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INSIGHTS

2019 YEAR IN REVIEW

IR35 – WHY ARE U.K. BUSINESSES SO CONCERNED?

A YEAR OF GUEST FEATURES

Insights Special Edition Vol. 6 No. 10

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EDITORS' NOTE

As is our tradition at *Insights*, the December special edition acknowledges the articles authored throughout the year by colleagues at law firms and accounting firms across the globe who have taken the time and interest to contribute to our jounal. Eighteen articles written by 25 guest authors have appeared throughout 2019. We begin by looking forward, with an article on employment tax rules in the U.K. that will apply to the private sector in April 2020, and follow up with the 17 guest pieces published throughout the year.

To our guest authors, thanks. To our readers, *happy holidays*!

2019 Guest Authors	
Penny Simmons Pinsent Masons LLP	**Claire Schmitt and Bruno Gasparotto** Arendt & Medernach
Antti Lehtimaja and Sanna Lindqvist Krogerus Ltd	**Sunita Doobay** Blaney McMurty
Christian Shoppe Deloitte Deutschland	**Sanjay Sanghvi and Raghav Kumar Bajaj** Khaitan & Co
Raghu Marwah and Anjali Kukreja R.N. Marwah & Co LLP	**Lous Vervuurt** Buren N.V.
Benjamin Twardosz CHSH Attorneys-at-Law	**Alicea Castellanos** Global Taxes LLC
Andreas Richter P+P Pöllath + Partners	**Arthur J. Radin** (in memoriam)
Thierry Boitelle and Aliasghar Kanani Bonnard Lawson	**Sunil Agarwal** AZB & Partners
Rachida el Johari and Madeleine Molster Sagiure Legal	**Adnand Sulejmani and Thierry Lesage** Arendt & Medernach
Daniel Paserman Gornitzky & Co.	**Jairaj Purandare** JMP Advisors Pvt Ltd

- **IR35 – Why Are U.K. Businesses So Concerned?** New U.K. tax rules are being introduced from April 2020 to make businesses liable for determining the employment tax status of contractors who work through personal service companies ("P.S.C.'s"). These outsourcing arrangements have had a devastating effect on tax collections and funding for National Insurance, the U.K. version of Social Security. The goal of the new rules is to make customers

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of P.S.C.'s liable for collecting wage withholding tax and National Insurance contributions that are not collected by the P.S.C. when the worker of the P.S.C. would otherwise be properly characterized for U.K. tax purposes as an employee of the customer of the P.S.C. under tests published by H.M.R.C. Any company involved in the P.S.C. arrangement may have inchoate liability for payments of wage withholding tax and National Insurance. Penny Simmons, of Pinsent Masons LLP, London, explains the scope of the exposure and expounds on procedures that should be adopted in advance of the April 2020 effective date.

- **New Developments on the V.A.T. Regime of Holding Companies.** Like state and local tax in the U.S., where tax exposure can be underestimated by many corporate tax planners, the V.A.T. rules in the E.U. contain many pitfalls. This is especially true when it comes to recovery of V.A.T. input taxes by holding companies. A corporate tax adviser may presume that all V.A.T. input taxes paid by a holding company are recoverable. Yet, despite abundant jurisprudence, debate continues regarding the V.A.T. recovery rights of holding companies. The starting point in the analysis is easy to state: Holding companies that actively manage subsidiaries can recover V.A.T., while holding companies that passively hold shares cannot. The problem is in the application of the theory, where the line between active and passive behavior is blurred by seemingly inconsistent decisions. Bruno Gasparotto and Claire Schmitt of Arendt & Medernach, Luxembourg, explain the rules and how they have been applied by the C.J.E.U.

- **2019 Welcomes New Finnish Interest Deduction Limitations.** Changes to the Finnish interest barrier regime have come into effect in 2019. They have been expected since 2016, when the E.U. released its Anti-Tax Avoidance Directive ("A.T.A.D."), which sets forth the minimum standards for interest deduction restrictions within the E.U. The limitations affect E.B.I.T.D.A.-based rules (*i.e.*, addressing earnings before interest, tax, depreciation, and amortization) adopted in 2014, which include the specific interest barrier rule affecting the deductibility of intra-group interest payments. Antti Lehtimaja and Sanna Lindqvist of Krogerus Ltd., Helsinki, explain the key elements of the new restrictions, including some considerations regarding the impact on Finnish taxpayers and investments in Finland.

- **Can Tax Authorities Demand Access to Audit Workpapers? Canadian Experience Follows U.S. Rule.** Recent victories in litigation have allowed the Canada Revenue Agency to review tax accrual workpapers of Canadian corporations, provided the request for access is not a "fishing expedition" attempting to find issues. In the U.S., the I.R.S. has enjoyed that power for many years. Sunita Doobay of Blaney McMurtry L.L.P., Toronto, examines the scope and limitations of the Canadian decisions. Stanley C. Ruchelman reviews case law in the U.S., the role of FIN 48, and the purpose behind Schedule UTP (reporting uncertain tax positions), which surprisingly is designed to limit examinations of tax accrual workpapers.

- **O.E.C.D. on Digital Business – Seriously?!** On February 13, 2019, the O.E.C.D. issued a discussion draft addressing the tax challenges of the digitalization of the economy and asked for feedback in a shockingly brief timeframe. Is the discussion draft — which in many respects mimics G.I.L.T.I.

provisions and highlights the value of a market as a key determiner of profit allocation — a move away from value of functions? In a stealth way, it may be a precursor to a global B.E.A.T. Christian Shoppe of Deloitte Deutschland, Frankfurt, cautions that the ultimate destination of B.E.P.S. may be added complexity in tax laws and expanded opportunity for double taxation. Bad news for taxpayers; more work for tax advisers.

- **Tax Authorities Eye GSK-HUL Merger: Could Attract Tax on Long-Term Capital Gains and Brand Transfer.** GSK Consumer Healthcare India (GSK India) is in the process of merging with Hindustan Unilever Ltd (HUL) in the biggest deal in India's consumer packaged goods space, valued at approximately $4.5 billion. Although the transaction is structured to be tax-free for shareholders, plenty of room exists for the Indian tax authorities to assert tax from the companies: The transfer of a brand owned outside India may generate Indian tax to the extent its value stems principally from India. In addition, arm's length pricing for royalty payments and accompanying withholding tax issues also come into play. Sanjay Sanghvi and Raghav Kumar Bajaj of Khaitan & Co., Mumbai and New Delhi, discuss the global tax issues surrounding the transaction.

- **Strategies for Foreign Investment in Indian Start-Ups.** Foreign investment in Indian high-tech start-ups can yield significant profit opportunities for savvy investors. During 2018, over 1,000 deals were struck, reflecting $38.3 billion in new investments. If these investments turn out to be profitable, the tax exposure for the investor will vary with the form of the investment. Choices of investment vehicles include (i) L.L.P.'s, (ii) Category I, Subcategory I alternative investment funds ("A.I.F.'s") registered with the Securities Exchange Board, (iii) Category III A.I.F.'s, and (iv) trusts. Each has unique tax consequences for investors receiving dividends and realizing gains. Raghu Marwah and Anjali Kukreja of R.N. Marwah & Co L.L.P., New Delhi, explain the entities choices and the resulting tax costs.

- **Trust Regulations and Payment Services: Dutch Law in 2019.** The Dutch government has taken steps in recent months to enhance regulatory oversight. The new Act on the Supervision of Trust Offices 2018 adopts serious best practices for trust companies designed to prevent Dutch entanglement in the next set of Panama Papers. KYC due diligence must be real. At the same time, the Second Payment Services Directive ("P.S.D. II") was transposed into Dutch law. With customer permission, companies involved in payment service businesses will have greater access to information on spending habits of customers. This generates a win-win scenario – a miracle for companies engaged in marketing activities and insights for consumers into their spending patterns, enabling them to make better financial decisions. Lous Vervuurt of Buren N.V., the Hague, explains how the new rules work, including new standards of account security.

- **Austria, France, and Italy to Introduce Digital Services Taxes.** A limerick that is popular among members of the U.S. Congressional tax writing committees sheds wisdom on the development of tax policy: "Don't tax you. Don't tax me. Tax the person behind the tree." Several countries in Europe have taken the rhyme to heart in developing unilateral digital services taxes designed to impose tax on extra-territorial activity of out-of-country companies.

The issue, as Austria, France, and Italy see it, is that these companies make huge profits in Europe but pay no tax there, while payments for digital services are often tax deductible in the countries where the services are used. According to proponents such as Austria, it is only fair to tax those profits on a destination basis. Benjamin Twardosz of CHSH Attorneys-at-Law, Vienna, explains the various proposals under consideration.

- **Foreign Investment in U.S. Real Estate – A F.I.R.P.T.A. Introduction.** Many economic, political, and cultural factors make U.S. real estate an attractive investment for high-net-worth individuals resident in other countries. These factors are supported by a set of straightforward tax rules that apply at the time of sale. Alicea Castellanos, the C.E.O. and founder of Global Taxes LLC, looks at the U.S. Federal income taxes and reporting obligations that apply to a foreign investor from the time U.S. real property is acquired to the time of its sale.

- **The Impact of Brexit on German Taxes for Private Clients and Nonprofit Organizations.** American business executives responsible for regional operations in Europe often see different approaches to problem solving in terms of cultural differences between various European countries. It can be said that British colleagues often continue to rethink decisions even after solutions are adopted, and German colleagues focus on engineering a unified approach to reach the best solution to the matter at hand. These cultural characteristics seem to have manifested in the different ways Parliament in the U.K. and the Bundestag in Germany are addressing Brexit. Parliament continues to debate whether, when, and how to implement Brexit, while the Bundestag has enacted several laws to address how a hard or soft Brexit will affect various aspects of German tax law. Dr. Andreas Richter of P+P Pöllath + Partners, Berlin and Frankfurt, provides the reader with an overview of the German tax consequences to be anticipated from a U.K. departure from the E.U. – with or without a formal Brexit agreement.

- **India and the Digital Economy – The Emerging P.E. and Attribution Issues.** The exponential expansion of information and communication technology has made it possible for businesses to be conducted in ways that did not exist 15 years ago. It has given rise to new business models that rely almost exclusively on digital and telecommunication networks, do not require physical presence, and derive substantial value from data collected and transmitted through digital networks. So how and where should these companies be taxed? Sunil Agarwal, an advocate and senior tax partner of AZB & Partners New Delhi, evaluates proposals already enacted in India and the U.K. and those under consideration at the level of the European Commission and E.U. member countries Italy, France, and Austria. Should the digital tax be a consumption tax passed on to the final consumer or a minimum income tax based on global profits or substantial economic presence? At this point, consensus does not exist.

- **2020 Will Mark the End of an Era: Swiss Corporate Tax Reform Accepted.** On May 19, 2019, Swiss Federal and Genevan cantonal voters accepted proposed corporate tax reforms by a large majority. As explained by Thierry Boitelle and Aliasghar Kanani of Bonnard Lawson Geneva, Switzerland will abolish its widely criticized cantonal special tax regimes and certain Federal

regimes. At the same time, Switzerland and the cantons will introduce generally applicable reduced and attractive corporate income tax rates and several new special regimes, meeting current international standards and requirements. These changes will be effective as of 2020.

- **Reflections on My 66 Years in Public Accounting.** Periodically in life, one comes across an individual who is best described as follows: He or she "gets it." Difficult to describe analytically, in the tax world, the term means that (i) in solving technical problems, the person focuses the material, leaving the immaterial to others; (ii) in making decisions, the person can separate the important from the unimportant; and (iii) in advising others on the impact of a new accounting rule or provision of tax law, the person can digest the complex and explain it in a series of simple sentences. Often, the individual is self-effacing. Arthur J. Radin was all of the above. He passed away in April. In his memory, we are pleased to republish an article written for the *CPA Journal* describing the way professional accounting changed during his 60-year career and, more importantly, the way the world changed. Arthur will be missed.

- **C.J.E.U. Judgments on Danish Beneficial Ownership Cases.** Earlier this year, the C.J.E.U. released two judgments dealing with the interpretation of the Parent-Subsidiary Directive ("P.S.D.") and the Interest & Royalties Directive in the E.U. In each case, a structure was meticulously built to comply with national and E.U. law allowing global investors to bring funds to the E.U. in return for dividends and interest that were subject to little or no national tax in any E.U. country. Nothing in the structure was unique, other than the reticence of the Danish tax authorities to grant withholding tax exemptions. To the surprise of many, the C.J.E.U. looked at the structure and concluded that it lacked economic substance and should be disregarded by reason of a general E.U. anti-abuse principal. The internal E.U. recipients of the dividend and interest payments were not considered to be the beneficial owners of the income. Almost 50 years after the *Aiken Industries* case in the U.S. Tax Court and 25 years after the anti-conduit regulations were adopted by the I.R.S., European substance-over-form rules have now been adopted by judicial fiat. Thierry Lesage and Adnand Sulejmani of Arendt & Medernach SA, Luxembourg, meticulously explain the reasoning of the court and suggest that the court may have erred by conflating anti-abuse rules with beneficial ownership concepts.

- **Employers in the Netherlands: Prepare for Changes to Labor and Dismissal Laws in 2020.** In May, the Dutch Senate adopted the Labor Market in Balance Act designed to reduce the gap in legal protection and financial compensation between employment arrangements under fixed-term contracts and employment arrangements with indefinite term. The act provides greater rights on termination and, as a result, is unpopular with employers. It also aims to resolve some of the negative effects of an earlier amendment to the law that has been the subject of relentless criticism. Rachida el Johari and Madeleine Molster of Sagiure Legal, Amsterdam, explain the way Dutch labor law will affect termination rights for employees and suggest a path forward for management. This is another area of E.U. law in which companies will need to re-educate executives on proper patterns of behavior.

- **India Budget 2019-20.** The first budget of the Modi 2.0 government was announced during the summer with a goal of bringing India to a growth trajectory. To that end, the Taxation Laws (Amendment) Ordinance, 2019, was introduced on September 20, 2019, to incorporate the proposed changes into law. Included are incentives for International Financial Services Centres, tax relief for start-ups, a boost for electric vehicles, and faceless tax examinations intended to ensure that tax examinations are carried out in a uniform way. Although anticipated by some, an inheritance tax was not introduced. Jairaj Purandare, the Founder and Chairman of JMP Advisors Pvt Ltd, Mumbai, explains the new provisions.

- **Israeli C.F.C. Rules Apply to Foreign Real Estate Companies Controlled by Israeli Shareholders.** Controlled foreign corporation ("C.F.C.") laws are all the rage with parliaments around the world. Israel is no exception. Israeli shareholders controlling offshore companies that derive low-tax passive income and gains can be taxed in Israel even though no dividend is received. A recent decision by the Israeli Supreme Court addresses a fundamental question in this area. Is passive income determined on a groupwide basis or on a company-by-company basis? The answer affects Israeli residents owning a chain of C.F.C.'s when an intermediary company in the chain sells shares of an operating subsidiary. Daniel Paserman, who leads the tax group at Gornitzky & Co., Tel-Aviv, explains the holding in Tax Assessor for *Large Enterprises v. Rosebud*. Israeli residents may not like the answer.

- **Collecting Another Country's Taxes – Recent Experience in the Canada-U.S. Context.** In an age of multilateral agreements to exchange information and other agreements to cooperate in the collection of taxes of another country, many people are unaware of the "revenue rule." This common law doctrine allows courts to decline entertaining suits to collect tax or enforce foreign tax judgments. In their article, Sunita Doobay of Blaney McMurtry L.L.P., Toronto, and Stanley C. Ruchelman explore (i) the general development of the revenue rule, (ii) its extension to North America, (iii) the applicable provisions of the Canada-U.S. Income Tax Treaty allowing for assistance in the collection of tax and exchange of information, (iv) one U.S. wire fraud case involving evasion of foreign import duties, and (v) several recent cases in the U.S. where taxpayers raised creative arguments to attack the validity of treaty provisions, but to no avail.

We hope you enjoy this issue.

- The Editors

IR35 – WHY ARE U.K. BUSINESSES SO CONCERNED?

Author
Penny Simmons

Tags
Employment Tax
H.M.R.C.
IR35
U.K.

Penny Simmons is a Legal Director in the tax team at Pinsent Masons LLP and specializes in corporate tax risk management. She works closely with large corporate entities to help manage their exposure to various U.K. tax risks. Penny also provides technical assistance to clients and members of the team on all areas of corporate tax, including corporate finance and M&A work, private equity, employment, and property tax. She has extensive experience training lawyers (both tax and non-tax) and clients across all areas of U.K. tax law.

INTRODUCTION

New U.K. tax rules are being introduced from April 2020 to make businesses liable for determining the employment tax status of contractors and off-payroll workers who work through personal service companies ("P.S.C.'s"). The changes to the tax rules, known as IR35, will create significant costs and compliance challenges for businesses that rely heavily on specialized contractors.

- From April 2020, businesses engaging contractors through P.S.C.'s will become responsible for determining the contractor's employment tax status.
- Businesses with large numbers of off-payroll workers face a huge compliance challenge to ensure that new systems are in place to deal with the new requirements.
- The new rules are driving changes in how U.K. businesses engage with contingent workers.

CURRENT RULES FOR ENGAGING CONTRACTORS THROUGH P.S.C.'S

It has become common practice in the U.K. for businesses to encourage the use of P.S.C.'s to engage individual contractors¬ – rather than directly engaging a contractor as a self-employed person or onboarding the contractor as an employee. While there is no legal definition of a P.S.C., typically, it is a company in which the same person is sole director and employee of the business and engages in the business of providing outsourced services to a client. The practice of using P.S.C.'s is so widespread that it cuts across the U.K. labor market and into most sectors.

The practice of engaging contractors through P.S.C.'s provides a business with increased flexibility, particularly where labor demands fluctuate throughout the year depending upon the requirements of particular projects. In addition, it creates important H.R. cost savings to businesses because company benefits such as sick pay and holiday pay for employees are not extended to the contractor engaged through the P.S.C.

Crucially, the use of P.S.C.'s generates significant U.K. tax savings. Currently, a private sector business that contracts with a P.S.C. does not deduct employment taxes through the U.K.'s Pay As You Earn ("P.A.Y.E") collection mechanism from payments made to the P.S.C., and it is not required to pay employer-side social security contributions, known as N.I.C.'s. Employer-side N.I.C.'s are currently payable at 13.8% of the compensation base to an employee. Therefore, engaging contractors through a P.S.C. offers a business significant tax saving on its payroll costs.

Once effective, the changes to IR35 will require that P.A.Y.E. taxes and N.I.C.'s be paid with respect to a person who provides services through a P.S.C. if that person would have been regarded as an employee had it been engaged directly by the business. Currently, where a private sector business engages a P.S.C. to provide outsourced services, liability to decide whether IR35 applies and to pay any employment taxes rests with the P.S.C.

The IR35 rules were originally introduced in 1999 to target perceived widespread avoidance primarily in the I.T. sector. However, avoidance continues to be the rule rather than the exception. Over the past 20 years, the use of P.S.C.'s to engage contingent workers has grown exponentially and now is commonplace. Despite the existence of IR35, H.M.R.C. considers that compliance remains low under the current regime. It is estimated that only 10% of P.S.C.'s that should pay tax under IR35 actually do so.

In April 2017, reforms were introduced to the public sector, causing public authorities and other public sector engagers of P.S.C.'s to be responsible for P.A.Y.E. and N.I.C.'s if a contractor is engaged through a P.S.C. and the individual who performs outsourced services would be regarded as an employee under the IR35 rules. The changes triggered a seismic shift in the manner in which the U.K.'s public sector engaged contractors, with many public authorities and public sector organizations choosing to disallow further engagements with P.S.C.'s and instead opting to pay all contractors through payroll.

Following independent research commissioned by H.M.R.C. into the implementation of the amended IR35 rules in the public sector, the U.K. government considers that the public sector reform has been "successful" in terms of increasing tax compliance without enforcement action by H.M.R.C. Last year, it was estimated that an additional £410 million of P.A.Y.E. tax and N.I.C.'s were collected under the public sector reforms.

PROPOSED CHANGES TO IR35

In its October 2018 budget, the U.K. government confirmed that the public sector changes to IR35 would be extended to the private sector from April 2020.

Following the publication of draft legislation in summer 2019, and notwithstanding the U.K. general election on December 12, 2019, it is now expected that, from April 2020, private sector businesses engaging contractors through P.S.C.'s will be responsible for determining their relationship with individuals engaged by the P.S.C. and collecting P.A.Y.E. tax and N.I.C.'s if they decide the individual would have been an employee if engaged directly. In these circumstances, the company that engages the contractor (referred to as the "client") will also be liable to pay employer-side N.I.C.'s.

The changes will not apply to small businesses that engage contractors through P.S.C.'s. Broadly, a "small company" will be defined as one that meets at least two of the following criteria:

- Turnover – not more than £10.2 million
- Balance sheet – not more than £5.1 million
- Employees – not more than 50

Businesses covered by IR35 will be required to provide a statement ("S.D.S.") to any contractor working through a P.S.C. The S.D.S. will reflect the determination of the contractor's employment tax status, including reasons behind the determination. A contractor will then have the right to disagree with the determination through a new business-led status disagreement process. Businesses with large numbers of P.S.C. contractors are likely to be concerned by the proposed status disagreement process, as they could find themselves engaged in numerous IR35 status disputes.

"Without further guidance, businesses with complex supply chains and large, flexible workforces are expected to struggle to meet the April 2020 deadline."

Where a business engages a P.S.C. through an agency, the liability to make P.A.Y.E. and N.I.C. payments will transfer to the agency, which is referred to as the "fee payer." Responsibility for determining the employment tax status of the contractor and issuing the S.D.S. will remain with the client. The client will be required to pass on the S.D.S. to both the fee payer and the contractor. If the S.D.S. reflects a determination that the contractor falls within the IR35 rules, the fee payer will be required to operate P.A.Y.E. and pay N.I.C.'s.

If the fee payer fails to make any of these required payments, the liability may pass back up the supply chain to the client. Further, if the client does not exercise reasonable skill and care when making a status determination, the liability for paying any employment taxes will also pass back to the client.

In complex supply chains, there may be a number of contracting parties between the client and the contractor engaged through the P.S.C. The fee payer will be the agency or entity that engages directly with the P.S.C. The S.D.S. must be supplied by the client to the contractor and also passed down the chain to the fee payer who will be responsible for P.A.Y.E. and N.I.C. payments. The possibility of liability passing back up the chain is troubling in such circumstances.

Guidance (or Lack Thereof)

Both clients and fee payers are concerned by the expanded IR35 proposal, particularly where they are involved in complex supply chains with a number of parties between the fee payer and the P.S.C. The draft legislation provides little information about how this will work, simply providing for further regulations to allow H.M.R.C. to recover tax that should have been paid in relation to IR35. H.M.R.C. has confirmed that the ability to transfer tax liabilities up the supply chain is only intended to apply to cases of noncompliance and "deliberate tax avoidance" and not where there has been a "genuine business failure." However, U.K. businesses still have cause for concern.

Much of the detail as to how H.M.R.C. will apply the rules has not been published as of December 10, 2019, although detailed H.M.R.C. guidance is expected prior to the implementation date. Basic guidance was published as a series of notes in August 2019; however, it includes little detail on how the rules should be applied in practice.

Although "extensive support" to ensure organizations are able to implement the new IR35 rules was promised by H.M.R.C., draft guidance published to date is so limited and for the most part simply repeats statements that have already been made. Without further guidance, businesses with complex supply chains and large, flexible workforces are expected to struggle to meet the April 2020 deadline.

It is anticipated that detailed guidance will be published after the U.K. general election and, hopefully, long before the April 2020 implementation date.

Transfer of Liabilities Up the Chain

To date, the draft guidance provides very little information regarding how the provision to transfer tax liabilities back up the supply chain will work in practice. The guidance simply confirms that liability may be transferred to the top parties in the supply chain if H.M.R.C. "cannot collect any outstanding tax or N.I.C.'s from parties below them." With only four months until the changes are introduced, it is concerning that this vital aspect of the new rules remains uncertain.

At this time, businesses remain unclear about the precise extent of their obligations under the new rules. It is particularly concerning that the published guidance does not include any information about how businesses can demonstrate that reasonable skill and care were exercised when making status determinations. To reiterate, where a business is deemed not to have taken "reasonable care," tax liabilities will transfer back to the business. Therefore, it is vital that businesses understand what this term means. To date, H.M.R.C. has failed to deliver on promises of clarification regarding the steps businesses must take to demonstrate compliance and limit exposure.

Given the lack of clarity on reasonable care, there is also concern that contractors may seek to use the term as a weapon against businesses, when disputing an S.D.S. under the disagreement process.

Group Status Determinations

When proposals for the new IR35 rules were first announced, it was envisaged that it would be possible for a client to make a single status determination for a group of contractors working in a similar way and on substantially the same terms. However, the draft guidance confirms that an S.D.S. will be required for every contract where an individual provides services through a P.S.C., casting doubt on the viability of group determinations under the rules.

H.M.R.C. has previously acknowledged that making group determinations may be acceptable for contractors with the same role, work practices, and contractual conditions, but even then, they caution that "it may [only] be appropriate in some circumstances." H.M.R.C. has not expanded on those circumstances. Furthermore, notwithstanding previous assurances, the current published guidance is silent on the issue.

The ability to make group determinations where appropriate is essential to businesses engaging with large numbers of contractors on the same basis and would significantly reduce the compliance burden, whilst still ensuring that the new IR35 rules operate as intended. It is hoped that a mechanism for group determinations will be included in the final detailed guidance.

Who Is the Client?

In most cases, it will be obvious who the client is and, therefore, which business has responsibility for making the status determination and issuing the S.D.S. However in the context of some "contracted out services" the position may be difficult ascertain. Broadly, the client is the entity that is in receipt of a "supply of labor" and to whom a worker is personally obliged to perform services.

Where a business contracts out a service, the business paying for the service will not be the client for the purposes of IR35 unless there is a supply of labor attached

to the provision of service. For example, where a business contracts with a security company for security services and the security guards engage with the security company through P.S.C.'s the question might arise as to whether the engaging business or the security company supplying the services is the client for IR35 purposes. The analysis is likely to turn on the specific facts. However, if the contract for the supply of security services specifies named individuals to be provided as security guards and those individuals become embedded in the business, it is possible that there could be a supply of labor in relation to those specified security guards, and therefore, the engaging business could be the client for IR35 purposes.

This is a significant point to bear in mind when assessing exposure under the new regime – is the client, or the business supplying services, the ultimate engager?

Check Employment Status for Tax

When considering whether an engagement with a P.S.C. falls within the IR35 rules, a client must determine whether the contractor would be considered to be an employee for tax purposes if engaged directly.

In the U.K., there is no precise legal test to determine whether an individual is an employee for tax purposes. Rather, the concept has been developed by a series of court decisions and is dependent on a number of factors – not just the contract terms but also on how the individual is treated in practice, which can lead to a difficult fact pattern. Relevant factors might include the following:

- The level of control and supervision that the client has over the work that the contractor undertakes
- Whether the contractor could send a substitute if unable to perform the work
- Whether there is mutuality of obligation between the parties
- The length of the worker's engagement
- Whether the worker provides the equipment used to perform services

Determining employment status for tax purposes can be complicated. H.M.R.C. has published guidance on when it considers an employment relationship to exist for tax purposes. It has also developed an online Check Employment Status for Tax ("C.E.S.T.") tool, which uses a series of questions to determine employment status for tax purposes only. However, existing effectiveness of C.E.S.T. has been limited, as it has failed to give an answer in 15% of cases. A revised version of C.E.S.T. was published at the end of November 2019. It remains to be seen whether the updated tool will provide a definitive result where the facts are complicated.

It may still be advisable to use C.E.S.T. to determine employment tax status under the IR35 rules, since H.M.R.C. has confirmed that it will stand by a determination made under C.E.S.T. if the information provided is accurate.

SHIFTING MARKET PRACTICES

In autumn 2019, some of the larger U.K. banks made it clear that they intended to take a risk-averse approach to the new IR35 rules and would not extend the contracts of contractors engaged through P.S.C.'s beyond April 2020.

It is not surprising that the banks have opted for this approach. Banks tend to have very large numbers of off-payroll workers. Deciding not to engage contractors through P.S.C.'s eliminates a significant compliance headache, since the obligation to make employment status determinations and issue S.D.S.'s under IR35 will not apply.

The decision by some of the larger banks to avoid the new regime is driving behavioral changes across the financial services sector. Some businesses are now opting for a blanket approach that avoids engagement with a contractor if a P.S.C. is involved in the supply chain.

In other sectors that are heavily reliant on a limited number of highly specialized contractors, a blanket approach may not be possible. Alternative models of engagement include routing all P.S.C. contractors through agencies. Although this may not solve the problem of making status determinations and issuing S.D.S.'s, it should reduce the risks associated with the obligation to make P.A.Y.E. and N.I.C. payments for a large number of contractors.

Ultimately, insurance companies may provide a product that addresses the risk of liability where appropriate steps are made to determine the status of contractors engaged directly or where liability passes up a chain of companies.

WHAT SHOULD BUSINESSES DO TO PREPARE?

If not already undertaken, U.K. businesses with a contingent workforce should take action to prepare for the changes to IR35 and the increased tax risk that is faced. H.M.R.C. has outlined four actions that businesses should take to prepare for the reforms. These include identifying and reviewing current engagements with intermediaries such as P.S.C.'s and labor supply agencies and putting in place comprehensive processes to determine the employment status of contractors. H.M.R.C. also recommends that businesses should review internal systems such as payroll software, process maps, H.R., and onboarding policies to see if changes are required.

H.M.R.C. has published several notices advising businesses to take action to prepare. This should be seen as a clear warning to act immediately. Businesses can expect H.M.R.C. to begin robustly reviewing compliance as soon as the new rules become law.

In the first instance, a business must identify how many P.S.C.'s it engages and the divisions that engage P.S.C.'s. Once a business has identified its P.S.C. population, it must undertake a comprehensive risk assessment to establish its exposure to IR35 and review whether changes to H.R. and procurement processes are required. A comprehensive IR35 compliance project in a large organization is likely to include a review and possible alteration to a business's I.T. and compliance systems. This could take some time to implement and is another reason for starting the project as soon as possible is recommended.

Businesses must ensure that clear processes for making status determinations and issuing S.D.S.'s across the supply chain have been adopted prior to engaging contractors through P.S.C.'s. The adoption of a standardized policy for making determinations, the rationale for individual status determinations, and the potential for objections from individuals who frequently do not understand the complexities of the

law, could be an organizational nightmare for businesses engaging thousands of contractors. Careful thought should be given to managing these obligations (where relevant) in conjunction with any agencies.

Businesses may wish to consider the provisions already in place in existing sub-contracts, main contracts, and templates and assess potential IR35 issues and any required changes.

Embarking on this compliance exercise as quickly as possible will be crucial for businesses in sectors that rely heavily on a flexible workforce – where large numbers of contractors are likely to be engaged through P.S.C.'s.

An alternative to this problem is a return to employment and payroll policies that existed prior to the widespread use of P.S.C.'s.

"H.M.R.C. is expected to begin robustly reviewing compliance as soon as the new rules become law in April 2020."

DO CONTRACTORS HAVE CAUSE FOR CONCERN?

There have been concerns that, under the new IR35 rules, if a business determines that a contractor is an employee for tax purposes that could open up the contractor's P.S.C. to H.M.R.C. challenges with respect to prior years if the P.S.C. had not been applying P.A.Y.E. In a recent news briefing, H.M.R.C. confirmed that it will not use information from employment status classifications under IR35 to open new enquiries into earlier years, unless there is reason to suspect fraud or criminal behavior. This news comes as a relief to many contractors concerned about being hit with a significant tax bill for previous years.

H.M.R.C. challenges to employment tax status decisions under IR35 have become commonplace in recent years. Most notably the British Broadcasting Corporation ("B.B.C.") has become embroiled in a number of tax tribunal decisions regarding the employment tax status of several of its television presenters previously engaged to provide services to the B.B.C. through P.S.C.'s.

CONCLUSION

Given the complexity of supply chains in some sectors, the prevalence of contractors operating through P.S.C.'s, and the continuing need for a flexible labor market, the new IR35 rules are expected to have widespread implications. Despite the limited guidance currently available, businesses should take action now to assess supply chains and implement any necessary changes to policies, contracts, and procedures. H.M.R.C. is expected to begin robustly reviewing compliance as soon as the new rules become law in April 2020.

NEW DEVELOPMENTS ON THE E.U. V.A.T. REGIME OF HOLDING COMPANIES

Authors
Claire Schmitt
Bruno Gasparotto

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Bruno Gasparotto is a principal in the Tax Law practice of Arendt & Medernach where he focuses on V.A.T. law. He advises on both national and international issues, including the V.A.T. aspects of financial transactions, especially in the private equity, real estate, and asset/fund management industries.

Claire Schmitt is a senior associate in the Tax Law practice of Arendt & Medernach focusing on V.A.T. law.

INTRODUCTION

It may come as a surprise to some that the European value added tax ("V.A.T.") regime applicable to holding companies is not supported by dedicated provisions in Directive 2006/112/EC (the "V.A.T. Directive"), which rules the European V.A.T. system. Instead, the V.A.T. regime for holding companies is ruled by numerous decisions issued by the Court of Justice of the European Union ("C.J.E.U.").

Through its interpretation of the V.A.T. Directive provisions, the C.J.E.U. has outlined the main features of the regime for holding companies in an attempt to harmonize treatment within the E.U.

Despite the abundant jurisprudence, debate continues to surround the V.A.T. recovery rights of holding companies, as evidenced by three recent C.J.E.U.'s decisions issued in 2018.

In this evolving context, it is worthwhile to recall the main features of the V.A.T. regime laid out in the V.A.T. Directive and their application to holding companies in light of new case law – with the caveat that the following does not constitute an exhaustive list of all C.J.E.U. decisions but addresses the main ones relating to V.A.T. recovery rights.

DISTINCTION BETWEEN PASSIVE AND ACTIVE HOLDING COMPANIES

An important feature of the V.A.T. regime is the distinction between "passive" and "active" holding companies. This distinction is based on the notion of economic activity for V.A.T. purposes.

The scope of the E.U. V.A.T. rules depends on whether a person is engaged in an economic activity, which is defined under Article 9, §1 of the V.A.T. Directive in the following terms:

> Any activity of producers, traders or persons supplying services, including mining and agricultural activities and activities of the professions, shall be regarded as 'economic activity.' The exploitation of tangible or intangible property for the purposes of obtaining income therefrom on a continuing basis shall in particular be regarded as an economic activity.

