treaty is deference given to other sources, such as the history of and legislative material on the treaty provision, domestic law (as stipulated in Article 3 paragraph 2 of the U.S. Model Tax Treaty), and interpretation thereof. In some instances, administrative guidance in the form of regulations has been utilized in the interpretation of treaties.[4] Still, the U.S. courts' position on the significance of I.R.S. interpretation has been unequivocal.

Most recently, the reluctance of courts to abide by the tax administration's interpretations of tax law – whether domestic or treaty-related – has been evidenced in the landmark decision of *Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commr*.[5] *Grecian* dealt with the tax implications of the redemption of a U.S. partnership interest by a foreign partner under domestic U.S. law and the U.S.-Canada Income Tax Treaty. Explaining the considerations in construing rules that do not contain an explicit rule for the case at issue, the court held that:

> Our level of deference to agency interpretations of law varies. Where the interpretation construes an agency's own ambiguous regulation, that interpretation is accorded deference * * * . On the other hand, where a revenue ruling improperly interprets the text of relevant statutes and has inadequate reasoning, we afford it no deference at all. * * * Between these poles, we follow revenue rulings to the extent that they have the 'power to persuade.'

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[3] U.S. Model Tax Treaty, art. 3, para. 2; see, *e.g.*, U.S.-Netherlands Income Tax Treaty (1992), art. 3, para. 2.

[4] *E.g.*, the definition of "trade or business" under the limitation on benefits clause in the U.S. Model Tax Treaty. Usually, reference is made to Code §367(a) and regulations promulgated thereunder to ascertain the meaning. U.S.-Netherlands Income Tax Treaty, Technical Explanation to Article 26.

[5] 149 T.C. 3 (2017); discussed in detail in "Foreign Partner Not Subject to U.S. Tax on Gain from Redemption of U.S. Partnership Interest," *Insights* 8 (2017).

In fact, certain U.S. courts have accorded a revenue ruling no more weight than a contention of any party to litigation.[6] It is, after all, the opinion of the Commissioner of Internal Revenue and has not gone through the rigorous procedures required of an I.R.S. regulation.

Even though U.S. treaties include the authority for competent authorities to reach an agreement on the interpretation on terms that are not defined in the treaty, this does not mean that courts accorded greater weight to such interpretations as compared to unilateral administrative guidance. This is illustrated in the case of *Xerox Corp. v. United States*.[7]

"The constitutionality of a mandated override of domestic law by a mutual competent authority agreement undermines jurisprudence."

The case involved an ongoing dispute by certain U.S. shareholders in U.K. corporations concerning the U.S. government's interpretation of Article 23 paragraph 1 of the U.S.-U.K. Income Tax Treaty with respect to the amount of U.S. foreign tax credit available to a direct investor. While the case was pending, and with the approval of the Claims Court, the U.S. Competent Authority invoked the mutual agreement procedure under the U.S.-U.K. treaty and entered into negotiations with the U.K. Competent Authority. After several years of correspondence and meetings between the U.S. and U.K. competent authorities, an agreement emerged in December 1986 in the form of an exchange of letters between representatives of the I.R.S. and the Inland Revenue. The U.S. government cited this agreement and certain other documents to support its construction of Article 23 paragraph 1. With respect to the agreement, the lower court observed:

> Moreover, [the] plaintiff can hardly minimize the importance of the Competent Authority Agreement as an expression of the intent of the treaty parties, since Article 25(3) of the Convention specifically empowered the competent authorities 'to resolve . . . any difficulties or doubts arising as to the interpretation or application of the Convention.' Courts have traditionally been reluctant to impinge on the judgments of competent authorities charged by the treaty states with responsibilities of interpretation and implementation.[8]

In contrast, the appellate court accepted the taxpayer's argument that the agreement did not address the key aspects of the issue before the court.

It remains to be seen whether an O.E.C.D.-level consensus can be reached on this point. The constitutionality of a mandated override of domestic law by a mutual competent authority agreement undermines jurisprudence. For that reason, its policy is questionable and may be subject to challenge in the courts. Furthermore, even if O.E.C.D. consensus is achieved, countries may express reservations, and in any event, U.S. courts do not appear to be bound by this type of provision.

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6 See, *e.g.*, *Crow v. Commr.*, 85 TC 376 (1985), regarding Rev. Rul. 79-152, which was issued in anticipation of litigation and was determined by the court not to "constitute a consistent and long standing administrative position with prior congressional or judicial approval" and thus was not due any special deference as an agency interpretation of treaty.

7 14 Cl. Ct. 455, 88-1 USTC ¶ 9231 (Cl. Ct. 1988), rev'd, 94-2 USTC ¶ 50,623 (Fed. Cir. 1994), reh'g denied, reh'g denied (February 7, 1995), cert. denied, 116 S. Ct. 72 (1995), action on decision, CC-1997-001 (recommending nonacquiescence).

8 *Id.*

ARTICLE 29 –ENTITLEMENT TO BENEFITS

Proposal and Public Comments

The new Article 29 (Entitlement to Benefits) of the Draft Contents contains three significant provisions: a limitation on benefits ("L.O.B.") rule (simplified and detailed versions), an anti-abuse rule for permanent establishments ("P.E.'s") situated in third countries, and a principal purposes test ("P.P.T.") rule. A footnote clarifies that the choice of which to incorporate into a treaty is left to the contracting states.

While the B.M.G. acknowledges the importance of an anti-abuse provision in tax treaties as part of the O.E.C.D.'s B.E.P.S. Project, it points out the complexities that countries face in implementing such provisions. The B.M.G. notes that most countries are likely to prefer the inclusion of the P.P.T., as this would allow them to apply the domestic anti-abuse provisions that are considered most appropriate. However, certain states, such as the U.S., may object to this approach, which seemingly permits too much discretion at the level of tax administrations. In this scenario, the U.S. could insist on the inclusion of a detailed L.O.B. provision. According to the B.M.G., the detailed rules are complex, difficult to apply in practice, and – as shown by the various revisions of the L.O.B. clause in the U.S. Model Tax Treaty – inadequate to prevent "ingenious and continually developing avoidance techniques."

The Draft Contents include a detailed version of the L.O.B. provision that has not been subject to public consultation. A previous version, produced as part of B.E.P.S. Action 6, was considered provisional pending finalization of the U.S. Model Tax Treaty. A similar was presented to the U.N. Committee of Experts and discussed at its December 2016 and April 2017 meetings. According to the B.M.G., it might be useful for the Commentary on the O.E.C.D. M.C. to refer to the U.N. model and point out any differences between the O.E.C.D. and U.N. texts.

Observations

Since 1979, all U.S. treaties ratified by the Senate have contained an L.O.B. provision of one sort or another, as have certain earlier treaties. The purpose of the L.O.B. article is to determine whether a resident of a treaty country has a sufficient connection with that country to justify entitlement to treaty benefits.

On February 17, 2016, the U.S. Treasury Department released a new draft of the U.S. Model Tax Treaty (the "2016 Model Treaty"), which is the baseline text the Treasury will use in negotiating tax treaties.[9] According to an accompanying Treasury press release, the 2016 Model Treaty "includes a number of new provisions intended to more effectively implement the Treasury Department's longstanding policy that tax treaties should eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance." In other words, the Treasury felt compelled to make adjustments that are in line with the B.E.P.S. initiative.[10]

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9 Technical Explanation to the draft were, however, not issued.

10 Interestingly, the five draft updates of the U.S. Model Tax Treaty preceding the 2016 draft were released on May 20, 2015 by Treasury, two days before the O.E.C.D. issued its revised discussion draft B.E.P.S. Action 6: Prevent Treaty Abuse (Action 6) and shortly before the United States was scheduled to meet with the O.E.C.D. in June 2015.

However, the 2016 Model Treaty was drafted in a prior administration, and in 2017, the current administration initiated a review of I.R.S. regulations to identify recent legislation that it views as complex, burdensome, and expensive for business. The Treasury Department has already selected eight regulations for withdrawal or modification, and the review is ongoing. Whether the 2016 Model Tax Treaty will fare any better than the other eight regulations is an open question at this time.

The fundamental differences between the 2016 Model Treaty and the prior 2006 model are that it likely will be more difficult to qualify for treaty benefits under the new standards, and for those companies that are able to qualify, the benefits will be more restrictive. While some of these changes are intended to be taxpayer favorable – such as including a derivative benefits test in the U.S. Model Tax Treaty for the first time, albeit of limited scope, and adding a new test for eligibility for "headquarters companies" – most of the changes add additional restrictions to treaty eligibility.