In line with this criterion, the C.J.E.U. has specified that the mere holding of shares without any involvement in the management of the subsidiaries cannot be assimilated

to the exploitation of intangible property, and as such, any resulting dividends are merely the product of passive ownership.[1]

Such holdings do not amount to economic activity, and therefore, passive holding companies do not qualify as taxable persons for V.A.T. purposes. This qualification has multiple consequences:

- The receipt of dividends does not fall within the scope of V.A.T.
- Passive holding companies lack the right to recover input V.A.T.
- Passive holding companies are exempt from any V.A.T. compliance obligations, such as V.A.T. registration and V.A.T. returns, subject to exceptions.

The same cannot be said for active holding companies. Indeed, the C.J.E.U. takes a distinct approach when the holding company is directly or indirectly involved in the management of its subsidiaries, for example, by supplying administrative, accounting, or I.T. services to subsidiaries.

From a general perspective and based on consistent C.J.E.U. case law,[2] once a holding company provides a taxable service to its subsidiary in exchange for consideration, it is deemed to perform a taxable economic activity and therefore qualifies as a taxable person for V.A.T. purposes.

“Since it performs taxable activities for V.A.T. purposes, an active holding company may deduct the input V.A.T. incurred on its costs.”

This qualification opens the right to recover input V.A.T. Indeed, since it performs taxable activities for V.A.T. purposes, an active holding company may deduct the input V.A.T. incurred on its costs, a cornerstone of the V.A.T. system.

The resulting question is whether the V.A.T. deduction right is full or only partial and, subsequently, under which conditions the right should be exercised. During the last ten years, these complex questions have been largely unanswered and regularly put on the table of the C.J.E.U.

EXERCISING THE V.A.T. DEDUCTION RIGHT

General Provisions on the V.A.T. Deduction Right

As a general principle, any person engaged in taxable activities is entitled to deduct input V.A.T. paid for costs incurred in relation to this activity per Article 168 of the V.A.T. Directive.

As laid out in the V.A.T. Directive and frequently reiterated in C.J.E.U. decisions,[3] this recovery right is meant to relieve the trader entirely from the burden of V.A.T. in the course of its economic activities. Only the end-consumer should bear such charge. This constitutes an integral part of the V.A.T. scheme.

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1. C.J.E.U., 06/20/1991, *Polysar* I*nvestments Netherlands BV v Inspecteur der Invoerrechten en Accijnzen*, C-60/90; C.J.E.U., 06/22/1993, *Sofitam* S.A., C-333/91.
2. C.J.E.U., 11/14/2000, *Floridienne S.A. and Berginvest S.V. v Belgian State*, C-142/99; C.J.E.U., 07/12/2001, *Welthgrove BV v Staatssecretaris van Financien*, C-102/00.
3. For instance, C.J.E.U., 02/14/1985, *Rompelman*, C-268/83.

While this principle appears relatively simple to implement with respect to commercial companies engaged in economic activities, the application of the V.A.T. deduction right in the context of active holding companies is more difficult to assess.

Since active holding companies qualify as taxable persons as a result of their involvement in their subsidiaries, they might be engaged in three types of activities from a V.A.T. perspective:

- Activities falling outside the scope of V.A.T.
- Activities falling within the scope of V.A.T. but that are V.A.T.-exempt
- Activities falling within the scope of V.A.T. that are fully taxable

In this context, the regular rules for exercising the V.A.T. deduction right[4] do not quite seem appropriate. While, in principle, the above-mentioned V.A.T. provisions only consider the performance of economic activities when assessing the right to deduct V.A.T., the role of the shareholding activity can hardly be ignored for active holding companies.

The other resulting question is to what extent this non-economic activity should be taken into account, bearing in mind that dividends might constitute significant income without necessarily being cost-consuming. On the other hand, the costs subject to the V.A.T. recovery claim could constitute a significant amount compared to the income generated from the taxable activity.

This mismatch has been notably addressed by Mrs. Juliane Kokott, Advocate General ("A.G."), in an opinion delivered on May 3, 2018, in the *Ryanair* case:

> A simple comparison of the values of the turnover from management services and from dividends neglects the fact that the holding of shares does not give rise to recurrent costs. Furthermore, the input tax surplus described above also exists only in the taxation period in which the acquisition of shares of a company occurs. If the management services are supplied for remuneration over a number of years, the situation is different.[5]

Consequently, this calls the determination of the input V.A.T. recovery right into question with respect to the allocation of costs incurred per activity performed.

C.J.E.U. General Principles for Determining V.A.T. Recovery Rights

The abundant C.J.E.U. jurisprudence establishes general guidelines for the allocation of costs to activities of the holding company:

- **Direct Allocation:** V.A.T. recovery is available for input trans- actions that are subject to V.A.T. and that have a direct and immediate link with one or more output transactions giving rise to the right to deduct. This condition is fulfilled when the expen- diture is a component of the price of the output transaction that gives rise to the right to deduct.

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[4] Article 167 *et seq.* of the V.A.T. Directive.

[5] C.J.E.U., 10/17/2018, *Ryanair Ltd v. The Revenue Commissioners*, C-249/17, §30.

- **Overhead Costs:** Where the expenditure cannot be directly allocated to a specific output transaction, the treatment de- pends on whether the costs incurred were part of the general expenses linked to the taxable person's overall economic ac- tivities. In this situation, the expenditure will have, in principle, a direct and immediate link with the taxable person's business as a whole. Depending on the nature of the business, the re- lated V.A.T. deduction will be (i) full (in the case of a fully tax- able business), (ii) zero (in the case of a fully V.A.T.-exempt business), or (iii) partial (in the case of a combination of both taxable and V.A.T.-exempt activities).

In theory, these guidelines easily outline the V.A.T. recovery rights of active holding companies. However, their practical application raises many questions about the integration of the non-economic activity (*i.e.*, shareholding activity) in the calculation of deductible input V.A.T., leading to discrepancies among Member States and, consequently, to questions of prejudice being placed before the C.J.E.U.

DETERMINING V.A.T. RECOVERY RIGHTS IN SPECIFIC SITUATIONS

V.A.T. Deduction for Expenditures Incurred in a Shareholding Acquisition

V.A.T. Deduction for Expenditures for the Acquisition of a Shareholding (C.J.E.U., 09/27/2001, Cibo Participations, C-16/00)

Cibo Participations placed the first question before the C.J.E.U. concerning the deduction right for general expenditures incurred in the context of an acquisition of shares in an entity to which the holding company will supply taxable services.

According to the C.J.E.U., it is clear that the direct allocation method cannot be used in such context since no direct and immediate link can be drawn between the various costs incurred in the acquisition and a specific output transaction.[6] However, such costs can be considered general expenditures, which have a direct and immediate link with the overall activity of the taxable person.

Where the overall activity includes output transactions entitled and also not entitled to a V.A.T. recovery right (*i.e.*, a mix of taxable and V.A.T.-exempt activities), costs should be apportioned between these two activities, and only the portion related to output transactions entitled to a V.A.T. recovery right should benefit.

In other words, when costs qualify as general expenditures, they are linked to the overall activities of the taxable person and, in the case of mixed activities, an apportionment should be made to determine the *pro rata* deduction.

In this respect, the C.J.E.U. enunciated the following rule:

> Expenditure incurred by a holding company in respect of the various services which it purchases in connection with the acquisition of a shareholding in a subsidiary forms part of its general costs and therefore has, in principle, a direct and immediate link with its business as a whole. Thus, if the holding company carries out both transactions in respect of which value added tax is deductible and transactions

[6] C.J.E.U., 09/27/2001, *Cibo Participations*, C-16/00.

> in respect of which it is not, it follows . . . that it may deduct only that proportion of the value added tax which is attributable to the former.

Apportionment of Expenditures Based on Involvement in the Management of Subsidiaries (C.J.E.U., 07/16/2015, Larentia + Minerva, C-108/14 and C-109/14)

In *Larentia + Minerva*, the C.J.E.U. distinguished the situation in which a holding company manages all subsidiaries from a fact pattern in which only certain subsidiaries were managed by the holding company:

> The expenditure connected with the acquisition of shareholdings in subsidiaries incurred by a holding company which involves itself in their management and which, on that basis, carries out an economic activity must be regarded as belonging to its general expenditure[,] and the VAT paid on that expenditure must, in principle, be deducted in full, unless certain output economic transactions are exempt from VAT.
>
> * * *
>
> The expenditure connected with the acquisition of shareholdings in subsidiaries incurred by a holding company which involves itself in the management only of some of those subsidiaries and which, with regard to the others, does not, by contrast, carry out an economic activity must be regarded as only partially belonging to its general expenditure, so that the VAT paid on that expenditure may be deducted only in proportion to that which is inherent to the economic activity, according to the criteria for apportioning defined by the Member States, which when exercising that power, must . . . provide for a method of calculation which objectively reflects the part of the input expenditure actually to be attributed, respectively, to economic and to non-economic activity.

Broad Definition of Involvement in the Management of Subsidiaries (C.J.E.U., 07/05/2018, Marle Participations, C-320/17)

In a recent C.J.E.U. case, *Marle Participations*, the court clarified the concept of involvement in the management of subsidiaries and the conditions for exercising the right to claim input V.A.T. deduction for holding companies.

As previously stated, involvement in the management of subsidiaries is crucial for holding companies to claim input V.A.T. deductions because it qualifies the entity as active and therefore as a taxable person for V.A.T. purposes. If a holding company provides taxable services to its subsidiary, it automatically qualifies as a taxable person, irrespective of the nature of the services supplied. Traditionally, this referred to the supply of administrative, financial, commercial, and technical services and was therefore understood to be restrictive.

However, the C.J.E.U. ruling in *Marle Participations* broadened the scope to include the mere lease of a building to its subsidiary, provided the rent is subject to V.A.T. and the premises are regularly supplied to the subsidiary. Occasional supplies are excluded from favorable treatment. Following this ruling, involvement is defined broadly as covering any service supplied to a subsidiary provided it is subject to V.A.T.

In regard to the input V.A.T. recovery right, the C.J.E.U. considers a cost to be linked to a shareholding acquisition even if the cost does not have a direct and immediate link to an output transaction. Indirect and deferred output transactions are considered linked to the overall economic activities of the active holding, *i.e.*, excluding the shareholding activity. The apportionment of costs linked to the shareholding activity applies only when the holding company is not involved in the management of all its subsidiaries.

In *Marle Participations*, the C.J.E.U. ruled that the V.A.T. Directive would no longer be used to determine the scope of the input V.A.T. recovery right, such as mandating a *pro rata* deduction of costs. Instead, Member States may determine an appropriate allocation key in accordance with the general principles of the V.A.T. system.

Considering these three decisions, the position of the C.J.E.U. seems quite favorable regarding the recovery right for input V.A.T. for general expenditures incurred by an active holding company in the context of a shareholding acquisition, subject to the conditions mentioned.

“Member States may determine an appropriate allocation key in accordance with the general principles of the V.A.T. system.”

V.A.T. Deduction for Abort Costs (C.J.E.U., 10/17/2018, Ryanair Ltd, C-249/17)

The C.J.E.U. issued another welcome decision for active holding companies regarding abort costs (*e.g.*, legal or due diligence costs) linked to an unsuccessful bid to take over shares of a competitor.

In regard to the qualification as a taxable person, the C.J.E.U. considers that the mere intention to supply management services to the intended target company constitutes preparatory acts for a taxable activity and therefore is sufficient to qualify the holding company as a taxable person at the time of incurring the abort costs. In addition, abort costs incurred in this context qualify as overhead costs linked to the economic activities of the holding company. Accordingly, the related input V.A.T. will be fully deductible in light of the intended taxable activity, even if not realized in the end.

This decision is in line with previous E.C.J. decisions and seems to confirm a favorable trend of access to the V.A.T. recovery right in the context of shareholding acquisition (even unsuccessful).

Limitation of the V.A.T. Deduction for General Expenditures for the Issuance of Shares (C.J.E.U., 03/13/2008, Securenta, C-437/06)

In regard to costs incurred in the context of the issuance of shares, the C.J.E.U. took a different approach while relying on the principles outlined above.

Although their qualification as overhead costs was not questioned, the C.J.E.U. ruled that the issuance of shares is linked to non-economic activity, *i.e.*, shareholding. In line with prior rulings, overhead costs must be linked with general activities of the active holding company, *i.e.*, economic and non-economic. Consequently, the input

V.A.T. deduction right should be apportioned to the economic and non-economic activities. However, the C.J.E.U. left the determination of apportionment between these two activities to the discretion of the Member States.

V.A.T. Deduction for Expenditures Incurred in a Share Disposal

V.A.T. Recovery for Expenditures Incurred in a Share Disposal (C.J.E.U., 04/06/1995, BLP, C-4/94)

In BLP, the C.J.E.U. adopted a restrictive approach with regard to the input V.A.T. recovery right for expenditures linked to a share disposal. The company in question incurred various legal, accounting, and banking costs in relation to a sale of shares carried out to meet liquidity needs – funds from the disposal of one subsidiary were to be used to finance the provision of management services to other subsidiaries.

The C.J.E.U. held that the transaction carried out by the holding company was the sale of shares of a subsidiary. That activity was exempt from V.A.T. Consequently, there was no cost incurred to carry out a trade in whole or in part and no input V.A.T. was incurred. In addition, the costs incurred contained no direct and immediate link to a taxable output transaction. Hence, no input V.A.T. deduction right could be granted.

As is apparent, the approach of the C.J.E.U. in BLP was far more restrictive with respect to share purchase transactions.

V.A.T. Recovery for General Expenditures Incurred in a Share Disposal (C.J.E.U., 10/29/2009, AB SKF, C-29/08)

In *AB SKF*, the C.J.E.U. later took a less restrictive approach in a similar context.

Following *AB SKF*, the C.J.E.U. makes a distinction between costs directly allocated to an output transaction, *i.e.*, the sale of shares, and general costs not allocated to a particular output transaction. Costs incurred to sell shares are components of the price of the shares to be sold. Where they are not incorporated in the price, they constitute overhead costs and therefore have a direct and immediate link with the taxable person's economic activity as a whole.

Costs not allocated to a particular output transaction do not require apportionment between economic and non-economic activities. As to these costs, the C.J.E.U. adopted a taxpayer-friendly approach:

> The costs of the services in question are part of his general costs and are, as such, components of the price of the goods or services which he supplies. Such costs do have a direct and immediate link with the taxable person's economic activity as a whole.[7]

This applies regardless of the V.A.T. treatment applicable to the disposal of shares, where the transaction is V.A.T.-exempt or falling outside the scope of V.A.T. For these costs, the input V.A.T. deduction right is largely available to active holding companies.

V.A.T. Recovery for Expenditures Incurred in a Share Disposal of a Managed Subsidiary (C.J.E.U., 11/08/2018, C&D Foods Acquisition, C-502/17)

The decision in *C&D Foods Acquisition* claws back the scope of the decision in *AB SKF*. In C*&D Foods Acquisition*, the C.J.E.U. ruled that a sale of shares, in itself, does not constitute an economic activity, implying that no deduction of input V.A.T.

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[7] C.J.E.U., 04/06/1995, *BLP*, C-4/94, para. 58.

on related costs can be granted. Thus, it seems to adopt the holding in *BLP*. However, the case goes on to say that, if the direct and exclusive reason for the share sale relates to the taxable activity of the parent company, or constitutes a direct, permanent, and necessary extension of the parent company's taxable activity, a V.A.T. deduction right may be recognized. This would be the case if a sale of shares is carried out with the purpose of allocating the proceeds directly to the taxable activity of the parent company or to the economic activity carried out by the group of which it is the parent company. In substance, this suggests that the favorable ruling in *SKF* should be an exception to the general rule of *BLP*.

In sum, a deduction on share disposal costs is now possible in specific circumstances demonstrating that the underlying purpose of the transaction causes the share disposal to be directly and exclusively linked to a taxable activity. If so, an active holding company may be entitled to a V.A.T. recovery right on share disposal costs. While it may be easy to state the rule, the application may not be clear at all. What facts must exist to demonstrate that the purpose of the transaction meets the test of *C&D Foods Acquisition*? Certainly, detailed legal documentation relating to the objective of the divestment of shares might serve to support V.A.T. recovery on the connected costs. However, if no business records kept in the ordinary course of business by operating personnel address a business goal of the transaction, mere legal documents prepared by savvy lawyers may not suffice to justify V.A.T. recovery.

CONCLUSION

These numerous developments highlight the difficulty of establishing clear guidelines for determining the V.A.T. recovery right of active holding companies, particularly the apportionment between economic and non-economic activities.

Despite the guidance provided by the C.J.E.U., room for interpretation still exists and different approaches can be found among the Member States. In this context, it can be expected that questions will continue to be referred to the C.J.E.U. where the final decision may be based on the quality of the advocacy rather than well thought through policy.

2019 WELCOMES NEW FINNISH INTEREST DEDUCTION LIMITATIONS

Authors
Antti Lehtimaja
Sanna Lindqvist

Tags
A.T.A.D.
Interest Deductions
Finland

The long-awaited Finnish government proposal[1] concerning new interest limitation rules was published on September 27, 2018. The Finnish parliament responded[2] on December 4, 2018, calling for certain minor changes and accepting the amendment into law. The new limitations took effect as of the beginning of 2019.

BACKGROUND

Before the tax year 2014, only the general anti-avoidance rule ("G.A.A.R.") and transfer pricing adjustments were potentially available to challenge interest deductions in Finland. The tax authorities rarely challenged an interest expense deduction, even in fairly aggressively-leveraged situations.

Following the lead of other European countries, Finland adopted specific E.B.I.T.D.-based rules (*i.e.*, addressing earnings before interest, tax, depreciation[3]) to be applicable in the tax year 2014. Since then, Finland has benefited from a specific interest barrier rule, applicable in both domestic and international situations, affecting the deductibility of intra-group interest payments.

Changes to the Finnish interest barrier regime have been expected since 2016, following the publication of the E.U. Anti-Tax Avoidance Directive[4] ("A.T.A.D."), which sets forth the minimum standards for interest deduction restrictions within the E.U.

A.T.A.D. implemented the recommendations set in the O.E.C.D. B.E.P.S. Project, which aims to prevent tax avoidance strategies that exploit gaps and mismatches in tax rules and attempts to find common international rules for combating inappropriate tax avoidance.

The O.E.C.D. countries have been concerned about corporations using debt financing to transfer taxable income to countries that have lower tax rates. The specific recommendations involving interest deductions and other financial payments are included in the B.E.P.S. Action 4.[5]

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1. Government Proposal HE 150/2018 vp.
2. Response by the Parliament EV 146/2018.
3. The Finnish interest barrier rule does actually not include adjustments for amortizations.
4. Council Directive (E.U.) 2016/1164 of July 12, 2016, laying down rules against tax avoidance practices that directly affect the functioning of the internal market.
5. The B.E.P.S. Actions can be found on the O.E.C.D. website. Action 4 was published in 2015 and was updated in 2016.

This article discusses the key elements of the new Finnish interest deduction restrictions, including a brief description of the new rules and some key considerations regarding their impact on Finnish taxpayers and investments in Finland.

INTEREST DEDUCTION RULES IN A NUTSHELL

Compared to the old rules, the new rules included in sections 18a and 18b of the Finnish Business Income Tax Act[6] have a broader scope, mainly in two ways:

- With certain exceptions, the new regime will generally apply to all Finnish-resident corporate taxpayers and partnerships, *i.e.*, not only entities that are deemed to carry on business activities but also other entities. In practice, this means a significant change especially for the Finnish real estate sector, since real estate companies and mutual real estate companies ("M.R.E.C.'s") have, in most cases, fallen outside the scope of the old interest barrier regime.
- Unlike the old restrictions, A.T.A.D. requires the new regime to be applied to all interest expenses, whether paid to a related or unrelated party. Interest payable on a bank loan can also become nondeductible if the amount of interest is high enough to disqualify it from exemptions.

"When the net interest expense exceeds €500,000, the deduction is capped at 25% of the adjusted taxable profit."

Like the old rules, the new rules include several levels of restrictions and exemptions, which are described below. In that regard, the structures of the old and new regimes are similar.

De Minimis Threshold

The first limitation rule is that if the amount of the company's total net interest payments (*i.e.*, interest expenses less interest income) do not exceed €500,000, the entire amount of net interest expense generally is deductible. The same minimum level existed in the old regime.

It should be noted that the €500,000 threshold is lower than its counterpart under A.T.A.D., which is set at net interest payments of €3 million. This stricter approach reflects the Finnish government's view that goal of implementing A.T.A.D. was not to increase allowable deductions under Finnish law in this regard. Thus, the principal of A.T.A.D. was adopted, but the threshold level for imposing restrictions on deductions remained unchanged.

Once the net interest payments exceed the threshold, the following rules apply.

Tax-E.B.I.T.D. Rule

When the net interest expense exceeds €500,000, the deduction is capped at 25% of the adjusted taxable profit ("Tax-E.B.I.T.D.").

Tax-E.B.I.T.D. is calculated by employing the following steps:

1. Starting with the taxable net profit or loss figure, interest expense and tax depreciation are added back into income.

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[6] The Finnish Business Income Tax Act (*laki elinkeinotulon verottamisesta*) 360/1968, as amended.

2. Then, any group contributions[7] from affiliates are also added into income.

3. Finally, group contributions to affiliates are deducted from income.

The Tax-E.B.I.T.D. rule predates the new regime. Under A.T.A.D., deductions could account for up to 30% of E.B.I.T.D. However, Finland has chosen to maintain the preexisting 25% limit. In practice, the Tax-E.B.I.T.D. rule means that large amounts of interest expense can be deductible if a company is sufficiently profitable.

Safe Harbor for Third-Party Loan Interest Expenses

As mentioned above, pursuant to A.T.A.D., interest barrier rules must apply to third-party interest as well as to related-party interest expense. However, the risk of aggressive tax planning involving interest expense has generally been associated with group related parties. Therefore, in the new Finnish regime it was deemed appropriate to provide more lenient regulations for interest payable to third parties.

If the Tax-E.B.I.T.D. rule would otherwise cap the deduction for interest expense, significant relief remains available for interest payable to parties other than group related parties: Net interest payable to third parties will be deductible up to a cap of

€3 million. In comparison to the €500,000 limit, the €3 million limit is a safe harbor rule. Even in cases where the net interest expense payable to parties other than group related parties exceeds €3 million, this amount is always deductible. Further explanation of group related parties appears below.

Balance Sheet Exemption

In cases where the interest ceiling is problematic, notwithstanding the three steps mentioned above, there is still a possibility of avoiding the loss of deductions under the cap.

Finnish tax law provides a balance sheet exemption under which a Finnish company, having a lower debt-to-equity ratio on a separate company basis than the group ratio computed on a consolidated basis, is allowed to deduct the interest expenses that would otherwise be nondeductible. A Finnish entity that has a debt-to-equity ratio that is lower than the consolidated ratio for its group has a greater percentage of its assets funded by equity than the group as a whole. In that set of circumstances, net interest expense of the Finnish company is not viewed to be abusive.

The balance sheet exemption has been extremely beneficial for taxpayers. In 2016, 190 Finnish companies were subject to the interest deduction limitation. The total non-deductible interest expense of all 190 companies amounted to €550 million. The same year, 59 companies were eligible for the balance sheet exemption. This enabled those companies to save a total of €215 million in the aggregate of deductible interest expense, a relatively large amount compared to the aggregate catch of the interest restrictions in that year.[8]

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7 In absence of a group taxation system or an unlimited consolidation of taxable profits within a group, contributions are the sole opportunity, under Finnish law,- to balance taxable profits and losses among Finnish entities in a group. Fairly strict criteria are set for granting group contributions.

8 Government proposal 150/2018, chapter 2.4.2.

With slight modifications, the balance sheet exemption under current law existed under the old interest barrier restrictions. Under the exemption, the parent of the group must be based in a Member State of the E.U. or the E.E.A., or in a country with which Finland has an income tax treaty in force.

In addition, the balance sheets must be prepared in accordance with the I.F.R.S. or legislation applicable in an E.U. or E.E.A. country, or in accordance with comparable standards such as U.S. G.A.A.P.

The new rule requires that both the individual company balance sheet and the group balance sheet be prepared in accordance with the same set of accounting principles. If the Finnish company's set of accounts is prepared under I.F.R.S. and the group's consolidated set of accounts is prepared under U.S. G.A.A.P., a reconciliation of one set of accounts can be prepared (either way) so that the computation of the debt-to-equity ratios of the company and the group can be made under the same set of accounting rules.

The balance sheet exemption has been subject to case law regarding the scope of its application. For example, in several cases, the Supreme Administrative Court ruled that only the ultimate group balance sheet may be used in the comparison – not a balance sheet of a sub-group parent company.

GROUP RELATED PARTIES

As explained above, only third-party loan interest may benefit from the €3 million safe harbor rule. In comparison, interest paid on Group Related Party loans may qualify only for the general €500,000 and 25% of Tax-E.B.I.T.D. exemptions. The treatment of the latter is the same as under the old interest barrier rules.

However, in the new interest barrier regime, the term is changed from etuyhteysyritys (which could be translated as "Related Party") to *konserniyhteydessä oleva osapuoli* (here, we use the term "Group Related Party").

As under prior law, the definition of Group Related Party is the same as the domestic law definition of related parties for transfer pricing purposes found in section 31.2 of the Finnish Act on Taxation Procedures.[9] However, Group Related Party is separate from the definition of Associated Enterprise used in A.T.A.D. when determining exempted Standalone Entities, which are explained below.

The parties are considered group related parties if one party has control over the other party or a third-party, alone or together with associated parties, has control over both parties to the loan transaction.

A party has control over the other party when

- it directly or indirectly holds more than half of the equity of the other party;
- it directly or indirectly holds more than half of the voting rights in the other party;

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[9] The Finnish Act on Taxation Procedures (*laki verotusmenettelystä*) 1558/1995, as amended.

- it has directly or indirectly the right to appoint more than half of the members of the board of directors or other comparable bodies (or a body having the right to appoint the members in the foregoing) in the other party; or
- it is managed jointly with the other party or it may otherwise *de facto* use control in the other party.

Even though bank loans normally qualify as third-party loans, a bank loan may be recharacterized as Group Related Party debt in back-to-back situations.

A more complex rule applies when a receivable owned by a Group Related Party is pledged to secure a third-party loan. To the extent of the pledge, the third-party loan is "contaminated" as a Group Related Party loan. In practice, the lender might forego taking a security interest in the receivable in order to enable the borrower to benefit from an interest expense deduction, thereby reducing its tax, which frees up additional funds to service the loan.

ITEMS INCLUDED AS INTEREST

Finnish tax legislation does not include a general definition of interest. Treatment as interest is generally based on case law and general tax practice. Usually, items that compensate the lender for allowing a borrower to use of the borrowed funds are considered to be interest.

To comply with A.T.A.D., the new law includes a specific definition of interest income and expense for purposes of the interest barrier rule. In addition to compensation for the use of debt financing, the definition also covers all expenses incurred in connection with the raising of debt financing. Interest expense and interest income are defined symmetrically.

A.T.A.D. includes an example list of payments that could be considered interest payments. The Finnish government proposal included additional views on which items should be considered interest for Finnish tax purposes:

- Payments under profit participating loans
- (Imputed) interest on zero coupon bonds
- Interest on capital loans, certain interest expenses which are capitalized
- Any interest amount which has been adjusted based on transfer pricing rules

As stated above, expenses incurred in connection with the raising of debt financing will also be considered interest under the new regime. Examples include the following:

- Guarantee fees and fees for granting security
- Arrangement fees and other non-recurring expenses charged in connection with raising debt financing
- Fees for changing loan terms or for premature repayment

The new rules will not affect the tax treatment of expenses from equity financing, such as initial public offerings. In addition, the following items are not considered interest:

- The interest component in a finance lease
- Amounts payable under interest derivatives (*e.g.*, payments based on interest rate swaps)
- Foreign exchange losses

Payments for services that do not constitute a fee for arranging debt financing are not regarded as interest expense even if they are somewhat connected to the debt.

Thus, for example, an advisor's fee for planning the structure of the debt financing transaction is not considered interest expense.

"Finland has chosen to utilize the possibility to exclude Standalone Entities from the scope of the interest barrier rules."

Financing charges payable by shareholders to M.R.E.C.'s will not fall under the definition of interest (even though, *de facto*, these payments may contain taxable components based on the interest payable by the M.R.E.C. to the bank). An M.R.E.C. is a special type of Finnish limited liability company. The M.R.E.C. owns the underlying real estate assets, but under the articles of association, the owners of the M.R.E.C. are entitled to possess the specified premises or real estate. Consequently, if the premises are leased, the owners of the company will directly receive the rental income. As the M.R.E.C. nevertheless incurs costs (*e.g.*, due to acquisition and ownership of the real estate), the owners must pay maintenance charges and financing charges to the company to cover its costs.

CARRY FORWARD OF NONDEDUCTIBLE INTEREST EXPENSES

Nondeductible interest expenses continue to be carried forward indefinitely. Also, in the case of a merger or demerger, the nondeductible part of the interest expense will be transferred. However, the nondeductible net interest expense from previous years may not be deducted beyond the limit that is computed for the current fiscal year.

Nondeductible net interest expense should be monitored separately with regard to loans to group related parties and other parties. In addition, if the Finnish entity has another source of income in addition to its business, the non-deductible interest amounts should be allocated to different income baskets, as set out in the law. Thus, maintaining the "tax asset" for the future requires some administrative work.

EXEMPTIONS

While the scope of the interest barrier rules is broad, some companies remain fully exempt from the restrictions:

Standalone Entities

A.T.A.D. introduces a new definition of "Standalone Entities" (*itsenäinen yritys*), which are exempt from the restrictions based on the assumption that there is lower

risk of tax avoidance in such entities. Finland has chosen to utilize the possibility to exclude Standalone Entities from the scope of the interest barrier rules.

A Standalone Entity is an entity that is not part of a consolidated group, does not have a permanent establishment abroad, and is not directly or indirectly entitled to more than 25% of the voting rights, capital, or profits of another entity (or vice versa). Moreover, no entity or natural person has a share of at least 25% in both the entity in question and another entity.

The definition of a Standalone Entity is new to Finnish legislation, and as noted above, it is not the same as a non-Group Related Party. For example, many Finnish residential housing companies will be exempt from the interest barrier rules as Standalone Entities due to their broad ownership base.

Financial Undertakings

The old Finnish interest barrier rules already included an exemption for companies engaged in the financial sector. In implementing A.T.A.D., Finland chose to align the definition to correspond with the definition of "Financial Undertaking" set out in A.T.A.D. in order to avoid any potential claims of illegal State Aid prohibited under E.U. law.

The new law explicitly lists the Financial Undertakings that are fully exempt from the restrictions. Compared to the old law, the definition is broader in certain parts and narrower in other parts. The following Financial Undertakings are exempt under the new regime:

- Credit institutions
- Investment firms
- Alternative investment funds and their managers
- Undertakings for a collective investment in transferable securities and their management companies
- Insurance companies

Certain Long-Term Public Infrastructure Projects

Finland has chosen to implement an A.T.A.D. exemption for certain long-term public infrastructure projects. The old interest barrier rules did not contain such an exemption.

As the current Finnish system for government-supported social housing production was already "approved" as compliant with the E.U. State Aid rules, it was decided that projects qualifying under the Finnish social housing production legislation would also be exempt from the interest barrier rules. This exemption is estimated to cover approximately one-third of all Finnish rental apartments.[10]

Since the exemption in A.T.A.D. is not limited to social housing, the Finnish parliament has, in its response,[11] required that the government and the E.U. Commission

[10] Government proposal 150/2018, chapters 4.3.4 and 3.4.3.

[11] Response by the Parliament EV 146/2018.

continue to assess the possibility of applying a broader exemption to other kinds of Finnish infrastructure projects.

Grandfathering Clauses

As allowed by A.T.A.D., interest expenses payable on certain existing debts are exempt from the restrictions. Interest payments are exempt if paid to parties other than group related parties when the debt is acquired prior to June 17, 2016, provided that no changes to the loan term or loan amount have been made after that date.

Also, interest expense that has been activated or included in the acquisition cost of an as- set prior to January 1, 2019, falls outside the scope of the new interest barrier rules.

These grandfathering rules strive to ensure that new, stricter rules do not have a harsh retroactive effect, especially on significant long-term investment projects.

TAKEAWAYS UNDER THE NEW RULES

"As a result of the new restrictions, it is likely that companies will favor equity financing."

Although Finland has chosen a fairly broad application of A.T.A.D. exemptions, the new rules are somewhat complex, and they will tighten the Finnish interest deduction regime – especially since the restrictions also cover bank loans and other third-party loans. Here are several points that should be taken into account when contemplating a financing arrangement for a Finnish venture.

- The limitations will be broadly applicable to limited liability companies and partnerships, including entities that are taxed under the Finnish Income Tax Act,[12] with exceptions for certain existing loans, Financial Undertakings, social housing projects, and Standalone Entities.
- Companies operating in the real estate investment sector should assess the impact of financing structures.
- Companies in other business sectors planning significant leveraged investments in Finland should take into account the interest barrier rules. Infrastructure projects, other than those related to social housing, fall under the restrictions.
- The definition of interest expense will be broader than in prior years and includes expenses that might not be recorded as interest in the accounts of the company.
- The different thresholds for group and third-party loans mean that taxpayers must monitor both categories and maintain separate baskets for possible non-deductible interest expense being carried forward.

As a whole, the interest deduction limitations probably fulfill their goal: to secure the tax base and to prevent overly aggressive tax planning involving interest deductions. As a result of the new restrictions, it is likely that companies will favor equity financing, especially over shareholder loans and other intra-group loans, in order to avoid non-deductible interest expenses, when possible.

[12] The Finnish Income Tax Act (tuloverolaki) 1535/1992, as amended.

In some situations, it may be possible to plan the group structure to optimize the Tax-E.B.I.T.D. base. In other situations, it could be feasible to utilize multiple debtor entities so that the *de minimis* threshold of €500,000 is not exceeded.

The change in law will cause an administrative burden. Taxpayers and their advisers must familiarize themselves with the new rules to ensure compliance and avoid non-deductible interest expenses. While these rules are based on A.T.A.D., the implementation of the directive will vary among the European countries. Thus, multinational groups and investment structures must account for the differences in various countries.