The treaty's L.O.B. article is intended to police "treaty shopping" by requiring residents of a treaty country to satisfy any of several objective tests that generally would indicate that a person has sufficient nexus to the treaty jurisdiction to conclude that person is not treaty shopping. Business entities generally can qualify for benefits of a treaty under the publicly traded company test, the subsidiary of a publicly traded company test, the ownership/base erosion test, the active trade or business test, or (where a treaty includes it) the derivative benefits test. The 2016 Model Treaty places significant additional restrictions on these tests that likely will make it difficult for many companies to qualify for treaty benefits and, at a minimum, will add additional complexity and uncertainty to nearly all companies' determinations of whether they qualify for treaty benefits.[11]

In light of the foregoing, the suggestion to clarify differences between the L.O.B. versions found in the Draft Contents and the U.N. model is on point. However, the criticism of the detailed L.O.B. clause as an inadequate tool to limit B.E.P.S. is overreaching.

Is the U.S. Model Tax Treaty's L.O.B. clause complex and not always clear in its application? Yes. Is there room for improvement? Yes. Technology enables and enhances new business models that take advantage of tax loopholes; this has been a challenge and will remain so in the future. That domestic anti-abuse rules provide a more adequate means of combatting tax avoidance involving multinational groups is questionable. In addition, one person's view of an abusive purpose is another person's view of proper planning and profit maximization.

Thus, even though the U.S. Model Tax Treaty is not perfect, experience can be drawn from the long-standing practice under its L.O.B. provision. Certain objective tests have proven adequate and others may be helped by revision.

Furthermore, the 2016 Model Treaty may serve as basis for discussion. The Luxembourg treaty may serve as an example. On June 22, 2016, the Treasury announced that the U.S. and Luxembourg were in the process of negotiating a protocol to the existing U.S.-Luxembourg Income Tax Treaty and that Luxembourg had introduced a bill in parliament with the text of an amendment to be included in the protocol

[11] For a detailed discussion of the revised L.O.B. article see "2016 Model Treaty – L.O.B. Revisions," *Insights* 3 (2016).

relating to the definition of a P.E. The amendments reflect changes introduced in the 2016 Model Treaty, proving that the process can be kept flexible to address new challenges.

COMMENTARY ON ARTICLE 5 – P.E. AND V.A.T.

Proposal and Public Comments

The Draft Contents include a new paragraph 1.1 to the Commentary on Article 5 of the O.E.C.D. M.C. This addition is intended to clarify that registration for value added tax ("V.A.T.") or goods and services tax ("G.S.T.") is by itself not relevant to the application and interpretation of the P.E. definition.[12]

The B.M.G., the B.I.A.C., the I.C.C., and other interested parties unanimously welcome changes to the Commentary on Article 5 regarding the definition of a P.E. They support the proposal to specify that the treatment of a foreign enterprise for V.A.T. or G.S.T. purposes is not in itself material to the determination of a P.E.; a company registering for V.A.T. or G.S.T. should not be negatively impacted for income tax purposes. According to one comment, this should specifically hold true if a foreign enterprise appoints a third party (*e.g.*, a tax professional) or a related party (*e.g.*, a local subsidiary) to carry out registration and representation before the relevant tax authorities. The B.I.A.C. recommends a cross-reference in the Commentary to the V.A.T. and G.S.T. guidelines and the B.E.P.S. Action 1 Final Report, which states that registration for V.A.T. or G.S.T. purposes does not constitute a P.E. for direct tax purposes. Only the B.M.G. adds that, while not constituting a P.E., voluntary or mandatory registration for V.A.T. or G.S.T. purposes could serve as indicia for local tax authorities to scrutinize a potential creation of a P.E.

Commentators highlighted the compliance time and costs associated with V.A.T. and G.S.T. registration. It was also pointed out that in a Federal tax system, such as those adopted by the U.S. or Canada, taxpayers may deal with compliance and administration on sales taxes at more than one level of government, which may create a huge administrative and compliance burden.

Observations

The proposed addition that no deference on the creation of a P.E. should be made merely based on registration for V.A.T. or G.S.T. purposes constitutes an important victory for taxpayers. It would serve the U.S. Model Treaty well to follow suit. One benefit may be that taxpayers feel less deterred from complying with the increasing amount of reporting obligations. To draw a distinct line between income tax and indirect taxes is welcomed and should be looked to as an example.