CAN TAX AUTHORITIES DEMAND ACCESS TO AUDIT WORKPAPERS? CANADIAN EXPERIENCE FOLLOWS U.S. RULE

Authors
Sunita Doobay
Stanley C. Ruchelman

Tags
Attorney-Client Privilege
Audits
Canada
U.S.

INTRODUCTION

When a Canadian or U.S.-based multinational finds itself under audit, the taxpayer and the tax authority are often at odds over what documentation is subject to disclosure and what remains beyond the prying eyes of the tax authority. In a landmark series of recent court cases in Canada, the Canada Revenue Agency ("C.R.A.") was given access to accounting workpapers and background documentation for transfer pricing reports to verify a position taken in a client's tax return. This is a major development in Canada. In the U.S., in contrast, the I.R.S. has been given access to workpapers and other information for many years. A comprehensive look at the long history of U.S. transparency may provide a roadmap of what Canadian-based multinationals should expect regarding matters of transparency.

TAX AUDITS

Whether a taxpayer is resident in Canada or the U.S., it may be subject to an administrative examination to determine whether tax liability has been calculated correctly in the tax return.

Sunita Doobay is a Partner at Blaney McMurtry LLP in Toronto, Canada. Equipped with over a quarter of a century of tax experience as an international tax lawyer, Sunita is a trusted tax advisor to a broad range of clients.

When the taxpayer is a large multinational, that tax audit involves a significant investment by the tax authorities in terms of staffing and resources. The examination portion of the audit may involve the issuance of information requests and possibly follow-up summonses that are intended to obtain data that may be used to test whether the taxpayer's claimed positions are justified under relevant tax law.

In a sense, the multinationals begin their investment long before the audit begins. They have sophisticated tax lawyers on staff and also retain sophisticated outside tax advisors. At the close of the year, the books and records of the enterprise are audited by a major accounting firm for the purpose of providing certification of the reported results.

When a tax examiner requests information regarding a specific transaction, the taxpayer may object on the grounds that the requested documentation is protected – either by attorney-client privilege or under the work product doctrine of privilege. The attorney-client privilege is a common law concept that dates back several centuries. The privilege protects information disclosed by the client to the attorney for the purpose of obtaining legal advice. The work product doctrine states that a party may not discover documents and tangible things prepared in anticipation of litigation or trial by a party or its representative. The work product privilege does not cover material assembled in the ordinary course of business or pursuant to public requirements that are unrelated to litigation or for other non-litigation purposes.[1]

[1] *Hickman v. Taylor*; 329 U.S. 495 (1947); *Wells Fargo v. U.S.*, Civil No. 10-mc- 57

A flash point for disclosure not covered by the work product doctrine is the tax provision analysis that forms part of the audit workpapers in support of a corporate taxpayer's published financial statements. When prepared by the audit firm, the tax provision analysis represents an outside professional's view regarding the expected tax exposure of a corporation in order to arrive at after-tax net profits. The analysis is designed to provide assurance that that the tax provision in the financial statement accurately portrays the financial condition of the company.

CANADIAN CASES

Source of C.R.A.'s Audit Powers

Subsection 231.1 of the Canadian Income Tax Act ("Act") grants broad powers to the C.R.A. to inspect, audit, or examine books, records, and inventory of a taxpayer. In carrying out its examination, the C.R.A. may issue a notice to a taxpayer requiring it to furnish information specified in the notice.[2] If a taxpayer refuses to comply, the C.R.A. may apply to the courts for a compliance order, if the requested information or document is not protected by solicitor-client privilege.[3]

Focus of C.R.A. Information Requests

In 2017 and 2018, a series of cases came before the Canadian Federal Court addressing the validity of a C.R.A. application for a compliance order seeking the production of tax workpapers and requesting the right to interview individuals who were officers and employees of the taxpayer.

In *MNR v. Cameco*,[4] the C.R.A. sought to interview 25 employees of Cameco to verify the information contained in its transfer pricing reports prepared by KPMG for tax years 2010 through 2012. In *BP Canada Energy Company v. MNR*,[5] the C.R.A. sought access to the taxpayer's tax accrual workpapers setting out its uncertain tax position for a specific year, not for the purpose of the initial examination of the tax return for that year but for the examination of tax returns filed for subsequent years. In *Canada (National Revenue) v. Atlas Tube Canada ULC*,[6] the C.R.A. sought access to a draft due diligence report prepared by EY, which had been prepared as part of an acquisition and reorganization of Atlas' corporate group.

Access to Interview Key Personnel of the Taxpayer

Cameco is one of the world's largest uranium producers and is headquartered in Saskatoon, Saskatchewan. Cameco has several foreign subsidiaries. In the Cameco case, the C.R.A. sought to interview 25 employees of Cameco and its related non-Canadian subsidiaries for purposes of substantiating a transfer pricing report prepared by KPMG for tax years 2010 through 2012. The employees were situated in Switzerland, the U.S., Barbados, and Canada. The C.R.A. offered to interview these individuals at their locations or by videoconference.

(D. Minn., June 4, 2013).

2 Section 231.2 of the Act.

3 Section 231.7 of the Act.

4 2017 F.C. 763.

5 2017 F.C.A. 61.

6 2018 F.C. 1086.

In the past, Cameco had granted the C.R.A. access to its personnel for assessment of tax years 2003 through 2006. The oral information obtained from the personnel led to a reassessment of those years that was subsequently challenged by Cameco. The matter was pending before the Tax Court of Canada when the C.R.A. applied for a compliance order seeking access to a larger number of Cameco's personnel for assessment of tax years 2010 through 2012. The Federal Court refused to issue a compliance order on the basis that issuing such order would prejudice Cameco:

> When the first audits were performed, Cameco agreed to have its personnel interviewed only by a CRA official. Those interviews were not recorded, though Cameco lawyers were allowed to be present during the interviews. Both the CRA and Cameco personnel took notes of the interviews. When the matter for those years proceeded to the Tax Court of Canada and Notices to Admit were served, it was found that the two parties had very different recollections of what was said at the oral interviews. . . . If the Minister's position is accepted, the CRA can compel oral interviews from as many persons as they see fit without any procedural limits. Oral interviews as sought on these facts at the audit stage would undermine procedural safeguards provided at the appeal stage. Furthermore, the Minister could use an isolated statement by an employee which the taxpayer would be forced to disprove at trial.

The C.R.A. requested to have a court reporter present during the interview process to prevent misinterpretation of information. However, the court rejected the request, as it would result in replicating an examination for discovery in a Tax Court proceeding with the C.R.A. hand picking interviewees instead of Cameco choosing its own officers for examination.

Access to Tax Workpapers for Future Audits

The *BP Canada* case is the first Canadian case to address an attempt by the C.R.A. to access a taxpayer's tax accrual workpapers without advancing any particular justification for their production. Tax accrual workpapers are papers created by or for independent auditors in order to assist in the process of certifying financial statements in accordance with Generally Accepted Accounting Principles ("G.A.A.P."). Tax accrual workpapers are used to identify uncertain positions and provide for reserves that will allow an independent auditor to certify that financial statements fairly and accurately reflect the financial situation of the corporation under audit.

In the course of the C.R.A.'s examination of BP Canada for 2005, the examiner identified an issue relating to refund interest paid by the C.R.A. to BP Canada. The accounting turned out to be erroneous, as the refund interest payment should have been booked in 2005. During the examination process, several accounting entries in an account entitled "Interest Expense Taxes Payable – Disputed Accruals Account" came to surface. The C.R.A. examiner sought access to the tax accrual workpapers from BP Canada to support the entries in that account. BP Canada refused on the basis that the disclosure of tax accrual workpapers was unnecessary in the fact pattern as only refund interest was questioned by the examiner. That issue was resolved, leading BP Canada to contend in effect that the C.R.A. examiner was partaking in a "fishing expedition." Further, BP Canada argued that disclosure of its tax accrual workpapers would not only provide the C.R.A. with a roadmap to its uncertain tax positions but would also allow access to the analysis behind those positions.

BP Canada, therefore, appealed to the Federal Court of Appeal and the Chartered Professional Accountants of Canada ("C.P.A.C.") participated as an intervener in light of the broad scope of the issue. The C.P.A.C. argued that the formal requests for the production of tax accrual workpapers should not be routine and uncontrolled, and that the obligation to produce these papers to the C.R.A. would undercut the public interest role of C.P.A.C. members in certifying financial statements. The court summarized the concerns of the C.P.A.C. in the following language

> Professional accountants have a direct role in ensuring a degree of confidence in publicly-traded corporations' financial statements through independent auditing. Because they act in the public interest, they are subject to professional and ethical obligations, such as an obligation of integrity, a duty of care, and a duty of objectivity. . . . In keeping with those obligations, professional accountants have to review [tax accrual workpapers] prepared by the corporations which they audit in addition to preparing their own [tax accrual workpapers].
>
> [The C.P.A.C.] thus fears that the order, if allowed to stand, will cause corporations to 'hesitate to voluntarily and fully disclose their tax risks.' Moreover, routine access by the Minister to subjective opinions on tax risks may 'discourage corporations from preparing such analysis in order to protect it from disclosure.'
>
> [The C.P.A.C.] invites the Court to interpret subsection 231.1(1) of the Act in light of 'the global context of rules of professional ethics and financial reporting.' This means that only objective information would be subject to production, such as the 'disclosure of all transactions that could have a material impact on the corporation's tax liability, without identifying the degree of tax risk that any of those transactions may have.'

Notwithstanding the legal arguments submitted by the C.P.A.C., the Federal Court of Appeal held that a taxpayer could be ordered to produce tax accrual workpapers where the tax accrual workpapers pertain to a specific issue under an existing audit. However, the deeper issue was whether subsection 231.1(1) allows general and unrestricted access to this information. In the *BP Canada* case, the C.R.A.'s request was specific to an existing audit. However, there was no existing audit pertaining to the information requested, and the C.R.A. sought access to BP Canada's uncertain tax positions for the purpose of using these positions to facilitate future audits. Therefore, the court held that BP Canada could not be compelled to produce the tax accrual workpapers.

Access to Workpapers in an Ongoing Audit

In the *Atlas Tube* case, the C.R.A. sought a compliance order application before the Federal court seeking the release of a due diligence report prepared by EY pursuant to a reorganizational transaction in 2012 which included the purchase of an unrelated company by Atlas's parent corporation, a U.S. entity. The due diligence report was prepared by the accounting firm, EY, to understand whether the Canadian sister corporations and Atlas had sufficient tax losses to offset the future revenue of the newly acquired entity. The C.R.A. initiated an examination of the tax return of Atlas. in the course of which it requested a copy of the due diligence report. Atlas argued

that the report was cloaked under solicitor-client privilege and therefore could not be released.

The Federal Court concluded that dominant purpose of the report was to inform the decision whether to proceed with the transaction and at what price. Because the purpose of the report was not to obtain legal advice, the court held that the solicitor-client privilege did not apply. The report included, *inter alia*, the tax attributes of the target corporations and the material tax exposures resulting from the prior Canadian tax filings including an assessment of the probability that the filing positions leading to the tax exposures would be sustained if challenged by the C.R.A. The court concluded that the assessment and evaluation represent accounting opinions by EY, which cannot be characterized as prepared for the purpose of obtaining legal advice on the structuring of the transaction.

The court also distinguished the *BP Canada* case on the basis that the report requested in the *Atlas* case was made in the context of an active examination of particular issues unlike the *BP Canada* case where the purpose was to facilitate future audits.

U.S. EXPERIENCE

Financial Accounting Conceptual Background

SFAS 109 (Accounting for Income Taxes)

Financial accounting concepts of income recognition are not identical to U.S. tax accounting concepts. As a result, pre-tax income for financial accounting standards may not look anything like the taxable income on a corporate tax return. The disparity could result from a variance in cost basis resulting from the computation of depreciation under two different sets of accounting standards or may reflect a mere difference in income or expense recognition rules.

To illustrate, assume an item of depreciable property is sold for a combination of cash and purchase money notes held by the seller calling for payment over time. For financial accounting purposes, all gain is recognized immediately upon the sale. That is the time when income or gain is more likely than not realized. For tax purposes, the recognition of gain may be deferred under rules applicable to an installment sale, where gain is recognized as payments are received. In addition, the amount of the gain may be measured differently. If a risk exists regarding the likelihood that full payment of the installment notes will be received, the amount of the gain for financial statement purposes may be adjusted for a reserve that takes into account the risk of full and timely payments of the promissory notes issued by the purchaser. No such reserve is generally allowed for tax purposes, which defers the effect of a potential loss until the loss occurs.

FIN 48 (Accounting for Uncertainty in Income Taxes)[7]

The foregoing example related to the sale of property is a relatively straightforward fact pattern. The complexity increases when a loss or credit is derived from one transaction but is used immediately to reduce tax otherwise due on income from another transaction. The reduction in tax resulting from the validity of the loss is viewed

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[7] Now codified in accounting literature as ASC 740-10.

as a tax position for financial statement purposes. Deciding whether the tax benefit from the loss is recognized and determining how much is recognized are accounting decisions made under the principles of FIN 48.

FIN 48 is an interpretation of SFAS 109 regarding the calculation and disclosure of reserves for uncertain tax positions. The evaluation of a tax position in accordance with FIN 48 is a two-step process:

1. The first step relates to recognition of a benefit arising from a tax position. In this step, the company determines whether it is more likely than not that a tax position will be sustained based on the technical merits of the position upon conclusion of examinations, I.R.S. appeals procedures, and litigation processes. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the company presumes that the position will be examined by the appropriate taxing authority and that the examiner has full knowledge of all relevant information.

2. The second step in the evaluation process is measurement. A tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured as the largest amount of tax benefit that is more than 50% likely to be realized upon ultimate settlement.

Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which any of the following occurs:

- The threshold is met (*e.g.*, by virtue of another taxpayer's favorable court decision)

- The position is "effectively settled" by virtue of the closing of an examination where the likelihood of the taxing authority reopening the examination of that position is remote

- The relevant statute of limitations expires

Only tax positions that meet the more-likely-than-not recognition threshold at the effective date may be recognized or continue to be recognized upon adoption of FIN 48. The cumulative effect of applying the provisions of FIN 48 is reported as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for the year of adoption, presented separately.

Arthur Young & Co. Case

In 1975, the I.R.S. began a routine examination to review Amerada Hess's corporate income tax liability for the tax years 1972 through 1974. When the audit revealed that the company made questionable payments of $7,830 from a "special disbursement account," the I.R.S. initiated a criminal investigation of Amerada's tax returns in addition to the civil examination. In that process, the I.R.S. issued an administrative summons to Arthur Young & Co., pursuant to Code §7602 as in effect prior to the adoption of the Internal Revenue Code of 1986.[8] The summons required

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[8] All statutory references are to the Internal Revenue Code of 1986 ("Code") as

Arthur Young to make available to the I.R.S. all its Amerada Hess files, including its tax accrual workpapers. The client instructed Arthur Young not to comply with the summons.

"Financial statement audit firms have a public responsibility to ensure that a company issuing publicly-traded stock accurately reports its financial accounts to the public."

The I.R.S. commenced an action in Federal district court for enforcement of the summons. The district court found that Arthur Young's tax accrual workpapers were relevant to the I.R.S. investigation and refused to recognize an accountant-client privilege that would protect the workpapers.[9] The Court of Appeals for the Second Circuit agreed that the tax accrual workpapers were relevant to the I.R.S. investigation but held that the public interest in promoting full disclosure to public accountants and ensuring the integrity of the securities markets required protection for the work that such independent auditors perform for publicly-owned companies.[10] The court of appeals fashioned a work product immunity doctrine for tax accrual workpapers prepared by independent auditors in the course of compliance with Federal securities laws.

Ultimately, the Supreme Court held that the tax accrual workpapers were relevant to the I.R.S. audit and therefore discoverable.[11] In addition, the Supreme Court found that no accountant-client privilege exists under Federal or state law. Unlike an attorney, whose role is to represent a client in the most favorable light possible, financial statement audit firms have a public responsibility to ensure that a company issuing publicly-traded stock accurately reports its financial accounts to the public. In substance, the Supreme Court acknowledged that financial statement auditors have a responsibility to users of financial statement information. This responsibility can create an adverse relationship between the company and its auditors.

Announcement 2002-63

Having won its case against Arthur Young, the I.R.S. understood that total and complete access to tax accrual workpapers would inhibit a full analysis by the outside accountants. Consequently, it scaled back its demands to see accountants' tax accrual workpapers except in extraordinary circumstances. In Announcement 2002-63, the I.R.S. explained the circumstances in which tax accrual workpapers would be requested during the cause of an I.R.S. examination:

- Workpapers could be requested in the course of the examination of any return filed on or after July 1, 2002, claiming a tax benefit arising out of a listed transaction, which in broad terms is a tax shelter in the view of the I.R.S. If the listed transaction was disclosed on the taxpayer's tax return, the review is limited to those workpapers related to the listed transaction. On the other hand, if the listed transaction has not been disclosed on a tax return, the I.R.S. will request all tax accrual workpapers.
- If the I.R.S. determines that tax benefits have been claimed from multiple investments in listed transactions, the I.R.S., as a discretionary matter, may request all tax accrual workpapers. It does not matter whether the listed transactions were disclosed on a tax return.

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in effect at the time, unless otherwise stated.

[9] *U.S. v. Arthur Young & Co.*, 496 F.Supp. 1152 (S.D.N.Y. 1980).

[10] *U.S. v. Arthur Young & Co*, 677 F.2d 211 (2S Cir. 1982).

[11] *U.S. v. Arthur Young & Co*, 465 U.S. 805 (1984).

- If there are reported financial accounting irregularities requiring a restatement of the earnings of a taxpayer that reported an investment of a listed transaction, the I.R.S. could request all tax accrual workpapers as a discretionary matter.

Textron Case

In 2003, the I.R.S. began an audit of Textron's tax return for 2001 and found that its subsidiary had participated in nine listed transactions that were potential tax shelters. In each of the nine instances, Textron purchased equipment from a foreign utility or transit operator and leased it back to the seller on the same day. The I.R.S. determined that these were sale-in, lease-out ("S.I.L.O.") transactions,[12] which are listed as potential tax shelters subject to abuse by taxpayers. The I.R.S. issued an administrative summons[13] to obtain the books, papers, records, or any other data that may be relevant to the inquiry.[14] Since Textron claimed benefits from multiple transactions, the I.R.S. sought all the workpapers for the years in question[15] from both Textron and its outside auditors, Ernst & Young. Textron refused to hand over its workpapers and intervened in the summons served on Ernst & Young.

The I.R.S. brought an enforcement action in connection with the administrative summons. Textron claimed that the documents listed in the summonses were protected from disclosure under the attorney work product doctrine. The main issue in the litigation was whether the documents being demanded were prepared routinely or in anticipation of litigation. In the latter case, the documents would be privileged.

The U.S. Federal District Court for the District of Rhode Island, which was the court of original jurisdiction, ruled that the work product privilege was applicable.[16] The decision was appealed by the I.R.S. to the First Circuit Court of Appeals.

The work product doctrine offers protection for documents by or at the direction of an attorney that are prepared in anticipation of litigation or for trial by or for another

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[12] For an excellent discussion of a S.I.L.O. transaction, see Wood and Hollingworth, "SILOs and LILOs Demystified," *Tax Notes* (October 11, 2010), p. 195. According to the authors, through March 12, 2004, when U.S. tax law was revised to eliminate the tax benefits of these transactions, U.S. taxpayers were involved in at least 400 S.I.L.O. transactions, claiming tax deductions of more than $35 billion.

[13] 26 U.S.C. §7602 (2006).

[14] In pertinent part, the subpoena served on Textron demanded the following documents:

> All accrual and other financial workpapers or documents created or assembled by the Taxpayer, an accountant for the Taxpayer, or the Taxpayer's independent auditor relating to any tax reserve for current, deferred, and potential or contingent tax liabilities, however classified or reported on audited financial statements, and to any footnotes disclosing reserves or contingent liabilities on audited financial statements. They include, but are not limited to, any and all analyses, computations, opinions, notes, summaries, discussions, and other documents relating to such reserves and any footnotes.

[15] I.R.S. Announcement 2002-63, 2002-27 I.R.B. 72 (July 8, 2002).

[16] *U.S. v. Textron Inc. & Subsidiaries*, 507 F. Supp. 2d 138 (D. R.I. 2007).

party or its representative.[17] A "because of" test is applied to determine whether a document is protected by the attorney work product doctrine. A document is protected if, in light of the nature of the document and the facts of a particular case, the document can be said to have been prepared because of the prospect of litigation. Conversely, a document is not protected from disclosure if it is prepared in the ordinary course of business or it would have been created in essentially similar form in the absence of the litigation. The work product doctrine applies in tax summons enforcement proceedings.[18]

Textron argued that the workpapers were prepared to ensure that a sufficient amount was set aside in the event of a dispute the I.R.S. The analysis of the tax positions in the return were conducted by the company's legal counsel. Textron argued that the analysis was prepared to analyze potential litigation with the I.R.S. over the very tax shelters that had been identified and the company's need to set aside reserves in case the tax benefits were disallowed by the I.R.S.

The I.R.S. argued that the work product privilege was lost because the workpapers also served a business or regulatory purpose – the accuracy of the published financial statements. Textron needed to prepare the same analysis to comply with the transparency rules applicable to capital markets in the U.S. It also argued that Textron could not have anticipated litigation at the time the accrual workpapers were prepared, and in any event, no specific litigation was identified by Textron. Finally, the I.R.S. argued that an adversarial relationship existed between the taxpayer and its independent auditor, so when the papers were shown to the audit firm, Textron caused the workpapers to lose any privilege that may have existed.

"A document is not protected from disclosure if it is prepared in the ordinary course of business or it would have been created in essentially similar form in the absence of the litigation."

A three-judge panel of the appeals court initially ruled in favor of Textron[19] regarding the application of the attorney work paper doctrine. The initial opinion acknowledged that Textron and the I.R.S. had a contentious relationship in regard to the examination of the company's tax returns. Evidence presented to the district court indicated that Textron was audited by the I.R.S. on a continuous basis. In every three-year audit cycle, hundreds of I.R.S. adjustments were made without challenge. Where adjustments were disputed, the matter was resolved through a conference with the audit team, by presentation of arguments to the I.R.S. Office of Appeals, or in litigation. The appeals court held that while not all aspects of a tax examination are adversarial, the resolution of disputes through administrative processes, including proceedings before the I.R.S. Appeals Office, is litigation. Consequently, the appeals court initially ruled in favor of Textron.

The I.R.S. timely petitioned the appeals court asking for review by the entire panel of judges in the court. The original decision by the appeals court was vacated, additional briefs were submitted, and *amicus curiae* briefs were filed by interested parties that might be affected by the ruling of the court. The full appeals court held that the Textron tax analysis workpapers were independently required by statutory and audit requirements and that the attorney work product privilege was not applicable.[20]

The final decision characterized the problem in the following terms:

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17 Fed. R. Civ. P. 26(b)(3)(A).

18 *Upjohn Co. v. U.S.*, 449 U.S. 383, 386 (1981).

19 553 F.3d 87 (1st Cir. 2009).

20 560 F.3d 513 (1st Cir. 2009).

> . . . [H]ow far work product protection extends turns on a balancing of policy concerns rather than application of abstract logic . . . [in the context of] a document [that] is not in any way prepared 'for' litigation but relates to a subject that might or might not occasion litigation.

The appeals court looked to *Hickman v. Taylor* for guidance:

> Proper preparation of a client's case demands that he assemble information, sift what he considers to be the relevant from the irrelevant facts, prepare his legal theories and plan his strategy without undue and needless interference . . . This work is reflected, of course, in interviews, statements, memoranda, correspondence, briefs, mental impressions, personal beliefs, and countless other tangible and intangible ways – aptly though roughly termed . . . as the 'work product of the lawyer.'

On this basis, the Supreme Court declared that the interrogatories, which sought witness interviews conducted by opponent's counsel in preparation for litigation, were protected by a qualified privilege. That privilege is now codified in Rule 26(b)(3) of the Federal Rules of Civil Procedure regarding disclosure of material to the opposing side in litigation. The tax accrual workpapers simply did not meet this standard. The immediate motive of Textron in preparing the tax accrual workpapers was to fix the amount of the tax reserve on Textron's books and to obtain a clean financial opinion from its auditor. Merely because Textron wanted to be adequately reserved in the event of litigation does not mean that the workpapers were prepared for use in possible litigation. The workpapers were prepared to ensure that sufficient reserves were established to cover liabilities that might be determined in litigation.

The appeals court concluded that an experienced litigator would describe the tax accrual workpapers as tax documents and not as case preparation material. The fact that the documents were prepared by lawyers or reflected legal thinking is not sufficient to trigger work product protection, even if the subject matter of a document might conceivably be litigated. Those documents are merely another type of material that is assembled in the ordinary course of business or in compliance with public requirements unrelated to litigation. They do not have immunity from disclosure.

The appeals court decision for the majority ends with the following comments:

> Textron apparently thinks it is 'unfair' for the government to have access to its spreadsheets, but tax collection is not a game. Underpaying taxes threatens the essential public interest in revenue collection. If a blueprint to Textron's possible improper deductions can be found in Textron's files, it is properly available to the government unless privileged. Virtually all discovery against a party aims at securing information that may assist an opponent in uncovering the truth. Unprivileged IRS information is equally subject to discovery. . . .
>
> The practical problems confronting the IRS in discovering under-reporting of corporate taxes, which is likely endemic, are serious. Textron's return is massive--constituting more than 4,000 pages--and the IRS requested the work papers only after finding a specific type of transaction that had been shown to be abused by taxpayers.

> It is because the collection of revenues is essential to government that administrative discovery, along with many other comparatively unusual tools, are furnished to the IRS. [Footnote omitted.]

Schedule UTP Reporting Uncertain Tax Positions

Having won the right to review tax accrual workpapers, the I.R.S. modified its approach by adopting a plan for transparency of corporate tax returns keyed to the tax return itself.

In a speech before the New York State Bar Association Tax Section Annual Meeting in New York City on January 26, 2010, then Commissioner Doug Schulman announced the introduction of Schedule UTP as a means of coordinating issue identification for tax purposes with the obligations imposed under FIN 48. I.R.S. statistics indicate that up to 25% of its time in large corporate audits is allocated to identifying issues rather than having a straightforward discussion with taxpayers about tax issues. The goal of the I.R.S. is to use the form to reduce the time it takes for I.R.S. examiners to find issues and complete an audit. It does this by assisting the I.R.S. in prioritizing the selection of issues and ensuring that the I.R.S. and taxpayers spend time discussing the law as it applies to the taxpayer's facts. Below is the plan that was announced by Commissioner Schulman:

> Reporting uncertain tax positions would be required at the time a return is filed by certain business taxpayers: those who have both a financial statement prepared under FIN 48 or other similar accounting standards reflecting uncertain tax positions and assets over $10 million. Under the Announcement, these taxpayers would be required to annually disclose uncertain tax positions in the form of a concise description of those positions and the maximum amount of US income tax exposure if the taxpayer's position is not sustained. By concise, we mean a few sentences that inform us of the nature of the issue, and not pages of factual description or legal analysis.
>
> Let me say a few things about this proposal. We have taken what I believe is a reasonable approach. We could have asked for more . . . a lot more . . . but chose not to. We believe we have crafted a proposal that gives us the information we need to do our job without trying to get in the heads of taxpayers as to the strengths or weaknesses of their positions. . . .
>
> The proposal does not require the taxpayer to disclose the taxpayer's risk assessment or tax reserve amounts. We are asking for a list of issues that the taxpayer has already prepared for financial reporting purposes, in order to improve the efficiency and effectiveness of tax examinations. We are also looking for the maximum exposure, so we can allocate our exam resources appropriately. We need to have a sense of materiality and whether we should spend exam resources on an issue. The principal guidance for completing the form comes from the instructions published by the I.R.S.

A Schedule UTP is required if each of the following four requirements are met: (i) a corporate tax return is filed, (ii) an asset threshold is met, (iii) audited financial statements are prepared, and (iv) either a reserve is reported for a tax position or

a reserve is not recorded because a decision has been reached to litigate the tax position if challenged. Each of these requirements is discussed below:

- **Corporate Tax Return Filed.** The corporation files a tax return on Form 1120, *U.S. Corporation Income Tax Return*; Form 1120-F, U.S. *Income Tax Return of a Foreign Corporation*; Form 1120-L, *U.S. Life Insurance Company Income Tax Return*; or Form 1120-PC, *U.S. Property and Casualty Insurance Company Income Tax Return*.

- **Asset Threshold.** The corporation has assets that equal or exceed $10 million. If the U.S. branch of a foreign corporation has less than $10 million in assets but the entire corporation meets that threshold, Schedule UTP must be filed.

- **Audited Financial Statements.** The corporation or a related party issued audited financial statements reporting all or a portion of the corporation's operations for all or a portion of the corporation's tax year. Audited financial statements mean financial statements on which an independent auditor has expressed an opinion, whether qualified, unqualified, disclaimed, or adverse, under G.A.A.P., I.F.R.S., or another country-specific accounting standard, including a modified version of any of the above. Compilations or reviewed financial statements – which may be prepared in the U.S. without the necessary audit steps to allow the audit firm to issue an opinion – are not audited financial statements for purposes of this test. If a corporation reconsiders whether a reserve is required for a tax position and eliminates the reserve in an interim audited financial statement issued before the tax position is taken in a return, the corporation need not report the tax position to which the reserve relates on Schedule UTP.

- **Reserve Recorded or Decision to Litigate.** The corporation has taken one or more tax positions taken on a tax return for the current or prior year and either it or a related party has recorded a reserve in audited financial statements, or a reserve is not recorded because the corporation expects to litigate the position. This is a two-step analysis: (i) defining a tax position and (ii) determining whether a reserve was taken for financial statement purposes.

A tax position taken on a tax return means a tax position that would result in an adjustment to a line item on any schedule or form attached to the tax return if the position is not sustained.

A tax position is based on the unit of account used to prepare the audited financial statements on which the reserve is recorded (or on which no reserve was recorded because of an expectation to litigate). A unit of account is the level of detail used in analyzing a tax position. The unit of account used by a G.A.A.P. or modified G.A.A.P. taxpayer for reporting a tax position on Schedule UTP must be the same unit of account used by the taxpayer for G.A.A.P. or modified G.A.A.P.

For a non-accountant, the term "unit of account" is not a clear term. However, an example in the instructions suggests that it means the method adopted by a corporation to report an item for accounting purposes. The example looks at two corporations, each independent of the other. Each conducts an independent research and development project, and each intends to claim a credit allowed for the outlays incurred in the activity. Many hurdles must be overcome to benefit from the

credit and so the credit is a tax position. One corporation chooses each individual research project as the unit of account for G.A.A.P. financial reporting purposes, since the corporation accumulates information for the tax return at the project level and expects the I.R.S. to address the issues during an examination of each project separately. The other corporation determines that the appropriate unit of account for G.A.A.P. financial reporting purposes is the functional expenditures, based on the amount of its expenditures, the anticipated credits to be claimed, its previous experience, and the advice of its tax advisors. The method chosen by each corporation to accumulate and report information for G.A.A.P. purposes must be used when preparing the Schedule UTP.

A reserve is recorded when an uncertain tax position or a FIN 48 liability is stated anywhere in a corporation's or related party's financial statements, including footnotes and any other disclosures, and may be indicated by any of several types of accounting journal entries. The initial recording of a reserve will trigger the reporting of a tax position taken on a return. However, subsequent reserve increases or decreases with respect to the tax position will not trigger reporting.

Although the use of a net operating loss ("N.O.L.") or a credit carryforward is a tax position taken on a tax return, the use of the N.O.L. or credit carryforward in the carryforward year is not reported on Schedule UTP if the corporation previously reported the tax position that created or added to the N.O.L. or credit carryforward on Schedule UTP.

Once reportable tax positions are identified, they must be ranked by size and reported in order from greatest to least material. The amounts involved for each tax position need not be reported anywhere on Schedule UTP. The ranking of each tax position is determined on an annual basis and is the amount of U.S. Federal income tax reserve recorded for that position.

"An unfettered exercise of power can be challenged not only on the grounds laid down by the Federal Court in the **BP Canada** ***case but also on the basis that a demand violates the general principles of natural justice."***

Finally, a concise description should be given of the tax position. This entails a very brief description of the relevant facts and information that can be reasonably expected to apprise the I.R.S. of the nature of the issue. The description should not include an assessment of the risks for the corporation or an analysis of legal authorities for or against the tax position in the return.

CONCLUSION

When Schedule UTP was first announced by the I.R.S. in 2010, Canadian tax advisers looked with disbelief at the transparency obligations imposed on applicable U.S. corporate taxpayers. Eight years later, the C.R.A. has won court cases giving it wide powers to require a taxpayer to produce documents relevant to identify issues for the year under examination. In comparison to U.S. practice, an unfettered exercise of power can be challenged not only on the grounds laid down by the Federal Court in the *BP Canada* case but also on the basis that a demand violates the general principles of natural justice. In the U.S., Schedule UTP shines a bright light on issues that were of concern at the time a set of audited financial statements were prepared. Access to workpapers, however, is limited to situations where factors suggest that corporate management has an appetite for aggressive tax planning.

O.E.C.D. ON DIGITAL BUSINESS – SERIOUSLY?!

Author
Christian Shoppe

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Christian Shoppe s a partner at Deloitte Deutschland, where his practice focuses on transfer pricing for German-based multinational groups.

O.E.C.D. ON DIGITAL BUSINESS – SERIOUSLY?!

On February 13, 2019, the O.E.C.D. issued a discussion draft addressing the tax challenges of the digitalization of the economy[1] and asked for feedback – in a shockingly brief timeframe – by March 1. Although the deadline is now generously extended to March 6, the draft itself is nothing to scoff at. Tax administrations and multinational enterprises ("M.N.E's.") should take this very seriously. Even organizations that do not the typically consider themselves digital businesses may be affected. Given that digital business was one of the first sectors identified by the B.E.P.S. Project, the current progression is troubling.

The draft has two *three* major sections:

1. **The Old Part.** The first provides for revised income allocation based on new nexus rules. In essence, the activity of a user, a local market intangible, or a significant economic presence should attract profits and thus taxes.

2. **The New Part.** The second provides for either a minimum taxation concept, following the global intangible low-taxed income ("G.I.L.T.I.") rules introduced in the U.S. from 2018 onwards, or transactional deduction barriers based on the level of taxation on the other end of the transaction.