COMMENTARY ON ARTICLE 4 – PERMANENT HOME AND HABITUAL ABODE

Proposal and Public Comments

The draft changes address the situation where residential real estate is rented to an

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[12] Paragraph 5 in the Commentary on Article 5.

unrelated person and whether this could be regarded as a permanent home available to the landlord for the purposes of the residence tiebreaker rule. The changes are made in paragraph 13 of the Commentary on Article 4 and refer to Article 4(2)(a) of the O.E.C.D. M.C. Further changes to clarify the meaning of "habitual abode" in the tiebreaker rule are made in paragraphs 17 and 19 of the Commentary to Article 4 and by the addition of new a paragraph 19.1 to the Commentary.

Some commentators considered that further clarification is needed in the proposed Article 4 changes regarding residence (*e.g.*, in relation to the issue of whether a house in a particular jurisdiction is available to the taxpayer).

Observations

It appears appropriate to deny a person treaty benefits if the claim is based on ownership of a home that is rented out and not actually available.

While this amendment targets claims of residence and access to treaty benefits, it also provides clarification under the opposite circumstances (*i.e.*, when a person is no longer deemed to be a resident of a treaty country). The latter would support determinations upon the transfer of residence by a person from one country to another.

Left open is a fact pattern where the property is owned by a person assigned abroad by his or her employer and the lease under which the house is rented has an early termination provision that is triggered in the event the individual returns early from the foreign assignment.

ARTICLE 10 PARAGRAPH 2(A) – REDUCED WITHHOLDING TAX ON DIVIDENDS FOR PARTNERSHIPS

Proposal and Public Comments

The draft changes include the deletion of the phrase "(other than a partnership)" from paragraph 2(a) of Article 10. The subparagraph has been changed to ensure that the reduced rate of withholding tax on dividends levied by the state of source applies where relevant to a transparent entity. This may be illustrated by the following example:

> A company resident in State A pays a dividend to a partnership, P, which State B treats as a transparent entity. One of P's partners, C, is a resident of State B. The part of that dividend that State B treats as the income of the partner C will, for the purposes of paragraph 2 of Article 1 of the convention between States A and B, be treated as a dividend paid to a resident of State B. If the other requirements under the treaty (e.g., minimum ownership requirement under Article 10, L.O.B. clause) are met, C would be eligible to the preferential withholding tax rate.

This change has been made because, under the new paragraph 2 of Article 1 of the O.E.C.D. M.C., income derived by an entity that is fiscally transparent under the laws of either contracting state is considered to be income of a resident of a contracting state to the extent that it is treated as income of a resident of that state for tax purposes. The change to paragraph 2(a) of Article 10 therefore ensures that the reduction of withholding tax on dividends provided for in that article can apply to dividends paid to a transparent entity where the relevant conditions apply. New paragraphs 11 and 11.1 have also been added to the Commentary on Article 10 in relation to this change.

This amendment was welcomed by the B.M.G.

Observations

In a U.S. context, these amendments are not new. The clarification can be found in U.S. income tax treaties.

One example is the U.S.-France Income Tax Treaty (the "Treaty"). Paragraph 3 of Article 4 of the Treaty provides that an item of income, profit, or gain derived by a fiscally transparent entity is considered to be derived by a resident of a contracting state to the extent that the resident is treated under the taxation laws of the state of residence as deriving the item of income. This applies to any resident of a contracting state that derives income, profit, or gain through an entity that is treated as fiscally transparent under the laws of either contracting state, where such entity is formed or organized in either contracting state or in a state that has concluded an agreement containing a provision for the exchange of information with a view to the prevention of tax evasion with the contracting state from which the income, profit, or gain is derived.[13] The Technical Explanation to the Treaty takes it a step further and explains the treatment of partners resident in third countries. The former should be eligible for treaty benefits under the tax treaty with his or her country of residence.

"An item of income, profit, or gain derived by a fiscally transparent entity is considered to be derived by a resident of a contracting state to the extent that the resident is treated under the taxation laws of the state of residence as deriving the item of income."