3. **The Silent Part.** Actually, there are only two sections in the O.E.C.D. draft. Although it talks about base erosion payments, the draft does not dedicate a section to this topic and is expressively silent on the approach introduced by the U.S. – the base erosion anti-abuse tax ("B.E.A.T.")

PART ONE – TOTAL DISASTER

The starting point is the notion that U.S. digital giants should pay taxes in other countries. This is contrary to the typical arm's length standard, insofar as functions, risk-taking, and assets are typically centralized and profits and taxes should arise where the substance sits. Granted, this is not the reality when we remember the Cayman Islands. However, this is a U.S. problem in the end and one partially solved by G.I.L.T.I.

The ideas contained in the first part of the draft are meant to allow arbitrary taxation with no real local contribution. Take for example the local customers. If the headquarters performs the majority of the development, enhancement, maintenance, protection, and exploitation of intangibles ("D.E.M.P.E.") functions under the current

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[1] O.E.C.D., "OECD Invites Public Input on the Possible Solutions to the Tax Challenges of Digitalisation," press release, February 13, 2019.

concept, the entitlement to the profit should reside with the headquarters. This is now supposed to be turned on its head, so that the location of customers should give rise to taxation on the profit – just because they sit in the country (a tremendous simplification).

This is nice for other economically developed O.E.C.D. members *vis-à-vis* the U.S. However, tax administrations in China, India, and other locations are waiting for this role to turn towards them. They would be happy to consider a local customer, supplier, or other economically important "contribution" to allow for income allocation. Hence, this first set of ideas, if it becomes real, will backfire.

Moreover, it will spill over to the traditional economy. For example, take a traditional consumer business running a limited risk distributor ("L.R.D.") abroad. Following the O.E.C.D. framework, the local tax administration notifies the business that it benefits from online reviews, local customers, and the importance of the local market. Now, the business must take steps to enact a profit split.

This leads us to the next problem: How to perform a profit split without traditional anchor points and without any reference to the arm's length principle? The answer is by relying on a largely non-functional mutual arbitration network.

Whether you are in a government, in a digital business, or even in a traditional economy, now is the time to eliminate the idea of "contribution." Otherwise, the ultimate result could be the arbitrary taxation of profits, anywhere in the world.

PART TWO – ADMINISTRATION WITH LITTLE EFFECT

The two main ideas in the second part of the draft (G.I.L.T.I. and deduction barriers) have one thing in common: a massive increase in administration. For 15 years, people have been saying that the job of a tax advisor will soon be obsolete, as machines will take over thanks to digitalization. However, the opposite seems to be coming true. Because of digitalization – or at least the taxation of the digital economy – the job will be safe.

In the case of G.I.L.T.I., the income of all subsidiaries must be determined according to the location of the headquarters and generally accepted accounting principles ("G.A.A.P."). This requires a lot of manual work.

In the case of deduction barriers, the following considerations must be made: Who is going to carry the client over the bar? Who will organize the proof of taxation? Who will assess the effective taxation?

Good news for the tax advisor, as can be seen now in the U.S., where modelling became a new business and prices for certain tax advice rose after tax reform. Bad news for M.N.E.'s that are subject to compliance regulations everywhere and struggling to concentrate on their business.

From a tax justice perspective, the proposals seem reasonable and may ease some pressure on governments. It makes sense to take out aggressive structuring with such measures. It is doubtful, however, that there will be much of a financial impact after M.N.E.'s restructure their transactional and value chain models.

From an economic perspective, there are downsides. Not all countries would follow the G.I.L.T.I. approach and headquarters suffering as a result of the G.I.L.T.I. provision may be interested in relocating to countries without controlled foreign corporation ("C.F.C.") rules. A deduction barrier, on the other hand, is nothing more than a tariff on intangibles. The world seems to have forgotten the value of free trade.

PART THREE – WHAT ABOUT B.E.A.T.?

The O.E.C.D. paper does not address B.E.A.T. Neither did it exist in U.S. tax reform plans until it was introduced one week before the tax reform was enacted. Nevertheless, it is important to keep in mind. The B.E.A.T. is easy to implement and leads to effective double taxation that most likely cannot be resolved.

The danger is that this easy solution for tax administrations leaves all problems with the taxpayer. B.E.A.T. is easy to implement and easy to calculate. It brings "justice" to administrations fighting base erosion. It has a limited risk of facing mutual arbitration between countries or other countries wanting to participate in taxing home country profits. All in all, this approach only leads to additional tax revenues with no downsides for the tax administration. For taxpayers facing double taxation, the problems abound.

CONCLUSION

Part one is a dinosaur from 2013 in a world where much has changed. Tax reform in the U.S. brought the country some relief from a justice viewpoint. European governments hopefully realize that such approaches fall back on them.

Regrettably, part two is relatively likely to be enacted. Germany has already enacted a license deduction barrier and the Finance Minister expressed his approval of the G.I.L.T.I. approach. One can envision the crazy world that will arise when countries enact G.I.L.T.I. rules and deduction barriers at the same time. An entire article could be devoted to a deduction barrier case for a subsidiary that makes payments to another M.N.E. subject to two G.I.L.T.I. regimes and applies the U.S. tax on foreign-derived intangible income ("F.D.I.I.") plus immediate depreciation in the context of group taxation.

Finally, one should not rule out the silent part three. Although not on the official agenda, M.N.E.'s can expect to be beaten by the B.E.A.T. in countries other than the U.S. When discussing the O.E.C.D. proposal, it might make sense to push for a G.I.L.T.I. or transactional deduction barrier approach in order to avoid the B.E.A.T. However, this form of taxation is a relatively logical consequence in cases where the O.E.C.D. project falls short of its taxation goals.

TAX AUTHORITIES EYE GSK-HUL MERGER: COULD ATTRACT TAX ON LONG-TERM CAPITAL GAINS AND BRAND TRANSFER[1]

Authors
Sanjay Sanghvi
Raghav Kumar Bajaj

Tags
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India
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Trademark

Sanjay Sanghvi is a Tax Partner with Khaitan & Co in Mumbai, India. Sanjay is a qualified chartered accountant and a lawyer with over 21 years of experience in domestic and international tax advisory and litigation.

Raghav Kumar Bajaj is a Principal Associate at Khaitan & Co. and a member of the Institute of Chartered Accountants of India.

GSK Consumer Healthcare India ("GSK India") is in the process of merging with Hindustan Unilever Ltd ("HUL") in the biggest deal in India's consumer packaged goods space. The proposed all-stock deal values GSK India at around I.N.R. 31,700 crore,[2] or close to U.S. $4.5 billion. Each shareholder of GSK India is likely to get 4.39 shares of HUL per share.

Given the size of the deal, the Indian income tax authorities have already begun dissecting its structure and mechanics to identify or assess any tax obligations resulting from the proposed merger.

STOCK ACQUISITION

While the merger may be "tax neutral" (subject to the fulfillment of prescribed conditions under the Income Tax Act, 1961), the shareholders of GSK India who will receive shares of HUL after the merger may be exposed to a 10% long-term capital gains tax upon a subsequent sale of the HUL shares received in the merger. This tax outcome must be taken into account.

This is, effectively, how mergers are taxed: exemption at the merger stage and subsequent taxation when shareholders subsequently sell the shares they receive.

BRAND TRANSFER

Apart from the stock, the deal also entails an offshore transfer of the Horlicks brand from GSK India's foreign shareholder, GSK PLC, to Unilever PLC, HUL's foreign shareholder.

The Indian tax treatment of the transfer of a brand between two foreign companies is a contentious tax issue in India, and the tax exposure likely will depend primarily on the situs of the brand and related aspects.

According to §9 of the Indian Income Tax Act, 1961, all income accruing or arising, directly or indirectly, through the transfer of a capital asset (*e.g.*, brands and trademarks) situated in India is deemed to accrue or arise (*i.e.*, to be earned) in India for tax purposes.

In the case of *CUB PTY Ltd. (formerly known as Foster's Australia Ltd) v. Union of India*, the ruling of the Delhi High Court supports the idea that if the owner of a

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1 This article first appeared on Moneycontrol.com.

2 In India, the term crore is used as a shortcut reference to 10 million. Thus, I.N.R. 31,700 crore equals I.N.R. 317 billion.

brand is not located in India, its situs should be regarded as outside India. Thus, the transfer of the brand should not be taxable in India.

However, since most of the value for the Horlicks brand is derived from India, the Indian tax authorities may take a position that the value of the brand is primarily derived from India. If this position is raised and successfully maintained by the Indian tax authorities, all or most of the gain realized from the transfer would be taxable in India. As in all tax controversies, much depends on the facts of the case.

However, given the value of the deal will lead to the creation of goodwill in HUL's books, HUL may be able to mitigate its tax outcome in the subsequent years by amortizing that goodwill on a year-over-year basis. Having said this, "allowability of depreciation" (which is a tax-deductible expense) is often looked at differently by taxpayers and tax authorities. While there are judgments to support HUL's possible claim for depreciation deductions, the tax authorities likely would dispute the claim, if history holds true. Should HUL succeed in a claim for depreciation, it would be an added advantage for the company.

It is anticipated that royalties will be paid by HUL for the use of the brand. This will contribute to additional tax controversy. In principle, the royalty will be deductible, but the amount of the deduction is a factual issue, ripe for controversy. The amount of the deduction is capped by arm's length concepts. Here, views typically differ between that authorities and taxpayers. To some extent, it is mitigated, as the amount paid under the license agreement would be taxable in India and subject to withholding tax obligations for HUL.

CONCLUSION

India's M&A sector has been picking up swiftly this year, allowing shareholders to unlock value with billion-dollar deals like Flipkart-Walmart, and now GSK-HUL. Companies and shareholders are looking for more operational synergies and strategic acquisitions, and they are willing to pay big-ticket prices for them.

One hopes that the parties involved will carefully examine and evaluate the income tax aspects of these deals, as any exposure on the income tax front can impact the deal dynamics. The Indian tax authorities have already begun to scrutinize the HUL-GSK India deal, and only time will tell whether it will be smooth sailing on that front.

TRUST REGULATIONS AND PAYMENT SERVICES: DUTCH LAW IN 2019

Author
Lous Vervuurt

Tags
Payment Services
Trust Services
Director Services

Lous Vervuurt, an attorney at law at Buren N.V. in Amsterdam and the Hague, the Netherlands, specializes in business law and financial law, advising multinationals, listed companies, investment companies, and investment institutions. Lous is a member of the Board of Representatives of the Dutch Bar Association.

Recently, Dutch legislators introduced a number of amendments to the Dutch financial regulatory environment. Two important changes are the new Act on the Supervision of Trust Offices 2018 (*Wet Toezicht Trustkantoren 2018*, or "W.T.T. 2018") and the implementation of the second Payment Services Directive ("P.S.D. II") into[1] Dutch law.

W.T.T. 2018

On January 1, 2019, the Act on the Supervision of Trust Offices was repealed and replaced by W.T.T. 2018. W.T.T. 2018 regulates the licensing and market conduct of Dutch trust offices (*trustkantoren*).

Under the new Dutch law, a trust office is defined as a legal entity, partnership, or natural person that provides one or more trust services on a commercial basis, whether or not in conjunction with other persons, legal entities, or partnerships.

The definition of trust services includes, *inter alia*, the following activities:

- Function as a managing director of a legal entity or as a partner of a partnership, on the instructions of a natural person or legal person that does not belong to the same group of companies as the managing director or partner.
- Provide domiciliation services (including a mailing address and/or physical address) for natural persons, legal persons, or partnerships in conjunction with one or more of the following services:
    - Providing legal advice
    - Arranging for the filing of tax returns and ancillary services
    - Providing services in connection with the preparation, review, or auditing of annual financial statements
    - Recruitment of directors for a legal person or partnership
- Make use of conduit companies (*i.e.*, legal entities that belong to the same group of companies as the principal but are used to provide trust services) on behalf of a client.
- Function as a trustee on the instructions of a natural person or legal person that does not belong to the same group of companies as the trustee.

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[1] Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC.

Market for Trust Services

Europe is an important market for trust offices. Approximately 57% of trust offices worldwide are domiciled in Europe, primarily servicing internationally operating corporations. The Netherlands is a big market for trust services due to the favorable business climate in the country. In the Netherlands, approximately 3,500 people are engaged in providing trust services, and they service approximately 20,000 companies. Most trust officers are highly qualified, having university-level educations.

Nonetheless, the Dutch legislator is of the view that providers of trust services enable international groups to carry out abusive tax plans. Dutch companies were involved in some of the structures revealed in the Panama Papers and the Paradise Papers. Those trust companies usually did not meet in person with corporate clients and their ultimate beneficial owners. Instead, they relied primarily on written instructions from law firms and tax advisers.

As the Netherlands has concluded a fair number of tax treaties, tax-driven structures were often used in international planning – and frequently involved offshore jurisdictions. Increasingly these structures were aimed at providing as little transparency as possible through a daisy chain of asset-protection structures. Hence, a need existed to tighten regulations and intensify supervision.

Licensing Trust Services

As under prior law, W.T.T. 2018 prohibits anyone with a seat in the Netherlands from providing trust services in the pursuit of a profession or business without a license from the Dutch Central Bank ("D.N.B."). A similar prohibition applies to anyone with a seat outside the Netherlands to provide trust services in the pursuit of a profession or business from that home country into the Netherlands or from a branch office located in the Netherlands without a license from the D.N.B.

The prohibition does not apply to natural persons, legal entities, or partnerships who are engaged in providing management and organizational services on an interim basis (*e.g.*, an interim manager), insofar as these activities qualify as trust services.

Financial legislation within the E.U. and the European Economic Area ("E.E.A.")[2] is harmonized. All national legislation regarding banking services, investment services, and institutions for collective investment has been based on either E.U. directives or E.U. regulations. In comparison, the regulation of trust services is based on local law. This means that trust offices with a license to provide similar services in their home country cannot make use of a passporting regime under which a license in one member country enables the holder to operate in all member countries, as is common for most financial services. A company licensed to provide trust services in a member country outside the Netherlands must apply for a full license with the D.N.B. in order to operate from a base in the Netherlands.

W.T.T. 2018 contains a reciprocity provision allowing the Dutch legislator to designate states that have adequate supervision so that trust offices in those states may perform their services in the Netherlands without procuring a license from the D.N.B. Nonetheless, no designation has yet been made yet.

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[2] The E.E.A. is comprised of the member states of the E.U. plus Liechtenstein, Norway, and Iceland.

Changes to Dutch Law under W.T.T. 2018

W.T.T. 2018 provides measures to (i) strengthen the integrity and professionalism of trust offices, (ii) improve client identification procedures, and (iii) extend the administrative instruments of the supervisory authority (*i.e.*, the D.N.B.) to enhance supervision and enforcement.

Organization of Trust Offices

With regard to strengthening integrity and professionalism, the main provisions adopted in W.T.T. 2018 are as follows:

- In order to obtain a license from the D.N.B., a trust office with seat in the Netherlands must be organized in the form of a public or private limited liability company under Dutch law or a *Societas Europaea*, which is a public limited liability company that can operate in different European countries using a single set of rules. Natural persons are no longer eligible for a license under W.T.T. 2018.
- A trust office must have a minimum of two people who are charged with the day-to-day policy making within the trust office to safeguard continuity, quality of service, and general governance.
- Each trust office must appoint a compliance officer. This function cannot be outsourced, as was allowed under prior law.

Client Identification

With regard to client identification procedures, the main provisions adopted in W.T.T. 2018 are as follows:

- Specific rules have been introduced regarding the provision of services to specified legal entities, including partnerships and trusts. In addition, rules apply to each specific trust service that is provided to a client.
- The concept of ultimate beneficial owner is expanded, thereby requiring a trust office to go beyond the formal control structure and examine the structure of *de facto* control.
- A trust office may no longer rely on client identification procedures carried out by an accountant, tax advisor, lawyer, or civil law notary; the trust office must independently carry out its client identification.

"The concept of ultimate beneficial owner is expanded, thereby requiring a trust office to go beyond the formal control structure and examine the structure of* de facto *control."

Segregation of Trust Services from Tax Advice

A specific prohibition has been adopted under which trust services cannot be provided if they relate to the implementation of tax advice given to the client by the trust office itself or by a natural person, legal person, or other entity forming part of the same group of companies as the trust office.

Expansion of Trust Services

The Decree on the Supervision of Trust Offices 2018 (*Besluit Toezicht Trustkantoren 2018*), promulgated under W.T.T. 2018, expands the definition of "trust services" to

include acting as an attorney in fact on the basis of a power of attorney, insofar as such power of attorney extends to exercising general managerial powers for the company receiving the service.

IMPLEMENTATION OF THE PAYMENT SERVICES DIRECTIVE II IN DUTCH LAW

In December 2018, the Dutch senate approved draft legislation transposing P.S.D. II into Dutch law. As of February 19, 2019, both the legislative proposal for P.S.D. II and the decree to implement P.S.D. II have entered into force. Most terms of P.S.D. II have been implemented into the Dutch Act on the Financial Supervision (*Wet op het financieel toezicht*, or the "A.F.S.") whereas certain terms have been implemented into Book 7 of the Dutch Civil Code (*Burgerlijk Wetboek*). P.S.D. II should have been implemented in the legislation of all E.U. Member States by January 13, 2018, and the Dutch legislator missed that deadline. This is not the first time that the Netherlands implemented E.U. directives on a delayed basis.

What Is P.S.D. II all About?

P.S.D. II is the replacement for the first Payment Services Directive ("P.S.D. I"),[3] which regulates payment services and payment service providers throughout the E.U. and the E.E.A. The goal of the P.S.D. I was to enhance competition within the E.E.A. and to facilitate participation in the financial sector. Special focus was placed on the creation of a level playing field with respect to consumer protection and the rights and obligations of payment services providers and their customers/users. P.S.D. I introduced a new category of payment services providers: the payment institution.

Payment services are defined as[4]

- services enabling cash to be placed on a payment account as well as all operations required for operating a payment account,
- services enabling cash withdrawals from a payment account as well as all operations required for operating a payment account,
- execution of payment transactions, including transfers of funds on a payment account with the user's payment service provider or with another payment service provider (including but not limited to execution of direct debits, execution of payment transactions through a payment card or a similar device, and execution of credit transfers),
- issuing of payment instruments and/or acquiring of payment transactions,
- payment initiation services, and
- account information services.

The last two services are new in P.S.D. II and are, as of the implementation of P.S.D. II into Dutch law, subject to an authorization requirement.

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[3] Directive 2007/64 EC.

[4] As mentioned in Annex I to P.S.D. II.

Changes to Dutch Law under P.S.D. II

A brief overview of certain major changes imposed by P.S.D. II is given below. These changes have been recently enacted into Dutch law. Generally, most have been published in the *Official Journal of the European Union*. The scope of account information services may create opportunities with respect to financial services, costs savings, and marketing. However, this may expose consumer's personal data and financial information.

Two-Factor Authentication

Strong Customer Authentication ("S.C.A.") under P.S.D. II requires that businesses use two-factor authentication for verifying online payments from accounts or for initiating electronic payment transactions (*e.g.*, through credit cards). As of September 14, 2019, transactions that do not meet the new authentication requirements and do not qualify for an exemption may be declined.

Two-factor authentication is defined as a combination of two out of three possibilities:

- "Something you know" (*e.g.*, password, passphrase, pin, secret fact)
- "Something you own" (*e.g.*, mobile phone, wearable, smart card, token)
- "Something you are" (*e.g.*, fingerprint, facial features, voice patters, DNA signature)

This means that credit card payments that make use of the card number and the Card Verification Code ("C.V.C.") will not be sufficient in the future.

One Leg Transactions

"One leg" transactions are transactions that are executed partly within the E.E.A. and partly outside of the E.E.A. These transactions fall within the scope of P.S.D. II. However, P.S.D. II legislation only covers the European part of the transaction. Entities established within the E.E.A. will be subject to a license requirement (or should register for an exemption), irrespective of the country to which payments are made. Transparency and conduct rules apply only to payments that are executed within the E.E.A. in an official currency of one of the E.E.A. countries.

Payment Initiation Services

Payment initiation services are made for use by holders of an account that is manageable online. Banks must grant third parties access to their customers' payment accounts in order to initiate payments by such customers. Payment initiation service providers may, subject to approval of the account holder, ask the bank to execute a payment order on behalf of the account holder, and the bank will process the order. These services are a new manner of making online payments and offer an alternative for credit card payments or payments through PayPal.

Account Information Services

Under P.S.D. II, banks must provide third parties with access to the payment accounts of their customers in order to access the account holder's payment data. These account information providers will be in the position to collect payment data and compile overviews and payment profiles for their customers.

This is particularly interesting for fintech companies. If a consumer grants a third party permission to analyze their personal payment data, that firm can collect payment data from the bank and provide specific reports. Fintech companies could combine the reports in an app that connects with a bank account, categorizing all receipts and expenses.

A mortgage service provider may not need paystubs if it can directly access salary details of a prospective customer.

In addition, a consumer may be able receive tailored marketing messages based on a payment profile. An example is a digital message from an insurance company advertising lower rates than currently paid for existing insurance.

While many see account information services as a miracle for companies engaged in marketing activities, these services can also help consumers gain insight into spending patterns in order to make better financial decisions through a digital budget planner. The former may be viewed as bad from a consumer protection viewpoint, and the latter may be viewed as good from an empowerment viewpoint. This type of data is easier to obtain using account information services, as opposed to personally reviewing and analyzing payment details.

Personal Data Protection Matters

With the newly created possibilities to access account data, privacy issues are of the utmost importance. Parliament has taken time to address account holder privacy and the processing of financial and personal data. Clearly, the gathering of payment data and personal data is a sensitive matter. Therefore, one of the most important provisions in P.S.D. II is that without explicit consent of the customer, no payment service provider may obtain access to the customer's personal data. This applies to all parties that have access to financial data of consumers, including banks, payment initiation service providers, and account information providers.

"Dutch banks are asked to provide their customers with a list of the payment services providers to which they have given explicit consent to access payment and account data."

Consent must be given explicitly. Customers must have the right to easily withdraw consent at any time. Although no standardized form has been provided to obtain consent, the form used by parties having access to financial data must be request consent clearly and unambiguously. Tacit consent or pre-ticked boxes will not qualify as explicit consent.[5] Consent must be given for each payment service, and if consent is given for a specific purpose, such consent is not deemed to apply to other parts of the contractual relationship between the payment service provider and the consumer. To illustrate, if a consumer has given explicit consent to a payment initiation service provider, this will effectively lead to a payment order to the bank. This consent cannot be revoked. However, if a consumer has given their consent for repeated payments to the same beneficiary, the consumer must have the right to contact the payment initiation service provider to withdraw that consent.

Consumers are not obligated to make use of payment initiation services. However, if those services are the only form of payment for online stores, they will not be able to buy products from those online stores.

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[5] These provisions are consistent with the E.U.'s General Data Privacy Regulation ("G.D.P.R."), which came into effect last year. For more on the global scope of the G.D.P.R., see "G.D.P.R. Is Imminent – Is Your U.S. Business Prepared?" *Insights* 5, no. 4 (2018).

Dutch banks are asked to provide their customers with a list of the payment services providers to which they have given explicit consent to access payment and account data.

Regulatory Supervision

Several regulatory bodies in the Netherlands are empowered to oversee P.S.D. II matters. These include the D.N.B., which oversees the provision of financial services; the Authority for the Financial Markets, which oversees the stock exchanges; the Dutch Data Protection Authority; and the Dutch Authority for Consumers and Markets.

CONCLUSION

Europe is moving towards greater regulation and oversight of financial services providers. W.T.T. 2018 and P.S.D. II are two examples. The former establishes standards for the provision of trust services and the latter introduces, though authorized, access to financial information of consumers. From a policy standpoint, both initiatives raise the standard of professionalism for gatekeepers to corporate structures and providers of financial services.

STRATEGIES FOR FOREIGN INVESTMENT IN INDIAN START-UPS

Authors
Raghu Marwah
Anjali Kukreja

Tags
India
Start-Ups

CA Raghu Marwah is Managing Partner at R.N. Marwah & Co LLP in New Delhi. He is experienced in the field of international tax with a keen interest in start-up advisory and corporate finance.

CA Anjali Kukreja is a manager at R.N. Marwah & Co LLP with experience in the fields of international, corporate, and direct tax and an interest in start-up tax issues.

Foreign investment in Indian start-ups offers significant opportunities for investors who understand their options. This is especially true for investment in technology start-ups developing artificial intelligence and consumer facing apps. Various investment avenues available to nonresidents are outlined in the paragraphs below.

INVESTMENT ENVIRONMENT

Indian start-ups have begun attracting nonresident high net worth individuals and family offices in significant numbers. These groups represent a large portion of the $38.3 billion garnered by Indian start-ups in over 1,000 deals during 2018.

In particular, wealthy business families have been promising supporters of Indian start-ups. These families often come with significant expertise in the industries where they invest and are more flexible in their exit strategies than venture capitalists, funds, and other investors. This has often resulted in nonresident individuals and families owning prominent and profitable Indian start-ups that were considered risky in their early stages.

PURCHASING SHARES AND DEBT

Nonresidents can invest directly in start-ups by subscribing to shares (equity or compulsorily convertible preference shares) or debt issued by the start-up. During the tenure of these investments, nonresident investors would continue to receive income in the form of dividends or interest to the extent of free cash.

Dividends paid by Indian companies are subjected to Dividend Distribution Tax ("D.D.T.") at the company level under Section 115-O of the Indian Income Tax Act, 1961("I.T.A.") and are tax-free in the hands of shareholders. Since individual investors do not directly incur the tax, it may be difficult for an individual to claim foreign tax credit relief in the home country for D.D.T. imposed on dividends without further analysis of the D.D.T. under home country tax concepts. Interest would be taxed under Indian tax law at the individual rate applicable to nonresidents, subject to relevant tax treaty relief.

Upon the sale of these shares or controlling rights, nonresidents would be liable to pay capital gains tax under domestic law, subject to any relevant tax treaty benefits. Under domestic law, the capital gains tax rate is dependent on the holding period. Where the holding period is more than 36 months (assuming the shares of the Indian start-up are unlisted), gains are taxed as long-term capital gains at the rate of 10% (plus applicable surcharge and cess) without the benefit of foreign currency conversion or cost indexing under Section 112(1)(c) of the I.T.A. Capital receipts would be received by nonresident H.N.W.I.'s (net of tax). Further, nonresidents

would be required to obtain a permanent account number ("P.A.N.") from the Indian tax authorities and file an Indian income tax return with respect to the transaction.

CAPITAL CONTRIBUTIONS IN LIMITED LIABILITY PARTNERSHIPS

Nonresidents can also invest in Indian limited liability partnerships ("L.L.P.'s") by way of capital contributions.

Income earned by an Indian L.L.P. would be taxed in hands of L.L.P. at a rate of 30% (plus applicable surcharge and cess). Any distributions to nonresident partners would be tax-free.

In the case of a change in shareholding, there may be no exit tax in the hands of the outgoing partner.

INVESTING THROUGH FUNDS

Nonresidents can incorporate alternate investment funds ("A.I.F.'s") registered with the Securities Exchange Board of India ("S.E.B.I.") (in the form of a company, trust, L.L.P., or body corporate) for the purpose of investing in eligible start-ups.

A.I.F.'s can take several forms:

- Category I, Subcategory I A.I.F.'s enjoy passthru status. That is, any income earned by these funds is tax-exempt in the hands of the fund under Section 10(23FB) of the I.T.A. and taxable in the hands of the nonresident investor under Section 115U of the I.T.A. Neither D.D.T. nor withholding tax would be applicable on the distribution of income to the nonresident investor.
- Other A.I.F.'s registered as Category I & II (also known as "Investment Funds") enjoy passthru status for income other than business income. That is, business income would be taxable in hands of the A.I.F. under Section 115UB of the I.T.A. and the distribution would be tax-free in the hands of the nonresident investor. All other income (other than business income) would be exempt for the A.I.F. under Section 10(23FBA) of the I.T.A. and, hence, taxable in the hands of the nonresident investor. No D.D.T. would be applicable on the distribution of income to the nonresident investor.
- Income from Category III A.I.F.'s does not enjoy passthru status. Income would be taxed at the rates applicable to the entity. For instance, if an A.I.F. is incorporated in the form of a business trust, its taxation would be governed by the income tax provisions applicable to business trusts. D.D.T. or withholding tax, as per the I.T.A., would be applicable on the distribution of income to nonresident investors.

In all these forms, the investor can exit at any time by transferring its interest in the A.I.F. and paying tax on the capital gains on the sale, subject to relevant tax treaty relief. Nonresident investors are entitled to claim tax benefits under a relevant tax treaty during the investment tenure and on exit, if the treatment is more favorable than the I.T.A. provisions.

INVESTING THROUGH BUSINESS TRUSTS

Nonresident individuals can set up business trusts that, in turn, invest in eligible start-up companies.

On the tax front, any interest and dividend income is exempt under Section 10(23FC) of the I.T.A. in the hands of the trust but is taxable in the hands of the investor as per applicable tax rates. Capital gains, business income, or other income is taxed in the hands of the trust in accordance with Section 115UA of the I.T.A. and, hence, is tax-free on distribution to the nonresident investor.

Upon a transfer of units in the business trust, the nonresident would be liable for tax on the capital gains, subject to the relevant tax treaty relief.

CONCLUSION

Investment in Indian start-ups is a high-risk, high-reward activity. The space offers a potential win-win for foreign investors looking to multiply investments with high rates of return and for the country as a whole, with Indian start-ups providing jobs, digitalization, and innovations that contribute to a vibrant economy and produce a positive social impact.

As an investor, there is always a question of whether to become involved in day-to-day management of the business or to let the concept owner take the lead. In either case, the ease of entry and exit, clear Indian tax laws, and availability of tax treaty benefits make investing in Indian start-ups a promising and lucrative opportunity for nonresidents.

AUSTRIA, FRANCE, AND ITALY TO INTRODUCE DIGITAL SERVICES TAXES

Author
Benjamin Twardosz

Tags
Austria
Digital Services Tax
E.U.

Benjamin Twardosz is admitted as an attorney-at-law and certified tax advisor in Austria and is a tax partner at CHSH Attorneys-at-Law in Vienna. He works at the Supreme Court in Austria and on tax litigation, international tax law, and transfer tax matters. He is the editor of a commentary on stamp duty and a handbook on appeals.

INTRODUCTION

The aim of a digital services tax is to subject companies offering digital services to taxation in the country where the service is provided. It is directed at use within a specific country and can affect search engines, video portals, or social media platforms selling advertising as it attempts to impose tax where the content is watched or clicked. Intermediary transport or accommodation, cloud computing, online gaming, and on-demand video services could also be subject to the tax, depending on how it is structured.

The general belief is that a digital services tax is directed at out-of-country providers of digital services, mostly based in the U.S. The logic is that out-of-country providers make huge profits in Europe but pay no tax there, whereas payments for digital services are often tax deductible by businesses in the countries where the services are used. A digital services tax is intended to change that equation.

After the European Commission proposal for a directive on the taxation of digital services was rejected, Austria and several other countries in the E.U. announced the unilateral introduction of digital services taxes. Such taxes raise a number of legal questions. This article addresses the commission proposal and questions raised by the unilateral approach that followed.

INTERNATIONAL TAXATION OF BUSINESS PROFITS

Non-European companies selling their goods or services to Europeans currently do not pay income tax on profits in Europe if the goods or services in question are not produced or performed in Europe and a taxable presence is not maintained in Europe. Nonetheless, they are subject to value added taxes, and if goods are sold in Europe, customs duties may be imposed. However, no customs duties are levied on digital services.

This reflects a basic concept of international trade: Corporate profits of a manufacturer that produces a product in one country and sells it for consumption or use in another country is generally taxed in the place of production. A similar rule applies to the provision of services performed in one country but consumed elsewhere. Thus, a German car manufacturer would not expect to pay corporate income tax on the sale of vehicles in the U.S., Africa, or South America in the absence of a taxable presence in those countries. (Typically, the German manufacturer sells to a distributor in the local country.) Similarly, an Austrian beverage producer does not pay Chinese tax on profits derived from the sale of beverages in China, and an Italian consultant does not pay Russian tax on profits earned by providing advice to

a Russian client. In the absence of a permanent establishment, a company in one country does not pay income tax in connection with the sales into a market located in a different country. The same is true for the performance of services in one country that benefits a consumer in a different country. In both instances, the location where activity occurs retains the principal right to impose income tax. The country where consumption occurs retains the right to collect turnover taxes and duties.

Bellwether U.S. companies such as Google, Amazon, Apple, and the like have paid little tax in the U.S. on global profits prior to U.S. tax reform at the end of 2017. While the U.S. was thought to have a global tax system in those earlier years, these companies engineered their facts and circumstances in a way that transformed the system into a territorial tax system. Only income from U.S. operations was taxed. Income from operations outside the U.S. was permanently deferred for financial accounting purposes and deferred indefinitely under tax law as long as repatriation events were avoided. This changed with the adoption of rules such as the mandatory deemed repatriation tax, the B.E.A.T. regime, and G.I.L.T.I.

However, the genie is out of the bottle as far as other countries are concerned. Developing countries and emerging economies, which historically did not have an administrative system in place to impose tax on a worldwide basis, determined that they are entitled to a share of the tax collected on income when profits arise from consumption of goods and services in their countries. The ability of industrialized nations to prevent developing countries from taxing these profits has sunset and with it the sanctity of the method of taxing business profits of a global enterprise.

THE E.U. AS A DEVELOPING COUNTRY

As far as digital services are concerned, the E.U. now appears to be in the process of adopting tax policies that were previously limited to developing countries. The vast majority of large digital service providers are based in the U.S. In this light, it makes sense from an E.U. perspective to collect consumption taxes related to the provision of digital services. Taxes on profits are not the right vehicle for raising tax revenue. E.U. countries that have adopted digital services taxes or are considering their adoption have focused on sales as the simple trigger for imposing tax. This means that customs duties and value added taxes are the mechanisms of choice. Limited constraints are imposed on the right of a country to impose a levy in connection with the sale of goods and services in the domestic market. In other words, the system of global taxation is in the process of being turned upside down in Europe in order to raise revenue from taxing companies that do not employ people who vote in local elections.