The Technical Explanation to Article 4.3 of the Treaty provide the following example:

> For example, if a corporation resident in France distributes a dividend to an entity that is formed or organized in the United States, and is treated as fiscally transparent for U.S. tax purposes, the dividend will be considered derived by a resident of the United States only to the extent that the taxation laws of the United States treat one or more U.S. residents (whose status as U.S. residents is determined, for this purpose, under U.S. tax laws) as deriving the dividend income for U.S. tax purposes. In the case of a partnership, the persons who are, under U.S. tax laws, treated as partners of the entity would normally be the persons whom the U.S. tax laws would treat as deriving the dividend income through the partnership. Thus, it also follows that persons whom the United States treats as partners but who are not U.S. residents for U.S. tax purposes may not claim any 3 benefits under the Convention for the dividend paid to the entity. Although these partners are treated as deriving the income for U.S. tax purposes, they are not residents of the United States for purposes of the Convention. If, however, they are treated as residents of a third country under the provisions of an income tax convention which that country has with France, they may be entitled to claim a benefit under that convention. In contrast, if an entity is organized under U.S. laws and is classified as a corporation for U.S.

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[13] Treasury Technical Explanation to the 2009 Protocol (2010) (the "Technical Explanation").

tax purposes, dividends paid by a corporation resident in France to the U.S. entity will be considered derived by a resident of the United States since the U.S. corporation is treated under U.S. taxation laws as a resident of the United States and as deriving the income.

Because the entity classification rules of the State of residence govern, the results in the examples discussed above would obtain even if the entity were viewed differently under the tax laws of France (e.g., as not fiscally transparent in the first example above where the entity is treated as a partnership for U.S. tax purposes or as fiscally transparent in the second example where the entity is viewed as not fiscally transparent for U.S. tax purposes).

The Draft Contents ensure that income of fiscally transparent entities or arrangements is treated, for the purposes of the O.E.C.D. M.C., in accordance with the principles reflected in the 1999 report of the Committee on Fiscal Affairs entitled "The Application of the O.E.C.D. Model Tax Convention to Partnerships."[14] That report provides guidance and examples on how the provision should be interpreted and applied in various situations.[15] The report, however, dealt exclusively with partnerships and while the Committee recognized that many of the principles included in the report could also apply with respect to other non-corporate entities, it expressed the intention to examine the application of the O.E.C.D. M.C. to these other entities at a later stage. As indicated in paragraph 37 of the report, the Committee was particularly concerned with "cases where domestic tax laws create intermediary situations where a partnership is partly treated as a taxable unit and partly disregarded for tax purposes." Whilst this may create practical difficulties with respect to a very limited number of partnerships, it is a more important problem in the case of other entities, such as trusts. For this reason, the Committee decided to deal with this issue in the context of follow-up work to this report. It will be interesting to see how the clarification for trusts will be structured.

CONCLUSION

While the U.S. has been publically criticized for its lack of commitment to the B.E.P.S. initiative, the examples outlined in the foregoing show that the O.E.C.D. M.C. may derive insights from the U.S. Model Tax Treaty and draw on the U.S. experience and revisions. Examples include the competent authority interpretation and a detailed L.O.B. article. In return, some of the clarifications included in the Draft Contents (*e.g.*, V.A.T. registration not creating a P.E. by itself and a lack of nexus in the case of rented property) could be food for thought when it comes to amending the 2016 U.S. Model Tax Treaty.

With respect to the Draft Contents, it remains to be seen whether approval will be

[14] Reproduced in Volume II of the full-length version of the O.E.C.D. M.C., p. R(15)-1.

[15] Paragraph 2 addresses this particular situation by referring to entities that are "wholly or partly" treated as fiscally transparent. Thus, the paragraph not only serves to confirm the conclusions of the report but also extends the application of these conclusions to situations that were not directly covered by the report (subject to the application of specific provisions dealing with collective investment vehicles; see Commentary on Article 1, paragraphs 22-48). Draft Contents, Commentary to Article 1, paragraph 4.

reached on an O.E.C.D. level. In any event, the O.E.C.D. M.C. and U.S. Model Tax Treaty are moving closer to each other. Hence the question remains whether the O.E.C.D. is moving closer to the U.S., the U.S. is moving closer to the O.E.C.D., or each is drawing upon the experience of the other to improve its model.

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TREASURY TURNS BACK THE CLOCK ON 2016 TAX REGULATIONS

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SECOND REPORT TO THE PRESIDENT ON IDENTIFYING AND REDUCING TAX REGULATORY BURDENS – EXECUTIVE ORDER 13789

On October , the "other shoe dropped" on eight regulations issued by the Obama administration in 2016 and January 2017. These eight measures were first identified in an interim Report to the President as unnecessary, unduly complex, excessively burdensome, or failing to provide clarity and useful guidance. They will be withdrawn, revoked, or modified as explained below.