THE COMMISSION PROPOSAL

In March 2018, the European Commission proposed a council directive regarding an E.U.-wide digital services tax with the following features:[1]

- The tax would apply to revenues created from activities where users play a major role in value creation and which are the hardest to capture with current

[1] Proposal for a Council Directive on the Common System of a Digital Services Tax on Revenues Resulting from the Provision of Certain Digital Services, COM (2018) 148 final.

tax rules. This would include revenues generated from (i) selling online advertising space, (ii) the performance of digital intermediary activities allowing users to interact with other users, thereby facilitating the sale of goods and services between them, and (iii) the sale of data generated from user-provided information.

- Tax revenues would be collected by the Member States where the users were located and would only apply to companies with total annual worldwide revenues of at least €750 million and E.U. revenues of at least €50 million.
- Taxable revenues obtained by an entity in a tax period would be treated as obtained in a Member State if users of the taxable service were located in that Member State.
- The tax rate would be 3%.

During the second half of 2018, Austria held the presidency of the Council of the E.U. One of Austria's main goals at the time was to forge a consensus among the Member States regarding the adoption of an E.U.-wide introduction of a digital services tax. However, nothing came of this approach as no unanimity of views existed. Sweden, Denmark, Finland, Malta, and Ireland raised concerns regarding the proposal.[2] In addition, Germany expressed concerns that the proposal could intensify the trade conflict with the U.S.[3] and proposed a lighter version of the tax that would be restricted to online advertisements. France expressed similar views at the time.[4] Tax directives require unanimous consent in the E.U.,[5] and neither proposal was approved.[6]

UNILATERAL APPROACHES

The U.K. introduced a national digital services tax in 2018.[7] The French,[8] Italian,[9] and Austrian[10] governments now plan to enact separate national digital services taxes. In each instance, the tax is justified by the national government as a means of taxing profits of low-taxed foreign companies. However, the digital services taxes are consumption taxes aimed at a very specific, narrowly-defined economic sector.

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2 "EU-Digitalsteuer scheint *bis* Jahresende möglich," *Weiner Zeitung*, September 8, 2018.

3 "EU-Digitalsteuer: Die wichtigsten Fragen und Antworten," *Futurezone*, October 30, 2018.

4 "Deutsch-französischer Vorschlag für Digitalsteuer ist gestoppt," *Zeit Online*, December 4, 2018.

5 Article 113 of the Treaty on the Functioning of the European Union.

6 "EU States Fail to Agree Plans for Digital Tax on Tech Giants," *Financial Times*, November 6, 2018.

7 HM Treasury, "Digital Services Tax: Budget 2018 Brief," October 29, 2018.

8 "Frankreich führt ab 2019 Digitalsteuer im Alleingang ein," *Futurezone*, December 17, 2018.

9 "Italy Prepares to Introduce Web Tax Worth €114 Million a Year," *The Local IT*, November 27, 2017.

10 "Österreichische Regierung macht Ernst mit der Digitalsteuer," *DerStandard*, December 30, 2018; "Austria Ramps Up Push for EU-wide Digital Tax on Big Tech," *Financial Times*, July 15, 2018.

They are protectionist in nature, an approach currently in vogue internationally. No matter the spin given to these taxes by governments, consumers will bear the economic burden of these duties if the service providers pass the taxes on to the customers via the price. That is likely to occur when the provider has a monopoly, which more or less is the case for the specific companies that are targets of the digital services legislation.

While the introduction of protectionist measures may sound good to local voters, they often produce a backlash as individual countries focus on raising revenues by taxing foreign companies or the revenues generated by such companies as a result of local sales. Bad ideas are not one-way streets, and the concept of taxing foreign companies based on local advertising activity may be gaining traction in other sectors. European automobile companies, which are known to advertise globally, could be the next target.

To attack the trade impediments now under consideration by national governments, the O.E.C.D. seeks to find a worldwide solution for changing business taxation. The target date is 2020.[11] The U.S. is participating in this project to ensure that the final report will not be aimed solely at companies in the U.S. In that regard, the O.E.C.D. approach contrasts with the uncoordinated unilateral measures by individual states, which are aimed at specific foreign providers or industrial sectors. It is possible that the O.E.C.D. proposals will result in an increase of customs duties and value added taxes on imports.

"While the introduction of protectionist measures may sound good to local voters, they often produce a backlash."

THE AUSTRIAN LEGISLATIVE PROPOSAL

The Austrian government published a legislative proposal in April 2019. This proposal, which is yet to be reviewed and resolved upon by the Austrian parliament, provides for the following:

- The tax will apply to online advertising directed to Austrian customers and appearing on the devices of users with an Austrian I.P. address.
- The tax will be incurred by the online advertising service provider, and a self-assessment must be payed to the Austrian tax office on a monthly basis.
- The tax base will be the price for the online advertisement.
- The tax rate will be 5%.
- The tax will enter into effect as of January 1, 2020.[12]

E.U. LAW RESTRICTIONS

If individual E.U. Member States begin to implement consumption taxes unilaterally, E.U. law may be infringed upon. Turnover taxes, indirect taxes, and excise duties are harmonized across the E.U. Digital services taxes that amount to a flat percentage of sales can distort competition and infringe upon pan-E.U. fundamental freedoms. Such taxes must treat all market participants equally and not obstruct

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[11] "OECD: Löger sieht entscheidenden Fortschritt für globale Digitalsteuer," *APA OTS*, January 30, 2019.

[12] *Mayr*, Das neue Digitalsteuergesetz 2020, RdW 4/2019, 264.

cross-border services within the E.U., including fact patterns involving a U.S. company offering its services to Austrian, French, and Italian customers via a subsidiary in Ireland.

INTERFERENCE WITH DATA PROTECTION RIGHTS

U.S. companies that are taxed on the provision of services will be required to track where the user is located when services are used. This will lead to the creation of permanent records of the movement patterns of European customers in protection against claims of double taxation within the E.U. An open question is whether data protection rules will protect users against such data collection. At one level, data protection obligations do not apply if there is a statutory requirement to collect and store data related to the individual. At another level, the right to data protection may prevail over the obligation of a company subject to a digital services tax to comply with the tax law. In the crazy quilt pattern of domestic legislation that is likely to continue within Europe for a period of time, it would not be surprising for a government to argue that a services provider must destroy records showing place of use and then to argue for a penalty because of the absence of proper recordkeeping.

FOREIGN INVESTMENT AN U.S. REAL ESTATE – A F.I.R.P.T.A. INTRODUCTION

Author
Alicea Castellanos

Tags
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U.S.R.P.I.

Alicea Castellanos is the C.E.O. and Founder of Global Taxes LLC. She has more than 17 years of experience in U.S. taxation of individuals from around the world. Alicea specializes in U.S. tax planning and compliance for non-U.S. families with global wealth and asset protection structures that include non-U.S. trusts, estates and foundations that have a U.S. connection, as well as foreign investment in U.S. real estate property.

INTRODUCTION

Whether in an up or down economy, the U.S. is attractive for foreign investors. U.S. economic and legal transparency, as supported by appropriate legal protection and a predictable regulatory environment, further enhances the attraction for foreign investment. According to Henley & Partners,[1] a key concern for high net worth individuals ("H.N.W.I.") is unease over political and economic uncertainty, which continues to drive key investment decisions such as owning wealth in offshore structures. As a result, real estate has now become the third-largest asset class – with residential property being more sought-after than commercial property for those over 40.

Like anyone else who invests in real estate, foreign investors buying real estate in the U.S. must evaluate the terms and conditions of the purchase to determine if it makes sense in a particular set of circumstances. However, non-U.S. investors must evaluate an additional factor that will come into play when they dispose of the property, the Foreign Investment in Real Property Tax Act ("F.I.R.P.T.A.").

STARTING WITH THE BASICS

F.I.R.P.T.A. allows the U.S. to withhold income tax when a foreign person disposes of a U.S. real property interest ("U.S.R.P.I."). The disposition of a U.S.R.P.I. by a foreign person is treated as if the person were engaged in a U.S. trade or business, and gain or loss must generally be recognized on the transaction.[2] The disposition by the foreign person is subject to tax,[3] and the transferee (buyer or his agent) must withhold tax in the absence of certain exceptions and submit the appropriate tax returns.[4] The withholding tax is 15% of the net proceeds, typically the sales price less any sales commissions (10% for dispositions before February 17, 2016, and in limited cases involving lower cost residential properties). However, treaty exceptions may apply. The withholding obligation rests on the buyer or its agent and not on the foreign seller. This is because it is easier for the I.R.S. to collect tax from someone with a U.S. connection.

For purposes of this law, a "foreign person" includes a nonresident alien ("N.R.A."), foreign partnership, foreign trusts, foreign estate, or foreign corporation that has not

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1 Henley & Partners, "How Citizenship Planning is Providing Millions in Revenue and Increased Freedom for the Wealthy," (presentation, STEP New York 15th Annual International Estate Planning Institute Conference, New York, NY, March 15, 2019).

2 Code §§897(a), 87(b) and 882(a).

3 Code §§1, 11, and 55.

4 Code §1445 and related regulations.

made an election to be treated as a domestic corporation for F.I.R.P.T.A. purposes (*i.e.*, a Code §897(i) election).

As explained in Code §§897(c)(1) through (c)(4), a U.S.R.P.I. is any interest in real property and associated property located in the U.S. or the Virgin Islands and any interest in a domestic or foreign corporation defined as a U.S. real property holding company ("U.S.R.P.H.C."). A U.S.R.P.H.C. is defined as a domestic or foreign corporation that has U.S.R.P.I.'s that equal or exceed 50% of the total fair market value of its U.S. and foreign real property and any other assets used in a trade or business. There is an exception for stock regularly traded on an established securities market. Assets held by a partnership, trust, or estate are treated as being held proportionately by its partners or beneficiaries.

Withholding Requirements

The 15% withholding rule noted above, and explained in Code §1445(a), generally applies regardless of the amount of gain or loss attributed to the foreign seller. The net proceeds realized for withholding purposes include cash, fair market value of other property, and liabilities assumed by the buyer or to which the U.S.R.P.I. is subject.

Several exceptions to the general rule are provided under Code §1445(b). These include the following situations:

- The property is acquired by the buyer for use as a residence, and the purchase price is less than $300,000.
- The corporate stock of the seller is regularly traded on an established securities market.
- A non-publicly traded corporation furnishes an affidavit that the interest being disposed is not a U.S.R.P.I., and the transferee has no knowledge that the statement is false.
- An N.R.A. transferor furnishes the transferee with an affidavit stating, under penalty of perjury, that the seller is not a foreign person, and provides a U.S. Taxpayer Identification Number on such an affidavit (the transferee can accept such an affidavit as long as no knowledge exists that the statement is false.
- The transferor applies for and receives a qualifying statement from the I.R.S. that exempts the transaction from withholding. The I.R.S. has 90 days from the date of receipt of the application to process a response.

The transferee has 20 days after the transfer date to file Form 8288, *U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests*, and Form 8288-A, *Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests*, and submit the tax withheld. The I.R.S. will return stamped copies of the forms to the transferor (and withholding agent) to be attached to the tax return at filing.[5] If the transferor was not able to obtain a Taxpayer Identification Number by the transfer date, the transferee is still obligated to file Forms 8288 and 8288-A and submit the tax withheld by the prescribed due date.

[5] Treas. Reg. §1.1445-1(c).

The transferor may still receive credit for the amount of tax withheld by attaching substantial evidence of withholding to the return. The 15% withholding is not the amount of tax but merely a mechanism for the U.S. to ensure the collection of tax. This withholding does not relieve the seller from filing a U.S. tax return (*i.e.*, Forms 1040NR, 1120, or 1120F).

The rules are different if the seller is a domestic partnership, trust, or estate with foreign partners or beneficiaries. Code §1446 withholding tax applies to the effectively connected income ("E.C.I.") of a domestic partnership to the extent that it is allocable to foreign partners. Non-grantor trusts and estates have a withholding obligation upon the distribution of cash or property to a foreign beneficiary. The fiduciary must maintain a special U.S.R.P.I. account to withhold 37% of any distributions to a foreign beneficiary up to the balance of the U.S.R.P.I. account. If a grantor trust has a foreign owner, the fiduciary must withhold 37% of the gain realized by the trust on the disposition of a U.S.R.P.I., to the extent the gain is allocated to the foreign person. If a domestic trust or estate has an N.R.A. as beneficiary and disposes of a U.S.R.P.I., the fiduciary may be required to withhold tax on the share allocable to the N.R.A. beneficiary.[6]

"Form 8288-B must include Taxpayer Identification Numbers for all parties involved, otherwise it will be rejected."

Withholding Certificates: Rules and Exceptions

Withholding certificates are commonly called reduced withholding or exemption certificates. Application for such certificate is made on Form 8288-B, *Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests*. This form is filed when sellers claim to be entitled to nonrecognition treatment or exemption from tax. It is also filed when sellers are certain that they have a loss or that the 15% withholding obligation is greater than their maximum tax liability on the gain from the sale. Another filing instance that is less common occurs when the seller claims that the special installment sale rules described in Section 7 of Rev. Proc. 2000-35 allows for reduced withholding. This form can be filed by an N.R.A. or foreign corporation.

The most common reason for requesting an exemption is a withholding obligation in excess of maximum tax liability, described above. For this claim, the filer must attach the following information:

- A calculation of the maximum tax liability showing that the applicable tax on the sale of the property is less than the 15% withholding obligation
- Sales contracts showing the amount of sale (or an appraisal, if there is no contract)
- Either a closing statement, *H.U.D. Settlement Statement*, or sales contract showing the original cost of property, along with any receipts showing improvements made to the property[7]

Form 8288-B must include Taxpayer Identification Numbers for all parties involved, otherwise it will be rejected. However, if the transferor is applying for an individual Taxpayer Identification Number ("I.T.I.N."), the phrase "Applied for I.T.I.N." may be used in lieu of an identification number. Form 8288-B should be attached to a complete I.T.I.N. application and sent to the I.T.I.N. Operation in Austin, Texas.

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[6] Treas. Reg. §1.1445.5(c)(1)(iii)(A).

[7] Code §897(j).

Although either the buyer or seller can file this form, it is typically filed by the seller or the seller's agent. The withholding agent identified on Line 4a of the form should be the buyer or the buyer's agent. A U.S. mailing address is recommended for the withholding certificate for ease of delivery and tracking. This address does not need to be the same as the transferor's (Line 1) or transferee's (Line 2) address. If an interest in a U.S.R.P.H.C. is being transferred, the submission must include a share certificate showing the ownership percentage of the foreign seller of the U.S.R.P.H.C.

Foreign Person's Tax Filing Requirements

N.R.A.'s who have a direct investment in a U.S.R.P.I. must generally file income tax returns, except where they are engaged in a U.S. trade or business and the fair market value of the U.S.R.P.I. does not exceed $50,000. In addition, any person subject to Code §897(a), as noted above, or Code §1445 (regarding withholding tax on dispositions of U.S.R.P.I.'s) must pay the required tax and file a return.[8]

Dispositions that are taxable events are broadly defined and include the following:

- Sales, exchanges, distributions, tax-free exchanges, certain gifts, and so forth of U.S.R.P.I.'s
- Sales of interests in partnerships, trusts, and estates that have U.S.R.P.I.'s[9]
- Contributions to capital of a foreign corporation[10]

The following transactions generally are not taxable since U.S. tax is only deferred and not avoided:

- A distribution of a U.S.R.P.I. by a foreign corporation in liquidation or otherwise, if the distributee would be subject to U.S. tax on a subsequent disposition of the U.S.R.P.I. and there has been no tax-free increase in the tax basis of the U.S.R.P.I.[11]
- An exchange of a U.S.R.P.I. in a nonrecognition transaction for another ownership interest if the subsequent sale of such interest would be subject to U.S. tax and there has been no tax-free increase in the tax basis of such ownership interest[12]

The 15% F.I.R.P.T.A. withholding will be credited toward the ultimate tax liability and the excess, if any, will be refunded to the foreign person, unless the withholding was not sufficient to satisfy the tax. Early refunds of excess withholding tax can also be obtained by filing a tax return as soon as possible, if the taxpayer has no other income to report on the U.S. tax return. If this is desired, prior year tax return forms can be used to file a return for the current year as long as the prior year is crossed out and marked as the current year. If filing a final corporate return, taxpayers should include the words "Final Tax Return" at the top of the return.

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8 Code §§6039C(a), (b), and (d).

9 Code §897(g).

10 Code §897(j).

11 Code §897(d).

12 Code §897(e).

The gain derived from the sale of a U.S.R.P.I. under Code §897 is considered to be E.C.I. In general, the 30% branch profits tax applies to a foreign corporation's effectively connected earnings and profits. This tax is in addition to income tax.

However, there is an exception under Treas. Reg. §1.884-2T if the foreign corporation "completely terminates" all of its U.S. trade or business. In order to be considered to have completely terminated the U.S. trade or business for purposes of this exception, the following three prongs must be satisfied:

- The foreign corporation has no assets used in a U.S. trade or business as of the close of the year.
- Neither the foreign corporation nor a related corporation uses any of the assets of the terminated U.S. trade or business nor earnings and profits of the foreign corporation in the year of the termination in the conduct of a different U.S. trade or business for a period of three years following the close of the taxable year in which the termination took place.
- The foreign corporation has no E.C.I. during the period of three years following the close of the taxable year in which the termination took place.

This last item is especially relevant if foreign investors have plans to purchase a U.S.R.P.I. at a future date and do not intend to dissolve the foreign corporation. However, if corporate dissolution is chosen, in addition to filing the corporate return (*i.e.*, Form 1120-F), Form 966, *Corporate Dissolution or Liquidation*, must be filed as required under Code §6043(a). A certified copy of the resolution or plan of liquidation and dissolution and all amendments or supplements not previously filed should be attached to the Form 966.

A second exception from branch profits tax exists when the gain relates to the sale of shares of a domestic corporation that is a U.S.R.P.H.C.

I.T.I.N.

N.R.A.'s who have never filed a U.S. tax return or are unable to obtain a social security number must obtain an I.T.I.N. by filing Form W-7, *Application for IRS Individual Taxpayer Identification Number*, with the I.R.S. An I.T.I.N. will be needed in order to file for a reduced withholding certificate on Form 8288-B and to file the required return if they are to receive a credit for overpayment of taxes.

If an I.T.I.N. application is filed for the purpose of reporting the sale of a U.S.R.P.I. on Form 1040NR, then Box "b" (Nonresident alien filing a U.S. tax return) should be checked off. When filing Form W-7, it should be the first form attached, followed by the certified (in English) passport copy, and the Form 1040NR, including Copy B of Form 8288-A stamped (typically in red) by the I.R.S. Copy B of Form 8288-A is proof of withholding.

If an I.T.I.N. application is filed for the purpose of applying for a reduced withholding certificate on Form 8288-B, then Box "h" (Other, Exception 4 – Disposition by a foreign person of U.S. real property interest – third-party withholding) should be checked off. Again, when filing Form W-7, it should be attached first, followed by the Form 8288-B, including any schedules (discussed above). It takes the I.R.S. approximately six to ten weeks to process an I.T.I.N. application.

If one or more parties involved are foreign corporations and do not have an E.I.N., they can simply apply for one by filing Form SS-4, *Application for Employer Identification Number*.[13]

CONCLUSION

This paper has covered the basic procedures for complying with Federal tax withholding requirements under F.I.R.P.T.A. Any non-U.S. person planning to purchase a U.S.R.P.I. should consult with an experienced tax advisor to learn more about how the Federal rules and applicable state laws may apply to a particular transaction.

[13] Certain procedures for obtaining an E.I.N. have changed as of May 13, 2019. See "The Responsible Party – Changes Effective May 2019" in this edition of *Insights*.

THE IMPACT OF BREXIT ON GERMAN TAXES FOR PRIVATE CLIENTS AND NONPROFIT ORGANIZATIONS

Author
Andreas Richter

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INTRODUCTION

On March 29, 2017, the U.K. informed the European Council of its intention to leave the E.U. and began the exit process by invoking Article 50 of the Lisbon Treaty. The U.K. was scheduled to depart from the E.U. following the passage of a two-year notice period. However, as no agreement has been reached between the E.U. and the U.K., the departure date is now postponed until October 31, 2019.

Whether the E.U. and the deeply divided U.K. will reach a withdrawal agreement ("soft Brexit") by the extended deadline is anything but certain. There have been several failed attempts and no consensus exists within the U.K. If no agreement is reached on a regulated withdrawal and the E.U. rejects a further postponement, the result will be a "hard Brexit."

The key concern of a hard Brexit is that all tax privileges enjoyed by E.U. Member States will cease to apply to the U.K. as of the departure date. Nevertheless, grandfathering will maintain the status quo for taxpayers, as long as all tax-relevant actions are completed before Brexit. Brexit itself should not cause the creation of a retroactive tax liability on completed transactions. In comparison, if a withdrawal agreement is reached, there will be no relevant changes in the status of the U.K. within the E.U. until a phase-out period is completed. The U.K. will be treated as a Member State until the end of the phase-out.

The German legislature has not waited to act with regard to the forthcoming changes. For the different scenarios, laws have been passed to take into account the tax problems that could arise. The Tax Accompanying Act (*Brexit Steuerbegleitgesetz*) and the Brexit Transitional Act (*Brexit-Übergangsgesetz*) are of particular importance.

This article provides an overview of the consequences of a departure by the U.K. in a hard Brexit and a soft Brexit.

CONSEQUENCES OF LEAVING WITHOUT AN AGREEMENT

U.K. Relapse into Non-Member State Status

If an agreement is not concluded or postponement of the withdrawal fails, the U.K. will cease being an E.U. Member State after October 31, 2019. The E.U. fundamental freedoms will cease to apply and all E.U. or E.E.A. entitlements to tax benefits will terminate. German law will not provide unilateral rules to mitigate the consequences of Brexit as far as post-Brexit transactions are concerned.

Consequences for U.K. Nonprofits and Their Donors

In the past, non-German not-for-profit entities encountered difficulty in meeting the requirements for tax exemptions under Section 55 et seq. of the German Fiscal Code (*Abgabenordnung*). It was difficult for a non-German entity to provide the necessary evidence to establish a civic purpose, and foreign nonprofits and their donors failed in most cases. Consequently, the practical impact of a hard Brexit is likely to be limited for foreign nonprofits.

A hard Brexit will mean that nonprofits from the U.K., which are currently subject to limited tax liability, (in particular charities under English law) will no longer be exempt from German corporation tax. At the same time, donors will no longer be able to deduct charitable donations from their taxable income, and there is an increased risk that donations will be subject to gift taxes. In addition, the carrying value privilege will no longer be in effect when an asset is withdrawn and transferred to a charitable organization in the U.K. Under this privilege, the transfer of assets will not trigger recognition of hidden reserves equal to the difference between fair market value and the carrying value on the books of the transferor. Instead, the transfer and the donation will both be measured according to the carrying value plus V.A.T. The transfer will be valued at fair market value, hidden reserves will be triggered, and no deduction will be allowed.

Example 1

Facts: German company A-Co decides to transfer its current inventory of computers to an English nonprofit.

Result: Theoretically, before Brexit, the computers could be withdrawn at the carrying value, provided the nonprofit could prove its entitlement to a tax exemption. Hidden reserves would not be taxed and the donation would equal to the carrying value (plus V.A.T.). After Brexit, the withdrawal can only take place at partial value and no deduction would be allowed for the donation when computing taxable income.

“In the case of a hard Brexit, it will be imperative for German tax-privileged corporations that support recipient organizations in the U.K. to embed a fundraising clause in their statutes.”

In addition, the annual tax allowances of €2,400 and €700 for training leaders and volunteers will not be allowed.

In the case of a hard Brexit, it will be imperative for German tax-privileged corporations that support recipient organizations in the U.K. to embed a fundraising clause in their statutes within the meaning of the Section 58, Article 1, of the German Fiscal Code in order to avoid risks under charitable law. Admittedly, this has been and still is recommended for any cross-border promotion.

Consequences for Beneficiaries of Trusts

The German Foreign Tax Act stipulates that the income of a foreign family foundation is attributed to the founder or, alternatively, to the beneficiaries. This also applies to foreign trusts. The founder, settlor, or beneficiaries must pay tax on this income as if it were their own income.

The law provides for exceptions for family foundations or trusts established in an E.U. or E.E.A. Member State. In order for the exception to apply, proof must be provided that none of the founder, settlor, or beneficiaries control how the foundation will dispose of the assets. In addition, in the case of a non-German foundation

or trust, information must be available to German tax authorities under the Mutual Assistance Directive. This has been the case in the U.K. thus far.

After a hard Brexit, it will no longer be possible to provide proof that a trust resident in the U.K. meets the conditions for applying the exception.

Example 2

Facts: A, domiciled in Berlin, is the beneficiary of a trust resident in the U.K., which realizes dividend income from shares in U.K.-resident companies. The settlor has already passed away. A has not yet received any distributions from the trust.

Result: After Brexit, the trust income will be attributed to A and other beneficiaries, possibly *pro rata*, on the basis of the German Foreign Tax Act, even if no distributions have been made. A will be taxed on the dividends derived by the trust as if they were received by him. If A later receives distributions from the trust, he should not be taxed a second time, provided he can prove earlier taxation at the time the underlying dividends were received by the trust.

Exemption from Inheritance and Gift Tax for Transfers of Companies

German inheritance tax law provides for relief when the assets owned by the decedent are business assets used in a permanent establishment in an E.U. or E.E.A. Member State. The relief is in the form of a total or 85% exemption from the tax. Relief is also provided under German inheritance tax law for shares that represent a holding of at least 25% in a limited company that has its seat of management in an E.U. or E.E.A. Member State. In the event of a hard Brexit, these reliefs will no longer be available.

Example 3

Facts: Mother A, domiciled in Berlin, is the sole shareholder of a corporation resident in London. After she has passes away, her daughter inherits the shares.

Result: Since Mother A was domiciled in Germany, the acquisition of the shares in the English corporation by her daughter is subject to German inheritance taxation. If the life of Mother A ends after a hard Brexit, the tax exemption for business assets and for shares in corporations can no longer be claimed for the shares in the English corporation.

In addition, the value used for computing inheritance tax on rented housing in the U.K. will no longer be capped 90% of actual value. The tax base will be increased to full fair market value. The full tax exemption for a U.K. family home when a surviving spouse or children inherit the property and continue to use it as a residence will also be abolished.

Example 4

Facts: Family A (all German citizens) has been residing exclusively in England for two years and live there in a family home that is owned. Both parents die in an accident. Their son stays in the family home. He is the only heir.

Result: Since the family has not lived abroad for more than five years, the parents' estates are subject to German inheritance tax. The family home can no longer be inherited tax-free because it is not located in an E.U. Member State after Brexit.

Finally, inheritance tax exemptions for cultural goods located in the E.U. or E.E.A. will likely end in the case of a hard Brexit.

Other Regulations

Advantageous regulations regarding the relocation of a corporation's seat to an E.U. Member State will no longer be applicable. Under a hard Brexit, the relocation will be a taxable disjunction, which is the term used to describe a deemed disposition of business assets treated as a taxable event for purposes of the German Transformation Tax Act and the provision of the German Foreign Tax Act imposing exit taxation.

"Grandfathering" When All Tax-Relevant Actions Are Completed

In order to ensure that Brexit does not have any negative legal consequences for a taxpayer that has completed an exit from Germany prior to a hard Brexit, the German Tax Accompanying Act extends special transitional rules to existing situations. The aim is to maintain the status quo, but only if the taxpayer completes all relevant actions for an exit prior to the effective date of a hard Brexit.

Inheritance Relief for Business Assets

German inheritance tax law has been amended to maintain certain tax exemptions granted in the past. Under German inheritance tax law, an 85% exemption is provided for the value of business assets if the business is continued for at least five years and the cost of direct wages during the five-year period is not less than 400% of the average annual direct wages in the five-year period prior to the death of the shareholder. Complete tax exemption is allowed if, *inter alia*, the wage expense during the seven years following the date of death does not fall below 700% of the average wage expense for the seven years prior to the date of death.

The computation is made by taking into account wages incurred by subsidiary corporations or partnerships in which an ownership percentage in excess of 25% is maintained. The subsidiary or partnership computation includes companies and partnerships based in the E.U. or E.E.A.

Provided the death occurs prior to Brexit, the exemption will continue to take into account the wage base in the U.K. both before and after Brexit takes place.

Taxable Disjunction (Deemed Disposition) of Assets

If an asset is removed from the pool of business assets located in Germany and transferred to a permanent establishment in a Member State of the E.U., an adjustment item is created in the form of a hidden reserve, which must be recognized over five years in equal annual amounts. If the asset ceases to be subject to the tax authority of a Member State, the unrecovered balance must be recognized immediately, and the resulting profit is taxed at that time. The German Tax Accompanying Act prevents the deferral from being eliminated and tax liability from being triggered solely by the U.K.'s withdrawal from the E.U.

Example 5

Facts: A-GmbH, based in Germany, has transferred a special crane from its German permanent establishment to its English permanent establishment. The special crane has hidden reserves of €10,000, which must be taken into account over five years.

Result: A-GmbH can recognize the hidden reserve in €2,000 annual increments over five years. Brexit does not end the write-off over five years. Immediate tax on the unrecovered reserve is not required.

<u>Maintenance of the Tax-Free Investment Reserve – No Interest on Tax Deferral in Case of Reinvestments in the E.U.</u>

The advantages of a tax-free investment reserve, which is intended to promote investment in E.U. Member States, are also preserved. In principle, the German Income Tax Act stipulates that the tax due on the capital gain can be paid in five equal annual instalments upon request if the hidden reserves are transferred to certain passive assets such as real estate. However, interest must be paid if there is no reinvestment in business assets located in the E.U. or E.E.A. According to the German Tax Accompanying Act, no interest payment is due if an application for payment in instalments is filed before Brexit and the business assets are reinvested in the U.K. after Brexit.

Example 6

Facts: A-GmbH, resident in Germany, maintains permanent establishments in Germany and in England. A plot of land that has belonged to the German permanent establishment for over six years is sold at a profit. The capital gain, which is taxable in Germany, is deferred upon request. After Brexit but within the following four financial years, another property is acquired in England.

Result: The deferral of the capital gain is not terminated by Brexit. The deferral granted by the instalments does not become interest-bearing, as the application is made before Brexit and the provisions of the German Tax Accompanying Act consider reinvestment in the U.K. to be sufficient.

<u>No Deemed Dissolution and Taxation in the Event of Departure of a Corporation Through Transfer of Management or Registered Office</u>

In principle, a transfer of the management or the registered office of a corporation to a non-Member State results in a deemed dissolution, since no Member State of the E.U. or the E.E.A. retains the right to impose tax on the worldwide income of the corporation. An amendment to the German Corporate Income Tax Act prevents a corporation that has transferred its management or registered office to the U.K. in the past from becoming subject to subsequent taxation due to Brexit. The amendment clarifies that Brexit is not sufficient event to trigger such tax liability.

Example 7

Facts: A-GmbH has relocated its management from Berlin to London. The U.K. then withdraws from the E.U.

Result: Since the transfer of management took place when the U.K. was a Member State, no dissolution is deemed and the hidden reserves of A-GmbH are not subject to taxation. Although Brexit is associated with the exit of A-GmbH from unlimited tax liability in a Member State, it does not give rise to any tax liability due to the provisions of the German Tax Accompanying Act.

No Subsequent Exit Taxation

If an individual departs Germany and establishes residence in a country that is not a Member State of the E.U. or the E.E.A., exit tax is imposed. The tax is deferred if the individual leaves Germany to establish residence in a Member State. The German Tax Accompanying Act prevents Brexit from triggering exit taxation on shareholdings of an individual if residence in the U.K. is established prior to Brexit.

"If the E.U. and the U.K. reach a withdrawal agreement with a transition period, the German Brexit Transition Act . . . will allow Germany to treat the U.K. as an E.U. Member State until December 31, 2020."

Example 8

Facts: After 12 years in Germany, A moves his domicile back to England, his country of birth. He is the owner of various participations in domestic and foreign corporations of more than 1%. The tax office defers the tax on departure without interest and without security. After his departure, the U.K. withdraws from the E.U.

Result: Withdrawal from the E.U. does not constitute a reason for revoking the deferral. Exit tax will continue to be deferred as long as A does not, for example, sell the investments or move to another third country. If A moves his residence to the U.K. after Brexit, he must pay tax on the difference between the acquisition cost and the fair market value of the shares as a notional capital gain. If security was provided, the payment could be deferred for a period of five years, if immediate payment represents a considerable hardship for A.

Other Regulations

There are also amendments to the German Transformation and Corporation Tax Act to mitigate the adverse effects of Brexit on companies resident in the U.K. For example, retroactive taxation of capital gains will not be triggered solely by Brexit.

CONSEQUENCES OF A WITHDRAWAL AGREEMENT

If the E.U. and the U.K. reach a withdrawal agreement with a transition period, the German Brexit Transition Act will enter into force. The act will allow Germany to treat the U.K. as an E.U. Member State until December 31, 2020, if the withdrawal agreement is accepted. The tax privileges of E.U. Member States would continue to apply until then.

The German Brexit Tax Accompanying Act has already entered into force. However, the individual rules presuppose that the U.K. is no longer a Member State or is treated as such. Thus, the effects of the German Tax Accompanying Act would only be felt after the transitional period ends on December 31, 2020.

INDIA AND THE DIGITAL ECONOMY – THE EMERGING P.E. AND ATTRIBUTION ISSUES[1]

Author
Sunil Agarwal

Tags
Digital Economy
India
P.E.

Sunil Agarwal, advocate, has been a senior tax partner with AZB & Partners in New Delhi, India, for more than 12 years. He works primarily on international tax, transfer pricing, and corporate tax matters from both the advisory and litigation side. Sunil represents clients before various forums, such as the Income Tax Appellate Tribunal, the Authority for Advance Rulings, the High Court, and the Supreme Court.

BACKGROUND

Do you remember the first thing you ever bought or sold online? As we have been living with a digital economy for an entire generation, many of us would need to take a long stroll down memory lane in order to find the answer. In fact, it was just over 20 years ago in Ottawa in 1998, when the O.E.C.D., together with Canadian government, held the first international ministerial meeting on electronic commerce – what we now call the digital economy. It is worth recalling that, in 1998, Google was in its infancy and Facebook, YouTube, and Twitter were still a long way off. Many mobile phones still sported visible antennas and the price of internet access was steep. Truly, we have come a long way.[2]

Almost a century ago (in the era of League of Nations), value creation in a cross-border business was pictorially described as below:

> The oranges upon the trees in California are not acquired wealth until they are picked, not even at that stage until they are packed, and not even at that stage until they are transported to the place where demand exists and until they are put where the consumer can use them. These stages, up to the point where wealth reached fruition, may be shared in by different territorial authorities.[3]

The above paragraph highlights value creation in multiple jurisdictions and value realization in the market jurisdiction, which is typical of a transnational business carried on by a multinational enterprise ("M.N.E."). Prior to the advent of digitalization, the M.N.E. could not do significant business in a market jurisdiction without having some kind of a physical presence there. This led to an allocation of taxing powers between the country of residence and the market jurisdiction based primarily upon the presence or absence of a tangible physical nexus, a so-called Permanent Establishment ("P.E."), in the market jurisdiction.