The Treasury Department also announced the initiation of a comprehensive review of all tax regulations, regardless of when they were issued. Included in the expanded review are longstanding temporary or proposed regulations that have not expired or been finalized but which to varying degrees appear to be unnecessary, duplicative, or obsolete. The rulemaking process for revoking regulations will begin in the fourth quarter of 2017.

WITHDRAWAL OF PROPOSED REGULATIONS

Withdrawal of Proposed Regulations Under Code §2704 on Restrictions on Liquidation of an Interest for Estate, Gift, and Generation-Skipping Transfer Taxes (REG-163113-02; 81 F.R. 51413)

Code §2704 addresses the valuation, for wealth transfer tax purposes, of interests in family-controlled entities. In limited cases, it disregards certain restrictions on the ability to dispose of or liquidate family-controlled entities when determining the fair market value of an ownership interest for estate tax, generation-skipping transfer tax, and gift tax purposes. Over the years, changes in state statutory law and case law eroded the scope of its application, thereby facilitating the use of artificial valuation discounts such as lack of control and limited marketability. The proposed regulations would have narrowed the use of these valuation discounts. However, the Treasury and the I.R.S. now believe that the proposed regulations are unworkable and the burden of compliance is excessive. The proposed regulations will be withdrawn in their entirety.

Withdrawal of Proposed Regulations Under Code §103 on Definition of Political Subdivision (REG-129067-15; 81 F.R. 8870)

Code §103 excludes from a taxpayer's gross income the interest on state or local bonds, including obligations of political subdivisions. Code §103 does not define "political subdivision." However, the case law requires a political subdivision to possess and exercise sovereign powers. The proposed regulations would have required a political subdivision to meet enhanced standards to show a governmental purpose and governmental control in addition to significant sovereign power. Although some enhanced standards for qualifying as a political subdivision may be appropriate, the proposed regulations will be withdrawn in their entirety because of their far-reaching impact on existing legal structures.

REVOCATION OF REGULATIONS

Partial Revocation of Final Regulations Under Code §7602 on the Participation of a Person Described Code §6103(n) in a Summons Interview (T.D. 9778; 81 F.R. 45409)

Final regulations under Code §7602 provide that the I.R.S. may use private contractors (*i.e.*, nongovernment employees) to assist the I.R.S. in auditing taxpayers. The regulations also allow private contractors to receive and review records produced in response to a summons, be present during interviews of witnesses, and question witnesses under oath, under the guidance of an I.R.S. officer or employee. Although, the court in *United States v. Microsoft Corp.*, upheld the I.R.S.'s legal authority to enlist outside attorneys, it expressed its concern regarding the law firm's level of involvement in the audit. The Treasury and the I.R.S. intend to amend these regulations in order to narrow their scope by prohibiting the I.R.S. from enlisting outside attorneys to participate in an examination, including a summons interview. However, the regulations would continue to allow outside subject-matter experts, such as an engineer or foreign attorney who is a specialist in foreign law, to participate in summons proceedings. They explained that since the experts have a circumscribed role in providing subject-matter knowledge, the government does not risk losing control of its own investigation.

Partial Revocation of Regulations Under Code §§707 and 752 on Treatment of Partnership Liabilities (T.D. 9788; 81 F.R. 69282)

These proposed and temporary partnership tax regulations govern how liabilities are allocated for purposes of disguised sale treatment and whether bottom-dollar guarantees create sufficient economic risk of loss necessary to be considered as a recourse liability. These rules proposed a novel way of allocating liabilities without a full analysis of its impact on areas beyond disguised sales. The proposed and temporary regulations will be revoked, while further study is given to the approach. In the interim, prior regulations will be reinstated.

Partial Revocation of Final and Temporary Regulations Under Code §385 on the Treatment of Certain Interests in Corporations as Stock or Indebtedness (T.D. 9790; 81 F.R. 72858)

These final and temporary regulations address two separate parts of Code §385. One part relates to the documentation regulations that establish minimum requirements for purported debt obligations among related parties to be treated as debt for Federal tax purposes. These regulations compel corporations to build expensive new systems to satisfy numerous tests related to documentation. They will be revoked and replaced by simplified and streamlined rules that would lower the burden on U.S. corporations while producing information sufficient for tax administration purposes. The other part involves indebtedness to fund distributions. These principally address inversions and takeovers of U.S. corporations, by limiting the ability of corporations to generate additional interest deductions without new investment in the U.S. The Treasury continues to firmly believe in maintaining safeguards against earnings stripping. However, the solution requires a legislative change to fix the structural deficiencies in the current U.S. tax system that incentivize inversions in order to eliminate the need for earnings of foreign subsidiaries to be locked in those subsidiaries. Tax reform is expected to obviate the need for the distribution regulations and make it possible for these regulations to be revoked. If a legislative solution is not achieved, the Treasury and the I.R.S. may propose more streamlined and targeted regulations.