More recently, the explosive growth and development of information and communication technology has enabled M.N.E.'s to sell goods and services in a market jurisdiction without the need for a traditional brick-and-mortar P.E., thereby avoiding payment of taxes to the jurisdiction where the M.N.E. derives a significant share of revenues.

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1 First published at the International Tax Conference organized by International Fiscal Association at New Delhi on April 26-27, 2019.

2 "Going Digital: Back to the Future," *OECD Observer*, no. 317 (2019).

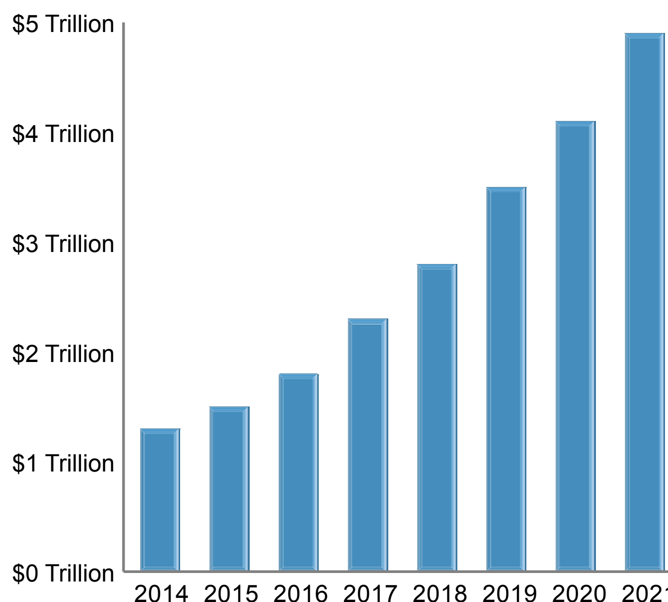
3 Excerpted in the Memorandum Explaining the Provisions in the Finance Bill, 2018.

EXPLOSIVE GROWTH OF INTERNET USERS[4]

Rank	Country	Internet Users (Millions)
1	China	746
2	India	699
3	USA	245
4	Brazil	123
5	Japan	117
6	Russia	110
7	Mexico	75
8	Germany	73
9	Indonesia	66
10	Pakistan	62
11	United Kingdom	62
12	Philippines	57
13	France	55
14	Nigeria	47
15	South Korea	47
16	Turkey	46
17	Vietnam	43
18	Iran	42
19	Egypt	37
20	Spain	37

[4] "List of Countries by Internet Users," Worldatlas, last updated January 15, 2019.

WORLDWIDE RETAIL E-COMMERCE SALES[5]



INDIAN RETAIL AND E-COMMERCE MARKETS[6]

Year	Total Retail Market	E-commerce Retail (out of total)
2017	$795 billion	$24 billion
2021 (projected)	$1200 billion	$84 billion

TAX ISSUES ARISING FROM EXPONENTIAL DIGITAL GROWTH[7]

The exponential expansion of information and communication technology has made it possible for businesses to conduct themselves in ways that did not exist earlier. It has given rise to new business models that rely almost exclusively on digital and telecommunication networks, do not require physical presence, and derive substantial value from data collected and transmitted through digital networks. These new business models have created new challenges for tax authorities around the world

5 "Global Retail E-commerce Sales 2014-2021," Statista.

6 "Indian E-commerce Market to Touch USD 84 Billion in 2021: Report," *The Economic Times*, February 26, 2019.

7 T. N. Pandey, "Income Taxation in Digital Economy," (presentation, Slideshare, July 4, 2017).

in terms of nexus, characterization, and valuation of data and user contribution. These challenges are recognized by the international community and have been formally addressed by the G-20 and O.E.C.D. under B.E.P.S. Action 1.

The ambiguities surrounding the taxation of income from the digital economy and the resulting tax disputes are not only a bane for tax authorities. They also place constraints on taxpayers, who may be subject to inconsistent approaches on the part tax authorities – a situation that, at best, should be avoidable.

POPULAR DIGITAL BUSINESS MODELS

The O.E.C.D. report on B.E.P.S. Action 1 lists some of the more prevalent forms of digital businesses in paragraphs 118 to 121:

> **4.2.1.1 Business-to-business models**
>
> 118. The vast majority of e-commerce consists of transactions in which a business sells products or services to another business (so-called business-to-business (B2B)) (OECD, 2011). This can include online versions of traditional transactions in which a wholesaler purchases consignments of goods online, which it then sells to consumers from retail outlets. It can also include the provision of goods or services to support other businesses, including, among others: (i) logistics services such as transportation, warehousing, and distribution; (ii) application service providers offering deployment, hosting, and management of packaged software from a central facility; (iii) outsourcing of support functions for e-commerce, such as web-hosting, security, and customer care solutions; (iv) auction solutions services for the operation and maintenance of real-time auctions via the Internet; (v) content management services, for the facilitation of website content, management and delivery; and (vi) web-based commerce enablers that provide automated online purchasing capabilities.[8]
>
> **4.2.1.2 Business-to-consumer models**
>
> 119. Business-to-consumer (B2C) models were among the earliest forms of e-commerce. A business following a B2C business model sells goods or services to individuals acting outside the scope of their profession. B2C models fall into several categories, including, for example, so-called “pureplay” online vendors with no physical stores or offline presence, “click-and-mortar” businesses that supplemented existing consumer-facing business with online sales, and manufacturers that use online business to allow customers to order and customize directly.[9]
>
> 120. The goods or services sold by a B2C business can be tangible (such as a CD of music) or intangible (*i.e.* received by consumers in an electronic format). Through digitization of information, including

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[8] *Id.*, para 4.2.1.1.

[9] *Id.*, para 4.2.1.2.

text, sound, and visual images, an increasing number of goods and services can be delivered digitally to customers increasingly remote from the location of the seller. B2C e-commerce can in many cases dramatically shorten supply chains by eliminating the need for many of the wholesalers, distributors, retailers, and other intermediaries that were traditionally used in businesses involving tangible goods. Partly because of this disintermediation, B2C businesses typically involve high investment in advertising and customer care, as well as in logistics. B2C reduces transaction costs (particularly search costs) by increasing consumer access to information. It also reduces market entry barriers, as the cost of maintaining a website is generally cheaper than installing a traditional brick-and-mortar retail shop.[10]

4.2.1.3 Consumer-to-consumer model

121. Consumer-to-consumer (C2C) transactions are becoming more and more common. Businesses involved in C2C e-commerce play the role of intermediaries, helping individual consumers to sell or rent their assets (such as residential property, cars, motorcycles, etc.) by publishing their information on the website and facilitating transactions. These businesses may or may not charge the consumer for these services, depending on their revenue model. This type of e-commerce comes in several forms, including, but not limited to: (i) auctions facilitated at a portal that allows online bidding on the items being sold; (ii) peer-to-peer systems allowing sharing of files between users; and (iii) classified ads portals providing an interactive, online marketplace allowing negotiation between buyers and sellers."[11]

CHARACTERISTICS OF THE DIGITAL ECONOMY

Digitalized business models have the following three characteristics:

- Scale without mass
- Heavy reliance on intangible assets
- Data & user participation

DISTORTIONS CAUSED BY THE DIGITAL ECONOMY

The most demonstrable distortion caused by digital businesses is horizontal inequity, whereby a nonresident enterprise selling goods and services in a jurisdiction does not pay taxes on the income earned from sales in that jurisdiction because of the absence of P.E., while at the same time a domestic enterprise engaged in similar business activities in the same jurisdiction would have to pay tax.

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10 *Id.*

11 *Id.*, para 4.2.1.3.

If this distortion is not addressed in a timely manner, this may lead to obvious undesirable economic effects in the economy of source jurisdiction, and consequently impede the transnational flow of goods, services, capital, and personnel.

OVERARCHING PRINCIPLES OF TAX POLICY

The following well-established principles of tax policy must be kept in mind when addressing the distortions caused by the digital economy:

- **Equity:** Taxpayers in similar circumstances should bear a similar tax burden.
- **Neutrality:** Economic choices available for carrying on businesses should be tax-neutral.
- **Efficiency:** Minimal compliance costs should apply to the taxpayer, as well minimal administration costs for governments.
- **Certainty and Simplicity:** Tax rules should be simple and easy to understand for the taxpayers.
- **Effectiveness and Fairness:** Taxation should produce the right amount of tax at the right time, avoiding either double taxation or double non-taxation.
- **Flexibility:** Taxation systems and policies should be flexible and dynamic enough to ensure they keep pace with technological and commercial developments.

O.E.C.D. PROPOSED SOLUTIONS[12]

During the course of deliberations on Action 1 of the B.E.P.S. Project, the O.E.C.D. recommended a two-pronged approach:

> There should be a significant salutary impact of other BEPS measures on BEPS concerns caused by Digital Economy, namely:
>
> - Changes suggested by BEPS Action 7 which could control artificial avoidance of PE status
> - Changes suggested by BEPS Action 8-10 strengthening transfer pricing rules

Pending an evaluation of the impact of other measures on the base eroding effects of the digital economy, the O.E.C.D. considered various options but stopped short of adopting any O.E.C.D. recommended standard. Rather, it left it to countries to consider whether to adopt any of the proposed options, either alone or in conjunction with other approaches, subject to countries having regard to existing treaty obligations.

The table in the following section evaluates the fundamental characteristics of the three options proposed by the O.E.C.D.

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[12] O.E.C.D., "Tax Challenges of Digitalisation: Comments Received on the Request for Input – Part II," October 25, 2017.

THREE APPROACHES TO TAXING THE DIGITAL ECONOMY[13]

	Option 1: Significant Economic Presence ("S.E.P.")	Option 2: Equalization Levy	Option 3: Withholding Tax
Type of Tax	Net income tax on M.N.E.'s	Tax on final consumption	Tax on final consumption
Tax Base	Net business income (gross receipts minus costs)	Gross receipts on sales to customers	Gross receipts on sales to customers
Geographic Concept	Residence (where firm is headquartered) and/or Source (where economic activity is located)	Destination (where customer is located)	Destination (where customer is located)
Scope of Tax	Applies to • income earned within the taxing country or • worldwide income	Limited to final consumer purchases	Limited to final consumer purchases

"Some countries have decided to impose a withholding tax on the gross amount of revenue derived by an M.N.E. from the source jurisdiction, while others have opted for an equalization levy."

THE CURRENT SITUATION

In view of the hands-off, wait-and-watch approach adopted by O.E.C.D., some countries have decided to impose a withholding tax on the gross amount of revenue derived by an M.N.E. from the source jurisdiction, while others have opted for an equalization levy.

Some details are outlined below:

- India imposes a 6% Equalization Levy on specified base-eroding digital businesses. This levy has been kept out of the tax treaty network, hence there are issues on the ability of the affected nonresident to receive a foreign tax credit for taxes withheld in India.[14]
- The E.U. recommended 3%. However, some countries in E.U. have opposed this levy, namely Ireland, Sweden, Denmark, and Germany.
- The U.S. has opposed the imposition of a digital tax, as it would have significant effect on the foreign tax exposure of the U.S. tech giants, like Facebook, Google, and Amazon, by forcing them to pay taxes in the countries where

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[13] *Id.*

[14] *Id.*

they do business, instead of in low-tax jurisdictions like Ireland or Luxembourg. It also will raise no tax in the U.S.

- The U.K. introduced a Digital Services Tax in 2017, and Austria, France, and Italy are proposing unilateral digital services taxes as well.[15]
- Bangladesh has also imposed a V.A.T. on digital businesses.

It is evident that these measures are unilateral and uncoordinated among countries. By their very nature, they are *ad hoc*, inconsistent, and lacking clarity, which will lead to the imposition of a disproportionate tax burden on M.N.E.'s operating in multiple tax jurisdictions.

Such measures cannot provide a lasting solution to the problem.

POSSIBLE FEATURES OF S.E.P.-BASED ECONOMIC NEXUS[16]

The new P.E. nexus may consist of the following elements:

- Specified sale and service transactions carried out digitally
- User threshold
- *De minimis* revenue threshold

For this purpose, a new Article 5(8) may be introduced in the O.E.C.D. Model Tax Convention (Article 5(9) in the United Nations Model) with the following suggested wording:

> If an enterprise resident in one Contracting State provides access to (or offers) an electronic application, database, online market place or storage room or offers advertising services on a website or in an electronic application used by more than 1,000 individual users per month domiciled in the other Contracting State, such enterprise shall be deemed to have a permanent establishment in the other Contracting State if the total amount of revenue of the enterprise due to the aforementioned services in the other Contracting State exceeds XXX (EUR, USD, GBP, CNY, CHF, etc.) per annum.

The advantage of this method is that the allocation of taxing powers can be implemented in line with the arm's length principle or through a combination of the arm's length principle and formulary apportionment.

As regards the former scenario, it may be necessary to amend the current O.E.C.D. Transfer Pricing Guidelines in order to allocate income between an enterprise and its P.E. based on digital presence.

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[15] See "Austria, France, and Italy to Introduce Digital Services Taxes," *Insights* 6, no. 4 (2019).

[16] See Peter Hongler and Pasquale Pistone, "Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy," (working paper, IBFD, 2015).

DUAL APPROACH: WITHHOLDING TAX PLUS OPTIONAL S.E.P.-BASED NET TAXATION[17]

This option considers both installing a withholding tax mechanism as the primary response to these challenges and using withholding taxes in support of a S.E.P.-nexus based solution.

A nexus-based solution should prove superior to the withholding tax solution since it is consistent with the O.E.C.D.'s approach to the matter; it is likely to be more efficient (*i.e.*, less wasteful); and it would likely be easier to fine-tune in order to reach a stable balance between taxation in the market and residence jurisdictions.

Consequently, a practical way could be to impose a global consensus-based standard X%[18] final withholding tax on all base-eroding business payments to registered nonresidents, with specific, again global, consensus-based exemptions to payees registered to be taxed in the market jurisdiction under a net taxation scheme. Such net taxation scheme may be a nexus-based solution or an elective scheme to avoid the withholding tax proposed here.

This proposal depends on a reliable, global consensus-based standard, quick, cheap, and automatically-shared registration system shared by at least the major economies actively participating in the B.E.P.S. Project spearheaded by G-20 and O.E.C.D. countries.

Payments to unregistered payees would be subject to a higher percentage of withholding tax as compared to nonresidents covered in the previous paragraph. These would include payments to accounts in or owned by low- or no-tax jurisdictions (*e.g.*, corporate tax at or below 15%). This tax may be non-final and partially refundable upon filing.

"A nexus-based solution should prove superior to the withholding tax solution."

B2C transactions would initially be exempt as non-base-eroding. Yet, if countries are already concerned with the revenue division implications of such a decision, a complimentary final withholding tax of X%[19] could be collected on all payments cleared by financial institutions, unless the payees register to be taxed under any net taxation scheme.

The withholding tax scheme is not perfect. However, in the event that countries cannot reach agreement on a nexus-based scheme, it permits a simple, if crude, response to the challenges of the digital economy. As such, however, it requires monitoring and perhaps tweaking over time based on experience gained. Therefore, the scheme should be accompanied by a review mechanism.

In addition, the multilateral instrument (Action 15) may be used for efficient standardization of the solution. Advances in reporting (*e.g.*, Country-by-Country ("CbC") Reporting) and automatic information exchange, as well as all monitoring aspects (Actions 11-13) also fit well with the necessary review mechanism.

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[17] See Yariv Brauner and Prof Andres Baez, "Withholding Taxes in the Service of B.E.P.S. Action 1: Address the Tax Challenges of the Digital Economy," (working paper, IBFD, 2015).

[18] This is a conscious departure from the working paper by Brauner and Baez.

[19] *Id.*

LONG-TERM PERSPECTIVE

In the long term, it appears that net basis taxation using S.E.P. as a nexus, in addition to the traditional brick and mortar P.E. concept, may be the most effective approach to address the taxation of the digital economy.

Basis of S.E.P.-Based P.E. Threshold

The nexus should be uniform globally. As an example, gross revenues from digital businesses derived by an M.N.E. from purchasers in one jurisdiction amounting to, say, $X million or an equivalent amount in local currency in a tax year. In other words, this basis would not work if every country were to decide its own threshold. A cue can be taken from the €750 million CbC Reporting threshold on transfer pricing matters under B.E.P.S. Action 13.

S.E.P.-Based P.E. Income Computation

Net income from the S.E.P.-based P.E. could be computed either on an attribution basis under the arms' length principle or using formulary apportionment, or a mix of the two. It should be noted that the O.E.C.D. has always preferred attribution over formulary apportionment. However, one cannot forget the old adage that "necessity is the mother of invention." Unique problems do call for unique solutions. There are obvious constraints in applying the attribution principle. In a digital business, it is likely that most of functions, assets, and even some of the major risks will not be located in the market jurisdiction. Only sales, revenue realization, and post-sale warranty obligations will happen there. Under these circumstances, it is anybody's guess how effective it will be to apply the arm's length principle.

However, if a global consensus on the attribution basis is achieved, it will be further desirable to apply all principles applicable to computation of business income as contained in Article 7 of double tax treaties, as far as possible, since the S.E.P.-based P.E. will also be a P.E. on par with a traditional brick and mortar P.E. In particular, a deduction should be allowed for business expenses of the S.E.P.-based P.E., including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred, whether in the market country or elsewhere.

ROLE OF THE MULTILATERAL INSTRUMENT

Since the S.E.P.-based P.E. will require an amendment to existing double tax treaties, the proposal suggested herein can be efficiently achieved only through the multilateral instrument already existing in terms of B.E.P.S. Action 15.

2020 WILL MARK THE END OF AN ERA: SWISS CORPORATE TAX REFORM ACCEPTED

Authors
Thierry Boitelle
Aliasghar Kanani

Tags
Switzerland
Tax Reform
T.R.A.F.

Thierry Boitelle is a tax partner in the Geneva office of Bonnard Lawson. His practice focusses on Swiss and international tax advice with a focus on inbound investment by multinational companies and immigration by high net worth individuals and company executives.

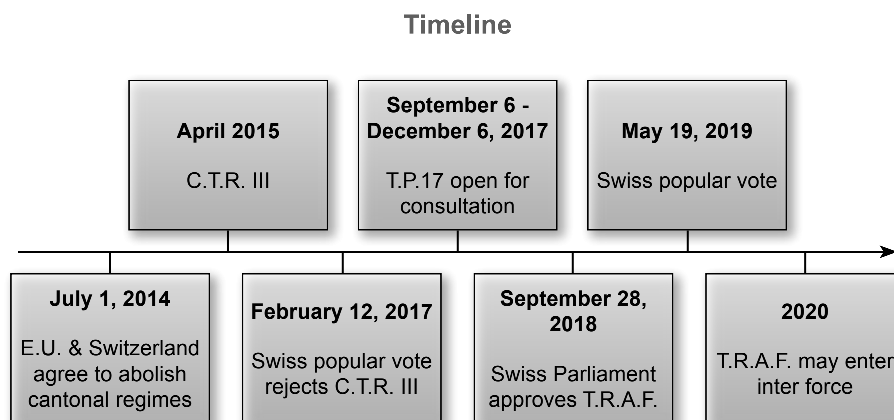
Aliasghar Kanani is a partner in the Geneva office of Bonnard Lawson. His practice focuses on Swiss and international corporate tax planning for multinationals and small and medium enterprises and financial restructurings.

INTRODUCTION

On May 19, 2019, Swiss Federal and Genevan cantonal voters accepted the 2020 Swiss Federal and Genevan cantonal corporate tax reforms by a large majority. As explained below in detail, as of 2020, Switzerland will, on one hand, abolish its widely criticized cantonal special tax regimes and certain Federal regimes. On the other hand, Switzerland and the cantons will introduce generally applicable reduced and attractive corporate income tax rates as well as several new special regimes, meeting current international standards and requirements. In sum, Switzerland is expected to remain attractive for existing and new corporate ventures.

CHANGES TO THE SWISS AND GENEVAN CORPORATE TAX SYSTEMS AS OF 2020

Timeline



In response to international criticism and strong pressure from the E.U. and the O.E.C.D., the Federal Act on Tax Reform and A.H.V. Financing ("T.R.A.F.") abolishes the current corporate tax privileges for (i) base, auxiliary, domicile, and mixed companies; (ii) holding companies; (iii) finance branches; and (iv) principal companies as of December 31, 2019.

At the Federal level, the Swiss Parliament previously accepted the law on June 14, 2016, as the so-called 3rd Corporate Tax Reform ("C.T.R. III"). However, the Swiss electorate rejected the C.T.R. III by referendum in February 2017. The general view was that C.T.R. III provided benefits for large corporations without benefitting ordinary individuals. The Swiss Federal Council originally intended to solve this issue by increasing family allowances. However, since this measure would not have

benefited the entire population by any stretch, Parliament instead decided in favor of linking corporate tax reform with supplementary financing for A.H.V. (*i.e.*, the first pillar of old age pension insurance).

In the spring of 2018, the T.R.A.F. proposal was introduced in Parliament. It was subsequently adopted there in a final vote on September 28, 2018. Finally, on May 19, 2019, the Swiss voters accepted T.R.A.F. by a large two-thirds majority. The reform can now enter into force on January 1, 2020.

At the cantonal level, the Geneva State Council adopted the draft law to implement T.R.A.F. on October 17, 2018. On December 11, 2018, the tax commission of the Genevan Parliament approved the cantonal draft law, which was accepted by voters on May 19, 2019.

As a result, the following measures are introduced as of 2020:

- **Tax Privileges:** As previously mentioned, T.R.A.F. abolishes the current corporate tax privileges for (i) base, auxiliary, domicile, and mixed companies; (ii) holding companies; (iii) finance branches; and (iv) principal companies as of December 31, 2019. In this context, please note that the Swiss Federal Tax Administration ("F.T.A.") no longer applies the practices of principal companies and Swiss finance branches to new companies beginning in 2019.

- **Effective Corporate Income Tax Rates:** The cantons have the option to reduce the effective cantonal corporate income tax rate. Each canton should decide which rate should be applicable.

  As of 2020, the canton of Geneva will provide an effective general cantonal corporate income tax rate of 13.99%, with an absolute minimum of 13.48%.

  Ahead of this, the canton of Vaud already reduced its corporate income tax rate from 23.5% (Lausanne) to 13.79% beginning in 2019 and approved by popular vote on March 20, 2016, with an astonishing majority of 87%.

- **Capital Tax for Companies:** T.R.A.F. allows cantons to introduce reduced capital tax rates for qualifying participations, patent box assets, and intra-group loans. Cantons were already allowed to credit the corporate income tax against the capital tax.

  As of 2020, the canton of Geneva will provide (i) a special reduced capital rate of 0.0012% for the above-mentioned qualifying assets and (ii) a progressive credit of corporate income tax against capital tax. As of the tax year 2024, 100% of the corporate income tax will be available for credit against the capital tax. In other words, no capital tax will be due as long as sufficient profits are maintained.

  Today, the canton of Vaud already provides for a full credit of corporate income tax against capital tax.

- **Patent Box:** As of January 1, 2020, a patent box will be introduced at the cantonal tax level to provide privileged taxation on income from patents and similar intellectual property ("I.P.") rights. The tax privilege will consist of an exemption from cantonal tax on up to 90% of qualifying I.P. income. The cantons are free to apply a lower exemption.

The O.E.C.D.'s nexus approach for I.P. regimes will be applied in the sense that I.P. income will qualify for benefits only to the extent that the taxpayer demonstrates the income results from R&D expenses that it has incurred in developing the I.P. This means that income derived from acquired I.P. will not qualify for the patent box exemption.

Individual enterprises ("Independents") will also be able to benefit from the new Swiss patent box regime.

The canton of Geneva will also introduce the new O.E.C.D.-compliant restricted patent box, but the cantonal reform provides that qualifying income from patents would benefit only from a reduction of up to 10%.

- **Cantonal Research & Development ("R&D") Incentives:** With the aim to promote Swiss-based R&D activities, the cantons are given the option to apply a super-deduction for Swiss R&D expenses up to a maximum of 150% of qualifying expenditures. The cantons are free to enact the new R&D tax incentives from January 1, 2020. If adopted, incentives will also apply to Independents. As of January 1, 2020, the canton of Geneva will introduce a super-deduction of 150% for Swiss R&D expenses.

- **Notional Interest Deduction ("N.I.D."):** As of 2020, T.R.A.F. will allow cantons to introduce an N.I.D., provided the effective overall corporate income tax rate in the capital city of the canton is at least 18.03%. Based on current legislation and proposals, it is expected that this will be the case only in the canton of Zurich, which plans to adopt an effective rate of 18.2%.

- **Hidden Reserves:** Hidden reserves and goodwill that were created when a company was abroad, or that relate to the relocation of assets or functions to Switzerland, can be capitalized (stepped-up) in the tax balance sheet without immediate taxation. Similarly, such hidden reserves and goodwill will be taxed immediately if the company, its assets, or its functions leave Switzerland or are otherwise no longer subject to Swiss tax (*e.g.*, in the case of liquidation).

  For newly arriving companies, the step-up remains tax-free and the hidden reserves can subsequently be amortized in the following years (*e.g.*, goodwill depreciation over ten years), resulting in substantial tax reductions. For existing Swiss-resident companies currently enjoying a cantonal tax privilege, the hidden reserves must be determined by way of a special assessment by the cantonal tax authorities at the time T.R.A.F. enters into force on January 1, 2020. At that time, hidden reserves will be separately taxed at reduced rates if and to the extent they are realized within a five-year transition period following the entry into force of T.R.A.F., *i.e.*, the tax day of tax year 2024. Geneva provides for a special reduced rate of 13% applicable to the above-mentioned hidden reserves.

- **Dividend Taxation:** The tax on dividend distributions to individual substantial shareholders (10% or more ownership) is increased to 70% of the tax base at the Federal level and a minimum of 50% of tax base at the cantonal level as determined by the cantons and using financing and compensation in connection with the measure. The reform accepted in Geneva provides for a base of 70% for private assets and 60% for business assets.

- **A.H.V.:** T.R.A.F. includes supplementary financing of around CHF 2.0 billion for A.H.V. – CHF 1.2 billion due to the increase in salary contributions (0.3%) and CHF 0.8 billion due to the increase in the Federal A.H.V. contribution and waiver of the Confederation's share of the percentage point of V.A.T. earmarked for demographic change.

- **Transpositions:** Anti-abuse provisions in the law treat a transposition as a taxable private capital gain by exception. Ordinarily, private capital gains are exempt from tax in Switzerland. "Transposition" is the term used for a sale to one's self. It occurs when an individual sells participation rights to a company in which he or she holds a controlling stake, which is at least 50%. The current statutory regulations provided for a *de minimis* rule under which tax is imposed only when at seller transfers at an interest of at least 5%. Apparently, major repetitive transfers were effected on interests below the 5% threshold. Parliament perceived that the *de minimis* transfer rule was prone to abuse. Consequently, the threshold has been abolished under T.R.A.F. as of 2020. At that point, the gain on a transposition will be taxed.

- **Capital Contributions:** As of 2020, Swiss listed companies must also distribute a taxable one-franc dividend for each franc distributed free of tax because they are paid from the capital contribution reserve. This will result in additional receipts for the Confederation, cantons, and communes. In Parliament, these additional receipts were estimated at CHF 150 million. Certain exceptions apply to restructurings and to foreign companies moving to Switzerland.

CONCLUSION

Approval of T.R.A.F. marks the end of an almost 14-year tax dispute between Switzerland and the E.U. As of 2020, Switzerland will generally provide attractively low corporate income tax rates to all economic actors, whether Swiss or foreign, while at the same time introducing some new special tax regimes that are fully compliant with today's strict international standards and requirements.

REFLECTIONS ON MY 66 YEARS IN PUBLIC ACCOUNTING[1]

Author
Arthur J. Radin

Tags
Accounting
Audit
Tax Returns

In Memoriam:

Arthur J. Radin, C.P.A., was a partner emeritus at Janover LLC, New York, N.Y., and a member of The CPA Journal Editorial Advisory Board. Arthur passed away in April 2019. He had a bright mind and a wonderful sense of the absurd. These qualities made him an excellent accountant, as they enabled him to understand the world as it is. He will be missed.

My initiation to the accounting profession came in 1951, when I was first old enough to get working papers. In my time off from school, I went to work for my father, a C.P.A. who was certified around 1925. I had such important functions as filing, copying documents, proofreading and collating reports, backing up the switchboard operator, and running messages.

After college, because I had not completed enough courses to take the C.P.A. exam and had not been in the army, I could not get a job with a major firm. (I kept all 63 rejection letters for 20 years.) A one-owner, three-staff firm did finally hire me; on my first assignment, I was told I would be working on a "statement" account. I thought I was to prepare financial statements; in fact, it meant I was to write up the 30 or 40 individual customer statements each month.

In January 1960, having obtained my M.B.A. and spent six months in the army, I returned to New York City, newly married and unemployed. My first stop was Touche, Niven, Bailey, and Smart (now Deloitte Touche Tohmatsu), where the personnel manager had liked me on my previous visit. I was hired on the spot for $525 a month. My wife and I wondered how we would ever spend so much money.

Eighteen years later, I elected for various reasons to return to a small company atmosphere, where I remain to the present day. In all, I have been with five firms, aside from my dad's office. Many things have changed. Some have not.

A CHANGING WORKPLACE

Back then, everything was handwritten, so good handwriting was essential. Reports were typed on manual typewriters. Accountants had to learn to add a column of numbers; I was not allowed to use an adding machine.

As there were no copy machines, carbon paper was used to create multiple copies. Negatives had to be in red, and typewriter ribbons had both a black and a red section. If there was a negative, we had to insert red copy paper. Everyone's hands were dirty; typos were a nightmare, accurate typing skills were essential. I couldn't thank my mother enough for insisting that I take typing in 11th grade, a skill that still serves me well in the computer age. Tax return preparation on the computer is wonderful, ensuring that we do not make obvious calculation errors, and it's nice that the I.R.S. no longer writes us that we added something wrong.

Office buildings at the time were hot in the summer – no air conditioning, only an open window. The dress code was suits and ties every day. For one large Touche

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[1] This article was originally published in the September 2018 Issue of *The CPA Journal* and is reproduced here with the journal's permission.

client, I had to wear a hat. I dutifully bought one from a friend's parents' haberdasher and wore it for a few weeks; after that, it collected dust.

In the firms, most of the accountants were men and most of the secretaries were women. Everyone dated, and there were lots of marriages. The demographics of the profession has changed for the better. When I started, it was almost all white men. Now we have many female accountants, and the office looks like the United Nations. I love it.

> ***"The client needs attention, wants to feel loved. Some of the best advice I ever received was that accountants lose clients when the client perceives that their accountant is indifferent."***

CHANGES IN THE CULTURE

One of the old concepts – client service – still prevails. The client needs attention, wants to feel loved. Some of the best advice I ever received was that accountants lose clients when the client perceives that their accountant is indifferent. In my youth, auditors loved to go to the client; staying at the office was a drag. All the information we needed was at the client, and more importantly, we met new people and learned how businesses worked. I was taught about the T.A.L.L. approach to practice development – Take A Lawyer (or client) to Lunch. This paid off; over the years, I brought in many clients.

These days, both my staff and my partners want to keep to the office. They're happy staying in, emailing the client the information needed for the audit, receiving it by email, entering it into our audit software, making selections, and receiving the selections by email. They're proud that the whole business can be done while never once visiting the client. It's very efficient – and very boring.

CHANGES IN PRACTICE AND PROCEDURE

When I started at Touche, I was suddenly an "auditor," although in the beginning I did not understand what that meant. (Yes, I took auditing in graduate school and received an A, but I never grasped that the purpose of auditing was to issue an opinion on the financial statements.) I have come to love auditing, although it used to be more fun. I used to claim that it took 20 years to become a good tax specialist, ten years to become a good G.A.A.P. accountant, and three years to become a good auditor. Auditing used to be all common sense; now it has become highly technical and not at all intuitive. The standards now run well over 1,000 pages of small print and, although they have been "clarified," I find it very difficult to get answers to my issues.[2] With all the checklists, evaluations of assertions, and required correspondence with clients, no one seems to have time to understand the clients or their businesses, or enjoy what they are doing.

The concept of "up-or-out" – either get promoted in a reasonable time or find another job – did not exist until around 1965, when the large firms started to adopt the policy. Eight years after starting at Touche and after many rapid promotions, I was made a partner at the age of 31. I did not think I was too young to be a partner; others did. (Today, 40 years after I left the firm, I am amazed how often someone introducing me says, "He was a partner of Deloitte," to establish my credentials.)

Early in my career there, I started working on clients who were registered with something called the Securities and Exchange Commission ("S.E.C."). I had to figure out for myself what this agency was and why it could tell my clients what to do.

My work on S.E.C. clients continued for the next 54 years, comprising some of my most interesting accounting and auditing experiences. Working on S.E.C. filings, including annual reports and new issue registrations as well as occasional testimony, was always fascinating and frequently nerve-racking.

Over the years, the profession became more disciplined. Accounting and auditing standards changed from suggestions to mandates. Generally accepted accounting standards went from a half-inch book to four books totaling eight inches. Notes have grown uncontrollably.

Back then, accounting standards were written by an unpaid group of accountants, the Accounting Principles Board. I loved having a Touche partner, Don Bevis, on the board. Clients could meet with Don and discuss the proposed standards. After they were adopted, we could receive instruction from someone who helped draft the standard. And just as wonderful, if I did not like the final standard, I had someone to complain to.

No one does bookkeeping anymore. It all seems handled by a computer using a program such as QuickBooks. I believe there's an advantage to having done bookkeeping, as the equation of the debits having to equal the credits becomes second nature. I find I occasionally have to plot out debits and credits for my staff.

Required Continuing Professional Education ("C.P.E.") did not exist in the old days. Despite the lack of C.P.E., we all managed to learn on the job. In fact, a best

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[2] See "Have Audits Become Too Inefficient and Expensive?" *The CPA Journal*, February 2016.

practice that remains unchanged in 66 years is the willingness of more experienced professionals to train less experienced staff. You still learn mostly by asking the person next to you.

Tax research seems to be much changed. I preferred the wonderful old CCH binders with the Internal Revenue Code, Treasury Regulations, and explanations; it was easier to handle than the modern computer references and search engines.

THE BENEFITS OF A SMALLER PRACTICE

After 18 years with Touche, two developments made my staying at the big firm for my entire career seem unlikely.

First, the requirement for rotation of audit partners on S.E.C. engagements resulted in my losing the business relationships I had built up. I started working with Macy's as a junior accountant, working myself up over 15 years to be partner in charge of the audit. Suddenly, I was being told that I had to give up the client, and if I was nice, management would give me another client. Personal relationships ended as the client's personnel had to deal with another partner. The human satisfaction of having done a good job over many years disappeared. (Incidentally, that satisfaction stays in the audit department of firms not requiring rotation.)

"In the end, I have no complaints. I am pleased with my choice of profession and recommend it strongly. I am proud of my profession for training our country's accounting and finance practitioners."

Second, being a partner in the "Big Eight" was high pressure. Retirement was required at age 62, but it sure seemed like many partners had heart attacks before then. On the other hand, I kept meeting partners of small firms who were in their 80s, including my father.

My years at Touche were wonderful, but as the firm grew, I began to feel that I really needed to work in a smaller environment. In addition, I had married a member of the audit staff, and since there was a "no nepotism" rule, one of us had to leave. I lunched with some friends who had a small C.P.A. firm; by the end of the lunch, I was joining them. My wife stayed at Touche.

My former partners were horrified. "What about your pension?" I said that if I was worried about my pension at 40, I was in deep trouble. "You're too dependent on a large client." In fact, I found that in many ways I became more independent. The loss of Macy's would have been a major disaster to Touche, while the loss of any client to a small firm is more easily handled.

Our new firm grew and prospered. In 1998, I again felt that I wanted a smaller firm and left with two of my partners. After 18 very successful years with three or four partners, we ran into the usual continuity issues and on January 1, 2015, we joined Janover L.L.C., where I will complete my career. While the firm is not mine, the partners are delightful to work with and very professional.

In the end, I have no complaints. I am pleased with my choice of profession and recommend it strongly. I am proud of my profession for training our country's accounting and finance practitioners. Lawyers always refer to the law school they attended; accountants refer to the firm they started with.

I have made a good living all these years. I was able to pay for all my children to go to college. My retirement is funded. All those lawyers I had lunch with all those years are still, mostly, available for lunch. I met my wife through accounting. I still

deal with my clients, although all have been assigned to another Janover partner who handles the accounting and tax matters, sometimes not as well as I did but sometimes better.

And I remember a refrain of the saying we used while hunched over our workpapers: Old accountants never die; they just fade away.

C.J.E.U. JUDGMENTS ON DANISH BENEFICIAL OWNERSHIP CASES

Authors
Adnand Sulejmani
Thierry Lesage

Tags
C.J.E.U.
Denmark
M.N.E.

Thierry Boitelle is a tax partner in the Geneva office of Bonnard Lawson. Thierry renders Swiss and international tax advice with a focus on inbound investment by multinational companies and on immigration by high net worth individuals and company executives.

Adnand Sulejmani is an associate in the Geneva office of Bonnard Lawson. Adnand favorite field of activity is Swiss and international corporate tax law, including international tax planning for multinationals and S.M.E.'s, and group and financial restructurings.

INTRODUCTION

On February 26, 2019, the Court of Justice of the European Union ("C.J.E.U.") released two judgments[1] in a total of six cases dealing respectively with the interpretation of the E.U. Parent-Subsidiary Directive[2] ("P.S.D.") and the E.U. Interest & Royalties Directive[3] ("I.R.D.") (jointly referred to as the "E.U. Directives"). Under the E.U. Directives, dividends or interest paid by a company resident in a Member State to its parent company in a different Member State are exempt from withholding tax ("W.H.T."), provided certain conditions are met. The aim of the E.U. Directives is to favor the grouping of companies within the E.U. Single Market and to eliminate double taxation.[4] The E.U. Directives are often more favorable than the tax treatment reserved for dividends and interest in double tax treaties, which mostly provide a reduced W.H.T. Multinational groups operating within the E.U. structure their groups in such a way as to benefit from that W.H.T. exemption. The cases concluded that the E.U. Directives apply only in circumstances where the structure is not viewed to be abusive.

BACKGROUND

Briefly summarized, in all the cases addressed by the C.J.E.U., Danish-resident companies paid dividends or interest to their European parent companies, which were established in countries such as Cyprus, Luxembourg, or Sweden. The European parent companies were directly or indirectly owned by companies or by private equity funds resident in third countries with which Denmark had not concluded any double tax treaty. Based on the E.U. Directives, the Danish companies considered that collection of W.H.T. on the dividends or interest paid to their European parent companies was not required, as the conditions for the W.H.T. exemption were met.

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1 C.J.E.U., February 26, 2019, Case C-116/16 (T Denmark) and Case C-117/16 (Y Denmark); C.J.E.U., February 26, 2019, Case C- 115/16 (N Luxembourg 1), Case C-118/16 (X Denmark), Case C-119/16 (C Denmark I) and Case C-299/16 (Z Denmark).

2 Council Directive 2011/96/EU of November 30, 2011, on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

3 Council Directive 2003/49/EC of June 3, 2003, on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

4 Contrary to the P.S.D., which eliminates both economic and juridical double taxation (*i.e.*, W.H.T. exemption and exemption from corporate income tax at the level of the parent company), the I.R.D. is designed to eliminate juridical double taxation only (*i.e.*, W.H.T. exemption).

However, some other relevant facts are of importance for the understanding of these two judgments. In all these cases, the interposition of European parent companies between the ultimate parents and the Danish companies lowered the tax burden on dividends and interest paid up the chain. The following circumstances could be observed in some or all of the cases:

- The activity of the European parent companies was limited to the management of their holdings and the granting of loans to their subsidiaries.
- They did not have their own office and had no (or very limited) staff.
- They realized very low margins and only a small portion of the dividends or interest received were kept in order to cover certain costs.
- The groups had undergone a restructuring in response to changes in domestic tax law. In the case involving a Cypriot company, the latter was set up and acquired the Danish subsidiary just a few days before a dividend payment.

In the case involving a Cypriot company, the latter was set up and acquired the Danish subsidiary just a few days before a dividend payment.

The Danish tax authorities were of the opinion that the Danish companies should have levied W.H.T. on the dividends and interest paid. The cases were brought in the Danish referring court, and in this context, the C.J.E.U. had to address the questions analyzed below.

GENERAL E.U. ANTI-ABUSE PRINCIPLE

Article 1(2) of the P.S.D. and Article 5(1) of the I.R.D. provide that "this directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse" (the "anti-abuse reservation"). These provisions give Member States the right to enact provisions in their domestic laws to restrict the application of the E.U. Directives in cases of abusive or fraudulent situations. Denmark did not exercise its right to enact an anti-abuse provision. At issue was whether it was necessary to have a specific domestic anti-abuse provision or an agreement-based provision to restrict the application of the E.U. Directives or whether a Member State could directly rely on Article 1(2) of the P.S.D. or Article 5(1) of the I.R.D. to deny the W.H.T. exemption.

On May 1, 2015, Denmark adopted a general anti-abuse rule ("G.A.A.R.") in its domestic law in anticipation of the E.U. Anti-Tax Avoidance Directive[5] ("A.T.A.D. I"), but Denmark did not have any similar statutory provision at the time when the dividend or interest payments in these cases were challenged by the Danish tax authorities. Until the adoption of the G.A.A.R. in 2015, there has been a long debate in Danish tax literature whether the "Reality Doctrine" (*Realitetsgrundsætningen*) could be seen as a non-statutory G.A.A.R. to combat fraud and abuse.

In her opinion given to the C.J.E.U., Advocate General Kokott claimed that a Member State cannot invoke directly Article 1(2) of the P.S.D. or Article 5(1) of the I.R.D. without having transposed these provisions into domestic law and that it was for

[5] Council Directive (EU) 2016/1164 of July 12, 2016, laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

the referring Danish court to determine whether a general provision or principles of national law (including case law-based principles such as the Reality Doctrine) exist and enable the denial of the W.H.T. exemption. Further, Advocate General Kokott took the view that none of (i) Article 2(1)(c) of the Danish Corporate Tax Act (transposing the P.S.D.), (ii) Article 2(1)(d) of the same act (transposing the I.R.D.), and (iii) the beneficial ownership requirement under the double tax treaties can be deemed a transposition of Article 1(2) of the P.S.D. or Article 5(1) of the I.R.D., respectively.

"Member States are obliged to deny the W.H.T. exemption on the basis of the general E.U. law principle."

Nevertheless, the C.J.E.U. did not follow the Advocate General's opinion and stated that "it is settled case law that there is, in EU law, a general principle that EU law cannot be relied on for abusive or fraudulent ends." Hence, it is not necessary for a Member State to have any specific domestic provision or agreement-based provision in order to deny the W.H.T. exemption in cases of abuse or fraud. Based on that principle, the C.J.E.U. reached a contrary conclusion and stated that Member States are obliged to deny the W.H.T. exemption on the basis of the general E.U. law principle in such cases.

This appears to be a revision of the C.J.E.U.'s former position. In fact, in the *Kofoed* case,[6] the C.J.E.U. had held that a Member State may not invoke a directive-based provision (*i.e.*, the anti-abuse reservation) that has not yet been transposed into domestic law against an individual or a company. Nevertheless, the C.J.E.U. held in the present judgments, by specifically referencing the *Kofoed* case, that this should not mean that a Member State cannot rely on the general E.U. principles in order to deny the W.H.T. exemption.

From a practical perspective, the C.J.E.U.'s position on the above question will have little (if any) relevance in the future, taking into account the inclusion of a mandatory G.A.A.R. in the P.S.D. as well as the G.A.A.R. provided under A.T.A.D. I.

INTERPRETATION OF THE BENEFICIAL OWNERSHIP REQUIREMENT UNDER THE I.R.D.

The term "beneficial owner" is a concept originating from common law and was introduced into the dividends, interest, and royalties articles of the O.E.C.D. Model Tax Convention (the "Model Convention") in 1977.[7] It has been seen by many countries as the first response to treaty abuse or, more precisely, to treaty shopping. The concept continues to be heavily debated in international tax literature. Although it was held in the *Indofood* case[8] that beneficial owner should have an autonomous and international meaning, we can observe that countries go in one of two directions, giving the term either a formal interpretation or a substance-oriented interpretation.

Countries using a narrow and formal interpretation establish a very low threshold for beneficial ownership, thereby denying the treaty benefits to agents, nominees, and conduit companies that, due to a legal or contractual obligation, have no discretion

[6] C.J.E.U., July 5, 2007, Case C-321/05.

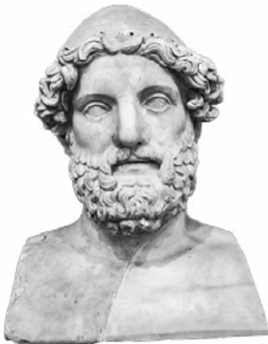
[7] Model Double Taxation Convention on Income and Capital, O.E.C.D., Paris, 1977.

[8] *Indofood International Finance Ltd. v. JP Morgan Chase Bank*, London Branch, [2006] EWCA Civ 158.

over the use of the income received. In other countries, the beneficial ownership requirement is based on a "substance-over-form" analysis, with a particular focus on economic control over the income received. In the latter approach, the income recipient has no control over the income received if there is a legal or contractual obligation to transfer the income to another person. Contrary to the formal interpretation, under the substance-over-form interpretation, it is possible that the obligation to pass on the income to another person might also be a mere factual obligation. Hence, the concept of beneficial ownership has different meanings across jurisdictions despite the O.E.C.D.'s attempt to draw the contours of this notion.

The income recipient must be the beneficial owner in order to benefit from the W.H.T. exemption under the I.R.D. The C.J.E.U. has provided guidance on the meaning of the term and on the relevance of the Model Convention and its commentaries for the interpretation of that term.

The C.J.E.U. has made it clear that when interpreting the concept of beneficial ownership no reference should be made to the meaning given in domestic law, as domestic law concepts might vary from one Member State to the other. Further, it appears from the translations of the I.R.D. in the different languages of the Member States that various expressions are used to designate the beneficial owner. Consequently, the term beneficial owner should receive an autonomous E.U. meaning, which might be different from the meaning given to that concept under a double tax treaty or domestic law.



According to the C.J.E.U., beneficial ownership should not be understood with reference to a formally identified recipient[9] but rather with reference to the person that benefits from the income received. The focus should be on the economic reality of the ownership, which is supported by Article 1(4) of the I.R.D. Consequently, an income recipient would only be considered the beneficial owner of the income if it receives the income for its own benefit and not as an intermediary, such as an agent, trustee, or authorized signatory, for some other person. It is, in this respect, crucial for the income recipient to have the power to freely determine the use to which the income is put. In order to benefit from the W.H.T. exemption provided under the I.R.D., the beneficial owner must be resident in the E.U., even if the direct income recipient – although an E.U. resident – is not the beneficial owner (the "look-through approach").

Having said that, it is worth mentioning that Advocate General Kokott suggested that the concept of beneficial ownership should be interpreted under E.U. law autonomously without regard to the commentaries on the Model Convention, as non-E.U. countries would otherwise have a say in the interpretation of the I.R.D. Nevertheless, the C.J.E.U. found that the Model Convention and its commentaries, as well as their successive amendments, are relevant when interpreting the concept of beneficial ownership in the context of the I.R.D. The C.J.E.U. has thus taken a dynamic approach to the meaning of the term beneficial owner, and any future amendments to the commentaries might reshape the meaning of that term.

The relevance of the Model Convention and its commentaries is justified by the fact that the 1998 I.R.D. proposal was inspired by Article 11 of the 1996 Model

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[9] It is therefore not sufficient to be the legal owner – as foreseen under the domestic (civil) law of the country in question – of the assets from which the income is derived.

Convention, which has the same objective (*i.e.*, the avoidance of double taxation). Thus, when the C.J.E.U. makes reference to conduit companies that cannot be considered beneficial owners, it actually refers to companies that have only very narrow powers from a practical perspective, rendering them mere fiduciaries or administrators acting on account of the interested parties. Although these companies are the formal owners of the income, they are not the beneficial owners within the meaning of the commentaries on the Model Convention.

ABUSE UNDER THE E.U. DIRECTIVES

In these judgments, the C.J.E.U. clarified the constituent elements of an abuse of rights in the context of the P.S.D. or the I.R.D. In order to establish the existence of abuse, there must be:

> First, a combination of objective circumstances in which, despite formal observance of the conditions laid down by EU rules, the purpose of those rules has not been achieved and, second, a subjective element consisting in the intention to obtain an advantage from the EU rules by artificially creating the conditions laid down for obtaining it.

In this context, the C.J.E.U. specified that it is necessary to examine facts on case-by-case basis in order to determine whether a specific situation is abusive. In this context, a particular focus should be put on whether the economic operators have created purely formal and artificial arrangements that are devoid of any economic and commercial justifications and aim essentially to benefit from an improper advantage. The C.J.E.U. laid down a certain number of indicators of abuse, but the C.J.E.U. specified that, even if these indicators are present, the taxpayer should have the opportunity to adduce evidence to the contrary.

In this context, the interposition of an entity between the entity paying the income and the beneficial owner, for instance, would be abusive if the interposed entity has not been set up for reasons that reflect economic reality, its structure is purely one of form, and its principal objective, or one of its principal objectives, is to obtain the W.H.T. exemption under the P.S.D. or the I.R.D. The C.J.E.U. clearly targets conduit companies that are not considered to be the beneficial owners of the income received.

Although the beneficial ownership requirement is expressly provided under the I.R.D., the condition is not contained in the P.S.D. Instead, the C.J.E.U. seems to hold that there is an implicit beneficial ownership requirement in the P.S.D. Moreover, it is somewhat misleading that the C.J.E.U. makes reference to the concept of "beneficial ownership" when analyzing "abuse" under the E.U. Directives, as these are two different concepts that should not be confused.

In addition, the C.J.E.U. notes that an indication of an artificial arrangement exists if an entity must quickly after receiving income pass that income on to another entity that does not fulfill the conditions for the W.H.T. exemption. Consequently, the tax authorities should examine whether an entity's sole activity is the receipt and transfer of income to the beneficial owner, thereby realizing only an insignificant margin on that activity.

An arrangement is also likely to be abusive in cases where an entity conducts no actual economic activity. In order to assess the existence or absence of actual

economic activity, an analysis must be performed of all the relevant factors, such as the management of the company, its balance sheet, the structure of its costs and expenditures actually incurred, the staff employed, and the premises and equipment of that entity. However, these factors are not similar if we compare, for instance, a pure holding activity with the activity of an operational entity. Consequently, that analysis has to be done in light of the features of the specific economic activity in question.

The artificiality of an arrangement may also be observed by analyzing the contracts existing between the companies involved in financial transactions in order to determine the way these transactions are financed, the valuation of the intermediary company's equity, and the latter's ability to have economic use of the income received. In this context, the C.J.E.U. held that the intermediary company might be legally or contractually obliged to pass the income received to another person, which would be an indication of an artificial arrangement. However, a legal requirement is not required in all instances as, in substance, the intermediary company may, in substance and from a factual perspective, be obliged to pass the income to another person even if no legal or contractual obligation exists to pass the income to another person.

The interpretation given by the C.J.E.U. to the term beneficial owner is in line with the commentaries of the 2017 Model Convention, which provide that the obligation to pass on the income might also be inferred from facts. However, given that the C.J.E.U. sticks to the commentaries of the Model Convention, an intermediary company involved into back-to-back financing should not be denied the status of a beneficial owner merely because it will pass the majority of the interest received to its parent company. In fact, the 2017 commentaries to the Model Convention clearly state:

> This type of obligation would not include contractual or legal obligations that are not dependent on the receipt of the payment by the direct recipient . . . and which the direct recipient has as debtor.[10]

"An intermediary company involved into back-to-back financing should not be denied the status of a beneficial owner merely because it will pass the majority of the interest received to its parent company."

In some of the cases at hand, like the one involving the Cypriot company, the group had undergone, closely before or simultaneously to changes in the domestic tax law of the countries involved, a restructuring in order to mitigate the tax burden that the group would have faced would they not have undergone that restructuring (*i.e.*, abusive restructuring). This can be a further indication of an artificial arrangement.

In a controversial manner, the C.J.E.U. states that it "is also unsure" whether there can be an abuse of rights in case where the beneficial owner of the income is a company resident in a third state with which the source country has concluded a double tax treaty providing comparable benefits to dividends, interest, or royalties. In that set of circumstances, the income paid would have been exempt had the income been directly paid to that company without interposing another entity in-between. The C.J.E.U. continues and specifies that the existence of "such a convention" providing a W.H.T. exemption in case where the income is paid directly to the beneficial owner resident in a third state would not exclude *per se* the existence of abuse. Nevertheless, the C.J.E.U. concludes that the existence of such a convention may be an indication that the group structure is unconnected with any abuse of rights and that the group cannot be reproached to have chosen such a structure rather than

[10] Paragraph 10.2 of the commentaries on Article 11 of the 2017 Model Convention.

direct payment of the income.

With regard to dividends, the C.J.E.U. seems to consider that there is an implied beneficial ownership requirement within the P.S.D. It does not matter that the direct recipient is or is not the beneficial owner, as the dividends would be exempt in both instances. Consequently, as long as (i) the conditions of the P.S.D. are met and (ii) the beneficial owner is resident somewhere in the E.U. ("look-through approach").

In comparison, the W.H.T. exemption should not be granted where the beneficial owner of the income is resident outside the E.U. Although the P.S.D. does not expressly provide for a beneficial owner requirement, the C.J.E.U. considers that the P.S.D. was not designed to apply where the beneficial owner is resident outside the E.U. The C.J.E.U. justifies its position on the ground that the aim of the P.S.D. is the avoidance of economic and juridical double taxation within the E.U. However, if the dividends are exempt from W.H.T. in the source country, and assuming that the distributed income was exempt as earned by the distributing company, the distributed income would not have been taxed at all in the E.U, which is not the aim of the P.S.D.

Another interesting point addressed by the C.J.E.U. concerns the burden of proof. In this regard, the C.J.E.U. states that the taxpayer must provide evidence that the conditions of the E.U. Directives are met, upon request by the tax authorities. However, where the tax authorities consider the arrangement to be abusive, they need only to put forward elements indicating that the arrangement is abusive, for example that recipient is not the beneficial owner. The tax authorities have no obligation to identify the entity considered to be the actual beneficial owner. The C.J.E.U. considers that identifying the beneficial owner might be impossible in certain circumstances. Taking into account the look-through approach previously described, the taxpayer would need to establish that the beneficial owner is resident within the E.U. This entails a full showing of the identity of the beneficial owner and that the latter is resident within the E.U.

S.I.C.A.R. OUTSIDE OF THE SCOPE OF THE I.R.D.

The next question addressed by the C.J.E.U. was whether a S.I.C.A.R. (*société d'investissement en capital à risque*) set up in a corporate form and governed by Luxembourg law would qualify as a "company of a Member State" within the meaning of the I.R.D. A S.I.C.A.R. is a regulated vehicle governed by the Luxembourg law of June 15, 2004, relating to the investment company in risk capital. A S.I.C.A.R. can either be set up in a corporate form or in the form of a partnership. In case where the S.I.C.A.R. is established in a corporate form, the S.I.C.A.R. is subject to corporate income tax and municipal business tax in Luxembourg. Income derived by the S.I.C.A.R. from securities is exempt. The S.I.C.A.R. benefits thus from a partial objective exemption and not from a general subjective exemption.

Three requirements must be met in order to be qualified as a "company of a Member State" for purposes of the I.R.D. The first is whether the S.I.C.A.R. takes one of the corporate forms listed in the Annex of the I.R.D. The second is whether the S.I.C.A.R. is resident in Luxembourg. The third is that the company receiving the income must be subject to one of the taxes listed in Article 3 of the I.R.D. without having the option of being exempt. The C.J.E.U. focused on the third requirement.

While recognizing that a S.I.C.A.R. is subject to corporate income tax in Luxembourg, the C.J.E.U. held that the S.I.C.A.R. would not qualify as a company of a Member State if the interest received is actually exempt from corporate income tax. According to the C.J.E.U., the recital of the I.R.D. provides that the interest income must be subject to tax at least once in a Member State, which would be impossible because the interest income is exempt at the level of the S.I.C.A.R. Hence, the S.I.C.A.R. should not be viewed as a company of a Member State.

In the authors' view, the C.J.E.U.'s reasoning is incorrect and diverges from the Advocate General Kokott's opinion on that point. Advocate General Kokott concluded that the I.R.D. does not presently contain a "subject-to-tax" requirement. Indeed, the European Commission unsuccessfully attempted to amend the I.R.D. on that aspect.

The question then becomes whether the S.I.C.A.R. would also not be considered a company of a Member State for the purpose of the W.H.T. exemption for dividends provided under the P.S.D. Given that under both E.U. Directives, the income recipient must qualify as a company of a Member State, it could be argued that the same reasoning should be transposed. However, the objectives of the P.S.D. and the I.R.D. are not identical. The aim of the I.R.D. is to exempt interest payments from W.H.T. in the source country (*i.e.*, the elimination of juridical double taxation) provided that the beneficial owner is subject to income tax in the E.U. The aim of the P.S.D. is to eliminate economic (*i.e.*, the dividends are exempt from corporate income tax in the country of the recipient) and juridical double taxation (*i.e.*, the dividends are exempt from W.H.T. in the source country) at the level of the recipient of the dividend. Given that dividends received by a S.I.C.A.R are exempt from corporate income tax in Luxembourg (*i.e.*, economic double taxation is nonexistent), it remains only to eliminate the W.H.T (*i.e.*, the elimination of juridical double taxation) in the source country in order to achieve the objective of the P.S.D. For this reason a S.I.C.A.R. which is exempt in its residence country from corporate income tax on the dividends received should qualify as a company of a Member State for the purpose of the P.S.D.

FINAL REMARKS

Although the judgments have the merit to align the meaning of beneficial owner with the meaning given to that concept in the Model Convention, it is regrettable that the C.J.E.U. is mixing the concepts of abuse and beneficial ownership – which address different matters – in its reasoning. Even if an arrangement is not artificial and abusive, the income recipient may not be considered the beneficial owner of the income. Multinational groups operating within the E.U. should thus monitor the substance at the level of the income recipient and should make sure that the latter is not factually, legally or contractually bound to pass on the income to another person. In other words, the income recipient should be able to demonstrate that it has capacity and actually retains cash (*e.g.*, in order to embrace new business opportunities).

The beneficial owner concept no longer seems to be only relevant for the application of the I.R.D. Also in the context of the P.S.D., the income recipient, or any other group entity resident in the E.U. (*i.e.*, look-through approach), should be the beneficial owner of the dividends received in order to benefit from the W.H.T. exemption.

Further, the C.J.E.U. has broadened the definition of abuse under the P.S.D. and

the I.R.D. In prior cases, the C.J.E.U. always made reference to "wholly artificial arrangements" in order to define abusive situations. In the cases at hand, the threshold for abuse has been lowered, and it seems to be sufficient for an arrangement to be considered as being abusive if the principal objective or one of the principal objectives is to obtain a tax benefit under the E.U. Directives. This reasoning is similar to that of the principal purpose test ("P.P.T.") which has been recently introduced in the Model Convention. Application of the O.E.C.D. Multilateral Instrument (introducing the P.P.T. in many treaty situations among E.U. Member Countries) already has begun and tax authorities of the different Members State may rely on C.J.E.U. judgments when applying the beneficial ownership concept or the P.P.T.

EMPLOYERS IN THE NETHERLANDS: PREPARE FOR CHANGES TO LABOR AND DISMISSAL LAWS IN 2020

Authors
Rachida el Johari
Madeleine Molster

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Payroll

Rachida and Madeleine are co-founders of Sagiure Legal a boutique law firm based in Amsterdam that operates at the interface of employment law and corporate law.

Rachida and Madeleine have particular expertise in cases involving mergers and acquisitions (including transfers of undertakings), outsourcing, cross border restructuring, privacy protection of employees and (European) works councils, business immigration, international employment and litigation.

INTRODUCTION

On May 28, 2019, the Dutch Senate adopted the Labor Market in Balance Act (*Wet Arbeidsmarkt in Balans*, the "Act"), which will go into effect on January 1, 2020. The Act is designed to benefit both sides of the labor market, offering opportunities for employers and employees.

The year 2015 saw the first significant changes to Dutch dismissal laws since 1945, which changed the labor law landscape profoundly. These changes were intended to make dismissal laws "simpler, less costly for employers and to [sic] create more legal fairness for employees." Soon after implementation, however, it appeared that the changes achieved the opposite effect. Dismissal laws became more complicated, more time consuming, and more expensive for employers, leading to pressure on the legislator to come up with proposals to mitigate the undesirable consequences. Once the Act becomes effective, employment laws in the Netherlands will undergo additional changes.

The Act introduces new grounds for termination and changes to the statutory transition fee and extends the limitation on fixed-term contracts to 36 months, thereby reinstating the pre-2015 threshold. Other legal protections are adopted, as well.

With these changes, the Dutch government intends to encourage the signing of indefinite term employment agreements, instead of the fixed-term contracts that have become more popular with employers.

WHAT TO EXPECT AND HOW TO PREPARE FOR 2020

The anticipated changes will affect the hiring process, the cost-effective allocation of "flex workers," the substance of boilerplate contract language, the process of extending fixed-term contracts, the prerequisites for termination, and the consequences of forced terminations.

Prudence suggests that all companies doing business in the Netherlands should review the Act carefully and take measures to ensure proper implementation and compliance, specifically if any of the following circumstances apply:

- It employs staff or hires flex workers through payroll agencies, fixed-term employment contracts, or on-call contracts
- It used standard or template severance calculation tools
- It maintains a company social plan that provides for severance packages

- It plans to renegotiate the social plan and collective labor agreements ("C.L.A.'s") with works councils or trade unions
- It addresses rights and payments in dismissal matters on a case-by-case basis
- It dismissed employees after 104 weeks of continuous illness at any time since the Dutch Work and Security Act became effective in 2015 or intends to do so in the future

New Grounds for Termination – I Ground or Accumulation Ground

Dutch dismissal law is renowned for a high degree of employee protection. Employment contracts can be validly terminated only in certain circumstances:

- Mutual consent – deemed voluntary
- Resignation – deemed voluntary
- Notice of termination with the employee's consent – deemed voluntary
- Notice of termination – involuntary dismissal. Employers must obtain prior approval from the UWV (the employee insurance administration agency) before giving notice that will lead to valid dismissal
- Court rescission – involuntary dismissal

The Dutch Civil Code lists eight statutory reasonable grounds for involuntary dismissal (the "A-H Grounds"):

a. Redundancy due to shut down of the company or restructuring/ re-organization;

b. Long term illness (104 weeks);

c. Regular inability to perform the agreed work due to illness;

d. Employees incapability/lack of competence to perform the agreed work for another reason than illness;

e. Culpable behavior of the employee;

f. Employee refusing to perform the agreed work due to serious conscientious objections;

g. Work related conflict between the employer and employee;

h. Other circumstances that are out of scope of the above grounds but are of such nature that the employer cannot reasonably be expected to prolong the employment contract.

Under the current legislation, involuntary dismissal due to employee conduct can occur only if at least one of the last six conditions is met ("C-H Grounds"). In the event that the employer unilaterally terminates the employment agreement under one of the eight grounds, the employee is entitled to a statutory transition fee (*transitievergoeding*).

“The year 2015 saw the first significant changes to Dutch dismissal laws since 1945, which changed the labor law landscape profoundly.”

From available case law, it appears that these grounds are not easy to prove, and the requirement is burdensome for employers who must endure a lack of flexibility, high costs of building a case file, and time-consuming litigation which is often costly. The legislator has introduced a ninth ground that allows employers to combine facts and circumstances that would otherwise not meet the requirements of one of the C-H Grounds but present a compelling case for dismissal. This additional basis for dismissal is referred to as the “I Ground” or the “Accumulation Ground.”

This improvement however comes at a price. If the court terminates the employment contract based on the I Ground, the court is allowed to grant the employee additional compensation up to half the amount of the transition fee.

In addition, the court can award increased “reasonable compensation” if it determines that the employer was seriously culpable in the dismissal. This compensation is by nature subjective. The court assesses the overall facts and circumstances and sets an amount that it deems “reasonable” based on its exercise of judgment. The subjectivity of court proceedings often results in a high level of out-of-court settlements, generally including more generous severance packages. If a settlement cannot be reached, the employer has no other choice than to seek termination through court proceedings. A court ruling in first instance is open to appeal and cassation.[1]

The overhaul of dismissal laws in 2015 continues to leave its mark on labor relations, and it will take many more years before the outcome of employment cases can be predicted with relative accuracy. Until then, employers must continue to carry on procedures to build accurate cases to be heard in court. This entails empowering Human Capital departments and legal teams to craft workforce management procedures that meet legal requirements and commercial objectives. As now seen in much of Europe, proactive education programs are required to ensure that managers understand the “do’s and don’ts” necessary to prevent allegations of seriously culpable behavior by the company. The goal is to create bottom-up and top-down awareness of the legal and financial consequences of excellent or poor people management. The driver for this type of program is not necessarily the creation of a better product or higher profits, but the optimization of the company’s legal position when justifying forced dismissals and countering claims of seriously culpable behavior by the company.

Transition Fee – Statutory Severance: The Changes

Transition Fee from First Day of Employment

As of January 1, 2020, employees will be entitled to receive statutory severance payments (the *transitievergoeding* or transition fee) from their first day of employment, including any trial period. Currently, employees are entitled to the transition fee only after two years of employment.

No Transition Fee

The transition fee is not due in the case of company downsizing or shutdown (A Ground) when the company is subject to a C.L.A. that was concluded with a trade

1 “Cassation” refers is a second level of appeal to the Supreme Court. The Court has discretion when deciding to accept the appeal.

union includes measures aimed at limiting unemployment, offers reasonable financial compensation, or a combination thereof.

Transition Fee Calculation

The formula for calculating the transition fee will change to one-third of the monthly gross salary for each full year of service plus a *pro rata* share for each month or day of service regardless of the employee's age or duration of service. The current distinction between the first ten years of employment, which is based on one-third of the monthly salary, and subsequent years, which is based on half of the monthly salary, will be eliminated.

Over 50: No Preferential Treatment

As of January 1, 2020, the measure entitling employees age 50 or older to greater compensation will no longer apply.

Reimbursement for Employers

In 2020, compensation will be available to employers for transition fees paid upon dismissal due to long-term illness or disability.

"With these changes, the Dutch government intends to encourage the signing of long-term or permanent employment agreements instead of the shorter fixed-term contracts that have become popular with employers."

In the Netherlands, employers must continue salary payments to employees on sick leave for a maximum of 104 weeks. If the employer has met all obligations during this period, the employment agreement can be terminated, with approval from the UWV ("B Ground"). Upon dismissal, the employee is entitled to receive a transition fee, which must be issued within a month of termination. The requirement to pay the transition fee has been viewed as onerous on employers and has led to prolonged employment in order to avoid paying the fee.

As of April 1, 2020, employers can apply for reimbursement from the UWV for transition fees paid for B Ground terminations since July 1, 2015. In order to benefit from this provision, companies must keep accurate records of any such transition fees. Requests for reimbursement on a retroactive basis (*i.e.*, terminations that took place from July 1, 2015 to March 31, 2020) can be submitted beginning April 1, 2020, until six months after that date (*i.e.*, September 30, 2020). The reimbursement is also available if an employment contract is terminated due to a company shutdown resulting from the retirement, illness or disability, or death of the employer. Reimbursement requests for transition fee payments made from April 1, 2020, onwards must be submitted within six months of the payment date. Reimbursement requests that are not timely will be rejected.

Successive Fixed-Term Employment Contracts: Back to 36 Months

In 2015, the contractual sequence of fixed-term contracts was limited from "3x3x3" to "3x2x6" (outlined below).

Consequently, employers were allowed to enter into a maximum of three consecutive fixed-term contracts, each covering a period of 24 months, with a maximum of six months of unemployment between the contracts. If parties entered into a fourth contract or the period of 24 months was exceeded, an indefinite-term contract would be deemed to exist by operation of law.