SUBSTANTIAL REVISION OF REGULATIONS

Substantial Revisions to Final Regulations Under Code §367 on the Treatment of Certain Transfers of Property to Foreign Corporations (T.D. 9803; 81 F.R. 91012)

These temporary regulations amend existing rules on transfers of property by C-corporations to Real Estate Investment Trusts ("R.E.I.T.'s") and Regulated Investment Companies ("R.I.C.'s"), generally in accordance with provisions of the Protecting Americans from Tax Hikes Act of 2015. The Treasury and the I.R.S. believe that R.E.I.T. spin-off rules could result in over-inclusion of gain where a large corporation acquires a small corporation that engaged in a spin-off under Code §355 and the large corporation subsequently makes a R.E.I.T. election. Revisions will limit the potential taxable gain so that it does not exceed the amount that would have been recognized if a party to a spin-off had directly transferred assets to a R.E.I.T. Only gain related to the assets of the corporation undergoing the spin-off will be recognized.

Substantial Revisions to Final Regulations Under Code §987 on Income and Currency Gain or Loss with Respect to a Code §987 Qualified Business Unit (T.D. 9794; 81 F.R. 88806)

Under existing regulations, currency gains or losses of a branch are recognized when the branch makes certain transfers of property to its head office. Under a transitional rule, previously unrecognized currency losses in years prior to the transition period are disregarded in the computation. In addition, the rules are unduly complex. The Treasury and the I.R.S. will issue rules allowing taxpayers to defer application of the regulations until 2019, at the earliest. A simplified method to compute the recognized currency gain will be developed. The transitional rule may be revised to provide alternative methods of computing the gain.

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"ON PAPER" RESIDENTS WITH NO SUFFICIENT NEXUS TO SWITZERLAND NOT ELIGIBLE FOR TREATY BENEFITS

A recent decision, involving Starr International Company ("Starr"), provides insight into what a court may view as relevant in deciding a treaty shopping case.[1] The taxpayer, Starr, was located in Bermuda until approximately 2004, when it relocated to Ireland. Its ultimate (indirect) beneficial owner was a New York charitable foundation. In 2006 – roughly a year after relocating to Ireland – Starr relocated to Switzerland, claiming that Ireland was not amenable to its charitable objectives and its assets were not sufficiently shielded from litigation in Ireland.

Starr was the largest shareholder of A.I.G., a U.S. corporation from which it regularly received dividends. In 2007, Starr filed a request for treaty benefits under paragraph 6 of Article 22 of the U.S.-Swiss Double Taxation Treaty, to obtain the benefit of a lower dividend tax rate. However, the I.R.S. rejected the application on the grounds that Starr had engaged in treaty shopping since the primary purpose of its relocation to Switzerland was to obtain treaty benefits.

Starr argued against the ruling, noting that Article 22(6) was meant to provide relief to any company resident in the one of the contracting states and not engaged in treaty shopping and that treaty shopping always involves a third-country resident (*i.e.*, a resident of a country not party to the relevant tax treaty). Because Starr was domiciled in Switzerland and its beneficial and voting ownership was (largely) either Swiss or American, it argued that it could not have been engaged in treaty shopping and therefore should be eligible to treaty benefits.

The District Court of the District of Columbia rejected Starr's position that treaty shopping involves a third-country resident on the basis of the limitation of benefits ("L.O.B.") provision in the 1996 income tax treaty between the U.S. and Switzerland. Further, the court held that "on-paper residency" does not necessarily entitle a taxpayer to treaty benefits. Rather, the Technical Explanation of Article 22 authorizes a tax authority to deny benefits, under substance-over-form principles, "to an individual or entity that does not have a genuine connection to the jurisdiction, even when it resides there on paper." Thus, if an on-paper resident has "a sufficient nexus to the Contracting State," it may be called a *bona fide* resident and eligible to treaty benefits. Additionally, the District Court held that the I.R.S. "reasonably applied" the Administrative Procedure Act's ("A.P.A.") "arbitrary and capricious" standard in denying discretionary treaty benefits to Starr.

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1 *Starr Int'l Co. v. U.S.*, No. 14-cv-01593 (C.R.C.).

TECHNOLOGY AND TAXATION

Changes in technology have spurred new ways of collecting information and taxes, and new taxpayer fears that their information may be compromised. In large part, the fears result from the enactment by many countries of new documentation requirements, including country-by-country reporting of tax data, to comply with new rules issued by the O.E.C.D. as part of the B.E.P.S. Project.

Brazil is a leader in the digital revolution. Brazil has been implementing a multilayered tax digitization project (known as SPED) since 2006, with a goal of having all phases operational by 2017. According to a 2016 report by Ernst & Young LLP, Brazil requires corporations to e-file accounting and tax books and records. A corporation's tax obligation is determined by the Brazilian tax authorities based on these digital reports. Corporate income tax and V.A.T. information can be exchanged among Federal tax authorities. Sellers must send e-invoices to the government for validation before shipping goods, and purchasers must check the e-invoices with the government before receiving goods. It has also been reported that Brazilian tax authorities use social media in its review of individual taxpayers.

The increased integration of technology in the tax system will accelerate. This will continue to change the way information is reported and tax is collected. The ultimate goal of this digitalization is to receive information in real time.

I.R.S. WILL RULE ON TAX-FREE STOCK DISTRIBUTIONS UNDER PILOT PROGRAM

Under Code §355, a distributing corporation may distribute stock and securities of a controlled corporation tax free, if certain requirements are met. In 2013, the I.R.S. announced that it would no longer rule on the tax consequences of several types of corporate transactions, including Code §355 distributions.

Under recently issued Revenue Procedure 2017-52, 2017-41 I.R.B., the I.R.S. introduced a pilot program expanding the scope of letter rulings to Code §355 stock and security distributions and provided the procedures to request such rulings. The pilot program widens the scope of available letter rulings for an 18-month period.

Revenue Procedure 2017-52 will apply to all ruling requests postmarked after September 21, 2017, and will expire on March 21, 2019, after which time the I.R.S. will evaluate the program's effectiveness and whether it should be continued.

THE STATE OF CORPORATE INVERSIONS

In 2016, the U.S. Treasury Department under President Obama introduced "anti-inversion" regulations under Code §7874 of the Code to discourage companies from expatriating by changing their corporate structures as a means to reduce their U.S. tax liabilities. The rule applies when former shareholders of an acquired U.S. company own 60% or more of the new foreign parent stock. If the shareholders own more than 60% but less than 80% of the new foreign parent, the availability of certain tax attributes is limited. Should the ownership meet or cross the 80% limit, the foreign acquiring company is treated like a domestic corporation for U.S. Federal income tax purposes.

The tax regulations appear to have had some effect in halting inversions. Pfizer Inc. and Allergan Plc aborted a $160 billion merger. Hewlett Packard Enterprise Co. and U.K.-based Micro Focus International Plc completed a spinoff and subsequent merger, and at least one commentator has suggested that the transaction may run afoul of the new anti-inversion rules. A Huntsman Corp. subsidiary, Venator Materials Plc, filed an initial public offering, effecting a "natural" inversion. Subsequently, Huntsman Corp. announced a merger with Swiss Clariant AG, pursuant to which Clariant shareholders would own 52% of the resulting company headquartered in Switzerland.

"By proposing favorable tax treatment for repatriation of existing earnings that are locked in abroad and the adoption of a territorial tax system moving forward, the carrot will be emphasized instead of the stick."

President Trump campaigned on a promise to clamp down on the practice of corporate inversions. However, the Code §7874 rules are subject to the president's April executive order, which directed the Treasury to scrutinize "significant" tax regulations issued since January 1, 2016, for possible changes or repeal. The American Institute of CPAs has asked Treasury Secretary Steven Mnuchin to take an especially close look at the Code §7874 Regulations, and the U.S. Chamber of Commerce has asked the Treasury to throw out the rules altogether.

As mentioned elsewhere in this edition of *Insights*, the current administration is urging Congress to take a different approach to the underlying economic problem that makes inversions attractive to management. By proposing favorable tax treatment for repatriation of existing earnings that are locked in abroad and the adoption of a territorial tax system moving forward, the carrot will be emphasized instead of the stick. The open question is whether these steps will put an end to the emigration of U.S. corporations.

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