As of 2020, employers will be allowed to conclude three fixed-term contracts of 36 months. The maximum period between contracts will remain six months. The

36-month period will also be applicable to current fixed-term employment contracts provided that they remain in effect until or after January 1, 2020. After 36 months or if a fourth fixed-term employment contract is agreed, the employment contract is deemed to be an indefinite-term contract.

Before 2015: 3 x 3 x 3
3 employment contracts
3 years (36 months)
3-month intervals

Current Rule: 3 x 2 x 6
3 employment contracts
2 years (24 months)
6-month intervals

Effective January 1, 2020: 3 x 3 x 6
3 employment contracts
3 years (36 months)
6-month intervals

On-Call Employment Contracts

Timely Notice

The time between when an employer contacts an on-call employee and when the employee must report to work is not regulated under current law. However, as of 2020, employers must provide at least four days advance notice to on-call employees. The on-call employee will be entitled to the agreed wage if the work is cancelled within those four days.

Deviation Under a C.L.A.

For employers who are subject to a C.L.A. with a trade union, the notice period may be reduced to 24 hours under the C.L.A.

Accrued Rights to Hours

An on-call employee who has been engaged or contracted by the company for 12 months is entitled to "guaranteed working hours." These hours must be based on the average number of hours the on-call employee worked in the preceding 12 months. If the employer does not offer sufficient hours to meet the guarantee, the employee is still entitled to the associated wages.

Equality for Payroll Employees

“Payrolling” is a form of employment where companies hire workers from a third-party “payroll company” that has no other activity than employing workers to be posted at their customers’ offices. The payroll company assumes all the employer’s risks and obligations. This form of labor allocation caters to many companies’ desire to eliminate employer liabilities and reduce operational and overhead costs and their need for a flexible workforce.

The differences in compensation and benefits created a business case for some payroll companies to offer their services at commercially attractive fees. However, these practices have not received much support from the trade unions and the legislator. The main concern relates to compensation, as payroll employees generally received lower pay and fewer employment benefits than direct employees of companies.

“Dutch dismissal law is renowned for a high degree of employee protection.”

As of 2020, the benefits of payrolling will be largely eliminated. Payroll employees will be entitled to the same compensation and benefits as employees of the company where posted. They will also be entitled to an “adequate” pension plan. It is likely that these legislative changes will increase the costs of employing payroll employees. The rules will not apply to temporary workers and seconded employees.

Lower Unemployment Insurance Contributions

Unemployment Insurance Contributions

In the legislator’s quest to promote indefinite term employment, social security insurance contributions for unemployment will no longer be differentiated depending on the sector category of the employer.

Beginning in 2020, unemployment insurance contributions for employees with indefinite-term employment agreements will be lower than contributions for employees with fixed-term contracts, with the exception of (i) on-call employment contracts and (ii) employees who are under 21 years of age and work for less than 12 hours per week.

Paystub Requirements

From 2020, paystubs must mention whether the employee works under a fixed-term or indefinite-term employment agreement. If the employer applies the lower unemployment insurance premium, a copy of the indefinite-term employment agreement must be kept on file in the salary administration office of the employer. This allows the tax authorities to verify whether the employer has correctly applied the lower premium.

Increased Premiums

In certain circumstances, the employer must retroactively adjust the lower unemployment insurance premium to the higher rate. This is applicable in the following instances:

- The employment contract is terminated within five months after the commencement date.
- Actual paid work amounts to 30% more than the agreed working hours specified by contract for a calendar year. This rule aims to prevent abuse by

employers who would deliberately require an excessively low number of working hours in order to pay lower unemployment contributions.

These changes will generally be implemented by the payroll company effective 2020. The percentage of unemployment premiums for 2020 will not be determined earlier than at the end of 2019. The government indicated a lower insurance premium of 2.78% and a higher unemployment insurance premium of 7.78%.

Premiums by Sector

Classification System Will Remain in Place

The premiums for the Work Resumption Fund (*Werkhervattingskas*) consist of charges relating to two components: (i) partial disability insurance (*Regeling Werkhervatting Gedeeltelijk Arbeidsgeschikten*) and (ii) sick benefits. For small and medium-sized employers, both components are partly determined based on commercial sector. This classification system remains in place.

Temporary Employment Agencies

Since May 18, 2017, temporary employment agencies (*uitzendbedrijven*) cannot be classified as part of the professional sector. Under a transitional rule, temporary employment agencies that were classified as in the professional sector were allowed to retain that classification. As of 2020, the transitional law will no longer apply, and all temporary employment agencies will be classified as part of the temporary employment sector.

Payroll Companies

Payroll companies will no longer be classified under the temporary employment sector but in business services. A split allocation (*gesplitste aansluiting)* may apply if the payroll company also assigns (*uitzenden*) its employees.

Personnel Companies

An exception continues to apply for limited liability legal entities (*besloten vennootschappen*) that serve as personnel companies. These companies will be classified as part of the sector to which the actual work or duties of the employees is allocated.

Self-Employed Workers: Stay Tuned, More Changes to Come

The government is currently preparing new legislation aimed to offer a legal and tax framework for self-employed workers, the equivalent of freelancers in the U.S. More clarity on these forthcoming measures is expected before 2020.

In addition, the government has installed a committee to advise on the regulation of new forms of labor, such as freelancers and members of the sharing economy, who are connected to work via digital platforms.[2] This advice is expected to be published in November 2019.

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[2] "The Sharing Economy Part 1: New Business Models + Traditional Tax Rules Don't Mix," *Insights* 4, no. 8 (2017).

INDIA BUDGET 2019-20

Author
Jairaj Purandare

Tags
Budget
India
Tax Policy

Jairaj Purandare is the Founder Chairman of JMP Advisors Pvt Ltd, a leading advisory, tax, and regulatory services firm based in Mumbai, India. Mr. Purandare has garnered three and a half decades of experience in tax and business advisory matters. Formerly, he served as Regional Managing Partner and Country Leader – Markets & Industries for PwC India.

INTRODUCTION

Budget 2019-20, presented on July 5, 2019, was a budget of many firsts. It was the first budget of the Modi 2.0 government and the first time that a female, full-time Finance Minister ("F.M.") presented the budget. The F.M. has commenced the process of bringing India back to a growth trajectory and is steering it towards becoming a $5 trillion economy by 2025. To this end, the F.M. has laid down a roadmap for growth along with financial inclusion.

On the tax front, some welcome measures include incentives for International Financial Services Centres ("I.F.S.C."), tax relief for start-ups, a boost for electric vehicles, and faceless tax scrutiny proceedings. Although it was expected in certain quarters, an inheritance tax has not been introduced.

Budget 2019-20 has now been introduced in the Income-Tax Act, 1961 (the "Act") in order to be afforded legal authority.

Subsequently, the F.M. held two press conferences, on August 23, 2019, and on September 20, 2019, to announce various tax revisions. Thereafter, the Taxation Laws (Amendment) Ordinance, 2019 (the "Ordinance") was introduced on September 20, 2019, to incorporate into law the announcements made at the press conferences. These amendments are effective from April 1, 2019.

DIRECT TAX

The direct tax amendments discussed below are effective from Financial Year ("F.Y.") 2019-20 (*i.e.*, April 1, 2019, to March 31, 2020) unless otherwise specifically stated.

Tax Rates

The basic tax rate for foreign companies remains at 40%. For domestic companies, however, the benefit of a lower corporate tax rate, of 25%, has been extended to companies with turnover or gross receipts not exceeding I.N.R. 4 billion (approximately $57 million as of September 24, 2019).

Further, as per the Ordinance, domestic companies that do not avail themselves of specified tax incentives or deductions, now have an option to pay income tax at the base rate of 22%. This amendment will be applicable to all domestic companies, which include Indian as well as foreign owned companies, irrespective of their size and turnover and whether they are listed or unlisted.

Further, new domestic manufacturing companies incorporated on or after October 1, 2019, and commencing manufacturing by March 31, 2023, would have an option to pay income tax at a lower base rate of 15%.

The surcharge has been reduced to a flat rate of 10% for companies opting for the lower 15% or 22% tax rate, and the provisions of Minimum Alternate Tax ("M.A.T") will not be applicable to such companies. For all other companies that do not opt for the lower 15% or 22% tax rate, the rate of M.A.T has been reduced from 18% to 15%.

The table below shows the new effective tax regime for domestic companies:

	Certain Existing Manufacturing Companies	Existing Companies	New Manufacturing Companies	Companies Not Opting for 22% Tax Rate	
				Turnover or Gross Receipts ≤ I.N.R. 4 Billion for F.Y. 2017-18	*Turnover or Gross Receipts > I.N.R. 4 Billion for F.Y. 2017-18*
Base Tax Rate	25%#	22%	15%	25%	30%
Surcharge	0%* 7% 12%	10%	10%	0%* 7% 12%	0%* 7% 12%
Health and Education Cess	4%	4%	4%	4%	4%
Effective Tax Rate*	**26% 27.82% 29.12%**	**25.17%**	**17.16%**	**26% 27.82% 29.12%**	**31.2% 33.38% 34.94%**
M.A.T.	**15%**	**–**	**–**	**15%**	**15%**

Subject to certain conditions

* No surcharge is applicable where aggregate income is less than I.N.R. 10 million. The surcharge is applicable at 7% if the aggregate income is between I.N.R. 10 million and I.N.R. 100 million or at 12% if the aggregate income exceeds I.N.R. 100 million.

For Individuals, Hindu Undivided Families ("H.U.F.'s"), Associations of Persons ("A.O.P.'s"), Bodies of Individuals ("B.O.I.'s") and Artificial Juridical Persons ("A.J.P.'s"), a higher surcharge on aggregate income exceeding I.N.R. 20 million (approximately $280,000) was proposed in the Budget. Accordingly, the maximum tax rates for F.Y. 2019-20 are given below:

Aggregate Income	Existing Surcharge Rate	Proposed Surcharge Rate	Effective Tax Rate
> I.N.R. 20 million < 50 million	15%	25%	39%
> I.N.R. 50 million	15%	37%	42.74%

However, after the announcement made by the F.M. at a press conference on August 23, 2019, and as per the Ordinance, the enhanced surcharge for the above taxpayers has been withdrawn with respect to long-term and short-term capital gains arising on the transfer of listed equity shares, units of equity oriented mutual funds, and units of business trusts.

Additionally, in the case of an A.O.P. categorized as a Foreign Portfolio Investor ("F.P.I."), the enhanced surcharge has been withdrawn with respect to all capital gains. Therefore, income from other sources such as interest arising to F.P.I.'s will continue to be subject to the enhanced surcharge. For all the above mentioned domestic and foreign investors (other than F.P.I.'s), the increased surcharge would continue to apply to capital gains arising on debt instruments and income under categories other than capital gains.

The revised Individual, H.U.F., A.O.P., B.O.I., and A.J.P. surcharge rates are below:

Aggregate Income	Surcharge on Capital Gains**	Surcharge on Other Income
Income including capital gains > I.N.R. 5 million < I.N.R. 10 million	10%	10%
Income including capital gains > I.N.R. 10 million < I.N.R. 20 million	15%	15%
Income from capital gains > I.N.R. 20 million	15%	N.A.
Income excluding capital gains > I.N.R. 20 million < I.N.R. 50 million	15%	25%
Income excluding capital gains > I.N.R. 50 million	15%	37%

** Capital gains on the transfer of listed equity shares, units of equity oriented mutual funds, and units of business trusts where Securities Transaction Tax has been paid and all capital gains in the case of A.O.P.'s and B.O.I.'s (including F.P.I.'s)

Gift from an Indian Resident to a Nonresident

Currently, a nonresident is taxed only in respect of income that (i) accrues or arises in India, (ii) is deemed to accrue or arise in India, (iii) is received in India, or (iv) is deemed to be received in India. The Act has been amended to widen the scope of income that is deemed to accrue or arise in India so that it includes a sum of money given without the receipt of consideration (gratuitously) by a resident to a nonresident. Excluded are gifts from a specified relative or under a will.

In the case of a nonresident seeking relief under an applicable Double Taxation Avoidance Agreement ("D.T.A.A."), the relevant article of the D.T.A.A. shall continue to apply for such gifts as well.

The above amendment is effective as of July 5, 2019.

Transfer Pricing – Secondary Adjustment

In the case of a transfer pricing adjustment prior to the budget announcement, a secondary adjustment applied if the amount of the primary adjustment exceeded I.N.R.

10 million (approximately $140,000) **and** the primary adjustment had been made for F.Y. 2016-17 or following years. Both conditions were required to be fulfilled. Under the budget, that is no longer required. The conditions are alternate conditions. As a result, the triggering amount no longer is relevant for original adjustments made for F.Y. 2016-17 and following years.

"100% of the profits of a unit in an I.F.S.C. will be allowed as a deduction for any ten consecutive F.Y.'s out of the first 15 F.Y.'s."

This amendment is effective as of April 1, 2017.

Currently, the excess funds in the hands of a party benefitting from a non-arm's length transaction must be repatriated to India within 90 days of the day on which the adjustment becomes final. Failure to comply will result in an interest charge at a specified rate for each outstanding year, as if the benefitting party borrowed the excess money from the party that was injured by the non-arm's length transaction. Under the budget, the benefitting party is given the option of paying a one-time additional income tax of 18% in in lieu of repatriating the excess money to India. No further credit or deduction will be allowed to the taxpayer on the amount paid by way of such additional income tax.

This amendment is effective as of September 1, 2019.

I.F.S.C.

Extension of Profit Linked Deduction

In order to maximize the benefit of the profit linked deduction to a unit located in an I.F.S.C., the Act has been amended to provide that the I.F.S.C. units will be able to defer the deduction to profitable years. Consequently, the budget provides that 100% of the profits of a unit in an I.F.S.C. will be allowed as a deduction for any ten consecutive F.Y.'s out of the first 15 F.Y.'s. The deduction will be allowed from the F.Y. in which the required permission was obtained under the relevant law.

In previous years, the 100% of the profits of an I.F.S.C. were exempt for the first five F.Y.'s, and for the next five F.Y.'s, the deduction was reduced to 50% of the profits.

Capital Gains Exemption for Category III Alternative Investment Fund ("A.I.F.")

In order to promote development of world-class financial infrastructure in India and to encourage investments in I.F.S.C.'s, the Act has been amended to exempt the income accruing or arising to or being received by a Category III A.I.F. on the transfer of certain capital assets on a recognized stock exchange located in any I.F.S.C. The exemption is subject to following conditions:

- The A.I.F. must be located in an I.F.S.C.
- All the units of the A.I.F. must be held by nonresidents other than a sponsor or manager.

Exemption from Dividend Distribution Tax

Under the current regime of dividend distribution taxation for a unit in an I.F.S.C, distributed income is exempt when the dividend is distributed out of current income. With a view to facilitate the distribution of dividends by companies operating in I.F.S.C.'s, an amendment has been introduced to extend the exemption so that it covers distributions of accumulated income derived from operations in an I.F.S.C. in the period beginning April 1, 2017.

The above amendment is effective as of September 1, 2019.

Interest Payment on Loans Taken from Nonresidents

With intent to facilitate external borrowing by units located in an I.F.S.C., the Budget has amended that the interest earned by a nonresident on debt issued by a unit located in an I.F.S.C. will be exempt from Indian withholding tax. The exemption is effective for interest paid on or after September 1, 2019.

Start-Ups

Relaxation in Condition for Allowability Setoff and Carryforward Loss

Presently, the benefit of setoff and carryforward of losses is available to an eligible start-up company when the holders of at least 51% of the shares at the end of the F.Y. in which the loss is incurred continue to own at least that percentage in the carryforward F.Y.

The Finance Act relaxed the condition for eligible start-ups to claim setoff and carryforward of losses. It provides that the benefit of the carryforward of losses will be available to eligible start-ups, as long as all original shareholders continue to be shareholders at the end of the F.Y. to which the loss is carried.

Measures to Ease Compliance for Start-Ups

In order to provide a hassle-free tax environment for start-ups, the C.B.D.T. has issued various circulars and clarifications from time to time that provide the following:

- Procedures to be followed for ongoing tax scrutiny of start-ups
- A specified time limit to complete tax scrutiny of start-ups
- A less aggressive approach toward ongoing Angel Tax litigation for recognized start-ups before the first and second level appellate authorities relating to the issue of shares for a consideration exceeding the fair market value of the shares
- No communication from the tax authorities with respect to outstanding Angel Tax demands if an elligible valuation report was submitted by a start-up
- The creation of a start-up cell to address grievances and tax-related issues

Tax on Buyback of Shares Applicable to Listed Companies

Prior to Budget 2019-20, only an unlisted company is subject to a buyback tax of 20% on distributed income upon buyback/repurchase of its shares. The income received upon buyback is exempt from further tax in the hands of the shareholders. The budget has introduced a provision to levy buyback tax on shares bought back/repurchased by listed companies as well. The provision is effective as of July 5, 2019. The buyback tax will be required to be paid by the listed company at 20% of the gain, which is the amount of the consideration paid buyback/repurchase over the amount that was received by the company upon the issuance of the shares. The shareholders involved in the buyback/repurchase of listed companies are exempt from further tax in the transaction.

At the press conference on September 20, 2019, the F.M. announced that the tax on the buyback of shares would not be applicable to listed companies that publicly announced a buyback prior to July 5, 2019.

Measures for Resolution of Distressed Companies

In order to ease the restructuring and rehabilitation of companies seeking insolvency resolution, a company taking over the business of the rehabilitated company is allowed to carry forward and set off loss of the rehabilitated company even where the plan of resolution results in a change in shareholding exceeding 49%. This benefit is applicable to companies whose resolution plan has been approved under the Insolvency and Bankruptcy Code, 2016.

The Act has been amended to extend these benefits to a company and all its direct and indirect subsidiaries where the board of directors and shareholding are changed pursuant to an order issued by the National Company Law Tribunal in cases involving the oppression of minority shareholders and mismanagement.

Withholding on Cash Withdrawals from Banks

In order to discourage cash transactions and move towards a cashless economy, the budget provided a new provision to charge a withholding tax of 2% on cash withdrawals in excess of I.N.R. 10 million (approximately $140,000) in the aggregate during the year from one or more accounts maintained by the recipient with a banking company, a co-operative bank, or a post office. The charge does not apply to certain specified recipients that handle substantial amounts of cash as a part their business operations.

The above amendment is effective as of September 1, 2019.

INDIRECT TAXES

The Budget 2019-20 encourages the government's Make-in-India policy by increasing customs duty on a slew of items that compete with goods manufactured in India. Covered by the new customs duty are, *inter alia*, gold and precious metals, automobile parts, electronics and electrical equipment, paper and paper products, and published books

Budget 2019-20 calls for the formation of a three-member National Appellate Authority for Advance Ruling ("N.A.A.A.") under the G.S.T. law in order to facilitate dispute resolution and determine legal precedents. A resolution and amnesty scheme is introduced to resolve and settle the huge backlog of pending litigation under Central Excise, Service Tax, and other related indirect tax law disputes.

CONCLUSION

Apart from tax amendments, Budget 2019-20 has key policy announcements in various sectors including infrastructure, banking and finance, and micro-, small-, and medium-enterprises. Budget 2019-20 places emphasis on making the best use of technology, providing an impetus for foreign investment, simplifying procedures, reviving the rural economy, promoting ease of living, and reducing red tape.

ISRAELI C.F.C. RULES APPLY TO FOREIGN REAL ESTATE COMPANIES CONTROLLED BY ISRAELI SHAREHOLDERS

Author
Daniel Paserman

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Foreign Investor
Holding Company
Israel
Real Estate

Adv. Daniel Paserman (LL.M, C.P.A.), TEP, is head of tax at Gornitzky & Co. in Tel-Aviv, Israel. Daniel is involved in tax litigation and intricate corporate tax planning – both domestic and cross-border. He also advises new immigrants and returning residents to Israel on taxation and tax exemption issues concerning their global assets and business activities.

INTRODUCTION

Recently, the Supreme Court published its judgment in the matter of *Tax Assessor for Large Enterprises v. Rosebud*, which deals with the interpretation of the provisions of Section 75B of the Israeli Income Tax Ordinance (the "Ordinance") regarding a controlled foreign corporation ("C.F.C."). In the judgment, the Supreme Court overturned a decision by the district court, in a move that is likely to have implications for the activities of Israeli taxpayers outside of Israel, through foreign companies in their control and, in particular, for companies that invest in real estate outside of Israel.

LEGISLATIVE BACKGROUND

In January 2003, a comprehensive reform of the Israeli tax laws was introduced. The reform, *inter alia*, adopted a global personal tax system to replace the territorial tax system previously in effect. According to the new global personal tax system, an Israeli resident for tax purposes is subject to tax in Israel on worldwide income. In addition, the tax legislation set forth a number of anti-avoidance provisions, which were intended to prevent taxpayers from taking advantage of the personal nature of the new law by setting up foreign companies based in low-tax jurisdictions. The main anti-avoidance provision took the form of the C.F.C. regime set forth in Section 75B of the Ordinance. The provision affects a C.F.C., as defined, and an Israeli resident who is a controlling shareholder of that C.F.C. Where the C.F.C. earns passive income in any year and fails to distribute that income to its shareholders, an Israeli resident that is a controlling shareholder will be considered to have received his or her *pro rata* share of the profits as a deemed dividend.

A C.F.C. is a private company that is a foreign resident for tax purposes and is controlled by Israeli residents, where most of its income or profits is derived from passive income and where the rate of tax in the foreign country does not exceed 15%. Passive income includes interest income, income from linkage differentials, dividends, royalties, rent, and proceeds from the sale of an asset, provided that such income does not qualify as business income.

ROSEBUD RULING

In the case at hand, Rosebud (an Israeli subsidiary of a publicly-traded Israeli company) indirectly held a number of companies in Luxembourg through a Dutch company. The Luxembourg entities held other foreign companies that each held a separate parcel of real estate. This structure, in which each company is a special purpose vehicle that holds only a single asset, is a common structure in the real

estate sector. This structure has many business advantages that do not arise from tax considerations, including (i) limitation of liability, (ii) financial benefits, and (iii) the possibility of selling assets separately – whether directly or through the sale of shares.

In Rosebud, assets and shares were sold. Rosebud claimed that the provisions of Section 75B of the Ordinance did not apply, because the matter concerned business income, which is not passive income. Thus, the question arose as to whether the sale by a company of its sole asset or the sale of shares of a company constitutes a capital event that generates a passive profit for purposes of Section 75B. Rosebud argued that its activity should be examined as a whole and that the group's operations, which include the development, management, appreciation, rental, and disposal of real estate assets, amount to business activity. Therefore, selling a particular asset out of a wide portfolio should be classified as business income rather than capital gain. In sum, the taxpayer argued that business income is not subject to the C.F.C. provisions and it is of no consequence that, in each transaction, only the sole asset of a company was sold by the company or the shares of a single company were sold by its shareholder.

The Israel Tax Authority, on the other hand, claimed that it is necessary to examine each corporation (asset) separately, without looking at the group of companies as a whole. This has been the position of the Israel Tax Authority since the C.F.C. legislation was introduced, in 2003.

The district court allowed the company's position and ruled that the group's operations should be examined as one business. Consequently, the Israel Tax Authority filed an appeal with the Supreme Court.

The Supreme Court, in an extremely short judgment, ruled that the district court had departed from the fundamental principle of corporate taxation in Israel, whereby each company is a separate tax unit. Thus, the Supreme Court classified the income as passive and ruled that the C.F.C. provisions apply.

CONCLUSION

Beyond the ruling, the Court did not go into an in-depth analysis of the issue, because the Luxembourg companies were insolvent and no further tax revenue would be raised. Although the rationale of the decision is sparse, the ruling is important, as a C.F.C. must be examined based on its own facts, not those of other members under common control.

With respect to Israeli investments in U.S. real estate, it is worth reiterating that the Israeli C.F.C. rules do not apply to a foreign company that is subject to a tax rate of more than 15%. It should be noted that dividends derived from income on which a foreign tax exceeding 15% was paid are also not be subject to the C.F.C. rules, provided that the company receiving the dividend holds at least a 5% interest in the publicly traded company distributing the dividends or at least a 10% interest in a private company. In this respect, if the investment in the U.S. is executed through a C-corporation that is liable for U.S. corporate tax at the standard rate of 21%, the Israeli C.F.C. rules are not expected to apply.

COLLECTING ANOTHER COUNTRY'S TAXES – RECENT EXPERIENCE IN THE CANADA-U.S. CONTEXT

Authors
Sunita Doobay
Stanley C. Ruchelman

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INTRODUCTION

When asking a U.S. tax adviser to describe the "revenue rule," it would not be surprising for the adviser to say that it refers to formal guidance issued by the I.R.S. that can be relied on by other taxpayers as authority for a position taken in a tax return.

However, the term has a much different meaning in a cross-border context. As explained by one author:

> The revenue rule, a common law doctrine with origins in the eighteenth century, is a battleground in the twenty-first century . . . . In its modern form the revenue rule generally allows courts to decline entertaining suits or enforcing foreign tax judgments or foreign revenue laws . . . .[1]

In a U.S. Supreme Court case of this century, the revenue rule is described in the following language:

> Since the late 19th and early 20th century, courts have treated the common-law revenue rule as a corollary of the rule that, as Chief Justice Marshall put it, '[t]he Courts of no country execute the penal laws of another.' . . . The rule against the enforcement of foreign penal statutes, in turn, tracked the common-law principle that crimes could only be prosecuted in the country in which they were committed. . . . The basis for inferring the revenue rule from the rule against foreign penal enforcement was an analogy between foreign revenue laws and penal laws [citations omitted].[2]

The revenue rule can be overridden by treaty, and where it has, the U.S. and Canadian tax authorities have, in recent years, collected the taxes due in the other country.

This article will explore (i) the general development of the revenue rule, (ii) the applicable provisions of the Canada-U.S. Income Tax Treaty (the "Treaty") allowing for assistance in collection and exchanges of information, (iii) one U.S. wire fraud case, and (iv) several recent cases in the U.S. where taxpayers raised creative arguments to attack the validity of the Treaty provisions but to no avail.

Sunita Doobay is a Partner at Blaney McMurtry LLP in Toronto, Canada. Equipped with over a quarter century of tax experience as an international tax lawyer, Sunita is a trusted tax advisor to a broad range of clients.

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1 Mallinak, "The Revenue Rule: A Common Law Doctrine for the Twenty-First Century," 16 Duke J. Comp. & Int'l L. 79 (2006)).

2 *Pasquantino v. U.S.*, 544 U.S. 349, 360 *et. seq,* (2005).

DEVELOPMENT OF THE COMMON LAW RULE

English Common Law

Under common law, a court will not enforce the revenue laws of other countries. In the English case *King of the Hellenes v. Brostron*,[3] Rowlatt J. emphasized this revenue rule, stating:

> It is perfectly elementary that a foreign government cannot come here – nor will the courts of other countries allow our Government to go there – and sue a person found in that jurisdiction for taxes levied and which he is declared to be liable in the country to which he belongs.

The Dutch government was also precluded from collecting Dutch succession duties levied on a Dutch estate with an English-resident beneficiary. Tomlin J. in *re Visser, The Queen of Holland v. Drukker*[4] stated:

> My own opinion is that there is a well-recognized rule, which has been enforced for at least 200 years or thereabouts, under which these courts will not collect the taxes of foreign States for the benefit of the sovereigns of those foreign States; and this is one of those actions which these courts will not entertain.

The reasons for not enforcing a foreign state's revenue laws was explained by the House of Lords in *Government of India, Ministry of Finance (Revenue Division) v. Taylor*:[5]

> If one State could collect its taxes through the courts of another, it would have arisen through what is described, vaguely perhaps, as comity or the general practice of nations inter se. . . . Tax gathering is an administrative act, though in settling the quantum as well as in the final act of collection judicial process may be involved. Our courts will apply foreign law if it is the proper law of a contract, the subject of a suit. Tax gathering is not a matter of contract but of authority and administration between the State and those within its jurisdiction. If one considers the initial stages of the process, which may, as the records of your Lordships' House show, be intricate and prolonged, it would be remarkable comity if State B allowed the time of its court to be expended in assisting in this regard the tax gatherers of State A.

Adoption in Canadian Courts

Canadian common law followed the revenue rule as set out in the above English case law. The revenue rule was applied by the British Columbia Court of Appeal in

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3 (1923) 16 Ll. L.Rep. 190, 193.

4 [1928] Ch. 877, 884; 44 T.L.R. 692.

5 [1955] A.C. 491. The factual background in this case is as follows. The government of India sought to enforce and collect capital gains tax from the sale of an English company that carried on business in India. The English company filed for voluntary liquidation and the Indian government brought its claim in the English bankruptcy proceeding. The House of Lords decision was unanimous.

United States v. Harden[6] when it refused to enforce a U.S. judgment obtained against Mrs. Harden, who was a Canadian resident at the time the case was brought. In earlier years, she was a resident of the U.S. In an attempt to sidestep the revenue rule, the U.S. government obtained a judgment against Mrs. Harden in the U.S. District Court for the Southern District of California, Central Division. The judgment was for outstanding tax plus interest in the amount of $200,037.28 for the 1945 U.S. taxation year and $439,462.87 for the 1946 U.S. taxation year.

In Canada, the U.S. conceded the application of the principle that no action will be pursued in Canadian courts by or on behalf of a foreign state to recover taxes payable under foreign revenue laws. However, the U.S. contended that the revenue rule does not apply once the foreign state has recovered judgment in its domestic courts and sues to enforce the judgment in Canada.[7] In essence, the U.S. argued that the once the matter was adjudicated in the U.S. court, the judgment stood on its own merits without the need of any reference to the underlying claim. However, the British Columbia Court of Appeal refused to enforce the California judgment because it remained a claim on behalf of a foreign state to recover taxation due under its law. The underlying claim tainted the enforceability of the judgment.[8]

"The introduction of Article XXVIA meant that a U.S. citizen would no longer be permitted to move to Canada in order to avoid his or her U.S. tax liabilities."

The Supreme Court of Canada unanimously upheld the decision of the British Columbia Court of Appeal.[9] At page 371 of its decision, the Supreme Court cited to the Irish decision *Peter Buchanan Ltd. & Macharg v. McVey*,[10] where Lord Sommervell of Harrow stated at page 515 that a foreign state could not circumvent the direct or indirect application of the revenue rule. The Supreme Court of Canada stated:

> A foreign State cannot escape the application of this rule, which is one of public policy, by taking a judgment in its own courts and bringing suit here on that judgment. The claim asserted remains a claim for taxes. It has not, in our courts, merged in the judgment; enforcement of the judgment would be enforcement of the tax claim.[11]

THIRD PROTOCOL TO THE TREATY ADOPTS ASSISTANCE IN COLLECTION

Article XXVIA (Assistance in Collection) was adopted by Article 15 of the Third Protocol to the Treaty, which was signed on March 17, 1995. That protocol replaced an earlier proposed protocol that was signed on August 31, 1994, but never went into force and was later withdrawn. The text of Article XXVIA appears in **Appendix I**.

The introduction of Article XXVIA meant that a U.S. citizen would no longer be permitted to move to Canada in order to avoid his or her U.S. tax liabilities as in *Harden*.[12] To that end, the Technical Explanation prepared by the Treasury Department

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6 (1962), 40 W.W.R. 428, 36 D.L.R. (2d) 602.

7 *United States v. Harden*, 36 D.L.R. (2d) 602 at p. 606.

8 *Id.* at p. 607.

9 [1963] S.C.R. 366.

10 [1955] A.C. 516.

11 *Supra* note 7 at p. 371.

12 Dianne Bennett, "Third Protocol to the Canada – U.S. Tax Treaty, " in *Report of Proceedings of the Forty-Seventh Tax Conference*, 1995 Conference Report

at the time the Third Protocol was submitted to the U.S. Senate as part of the approval process described the purpose and workings of the provision in the following language:

> Article 15 of the Protocol adds to the Convention a new Article XXVI A (Assistance in Collection). Collection assistance provisions are included in several other U.S. income tax treaties, including the recent treaty with the Netherlands, and in many U.S. estate treaties. U.S. negotiators initially raised with Canada the possibility of including collection assistance provisions in the Protocol, because the Internal Revenue Service has claims pending against persons in Canada that would be subject to collection under these provisions. However, the ultimate decision of the U.S. and Canadian negotiators to add the collection assistance article was attributable to the confluence of several unusual factors.
>
> Of critical importance was the similarity between the laws of the United States and Canada. The Internal Revenue Service, the Justice Department, and other U.S. negotiators were reassured by the close similarity of the legal and procedural protections afforded by the Contracting States to their citizens and residents and by the fact that these protections apply to the tax collection procedures used by each State. In addition, the U.S. negotiators were confident, given their extensive experience in working with their Canadian counterparts, that the agreed procedures could be administered appropriately, effectively, and efficiently. Finally, given the close cooperation already developed between the United States and Canada in the exchange of tax information, the U.S. and Canadian negotiators concluded that the potential benefits to both countries of obtaining such assistance would be immediate and substantial and would far outweigh any cost involved.

However, the two countries were hesitant to allow the application of collection procedures to their respective citizens doing business in the other country. To that end, Paragraph 8 of the Article XXVIA provides:

> No assistance shall be provided under this Article for a revenue claim in respect of a taxpayer to the extent that the taxpayer can demonstrate that . . . the revenue claim relates to a taxable period in which the taxpayer was a citizen of the requested state.

EXCHANGE OF INFORMATION

Article XXVII addresses exchanges of information between the tax authorities in the U.S. and Canada. Originally adopted in 1984, the provision was modified by the Fifth Protocol to the Treaty signed on September 21, 2007. The text of Article XXVII appears in **Appendix II**.

(Toronto: Canadian Tax Foundation, 1996), 44:1-25, at 44:10. *Harden* was cited favorably by the Federal Court in 2015 F.C. 1082 at Paragraph 52 where the Federal Court stated that it was well settled that in no circumstances will a court directly or indirectly enforce the revenue laws of another country, unless expressly allowed to so in the home country of the person in question.

As currently in effect, Article XXVII authorizes the competent authorities to exchange information as may be relevant for carrying out the provisions of the Treaty or domestic tax law, insofar as the taxation under domestic law is not contrary to the Treaty. The Technical Explanation of the Fifth Protocol prepared by the U.S. Treasury Department as party of the approval process in the U.S. explains that the phrase "may be relevant" expresses the intention to allow the I.R.S. to obtain items of potential relevance to an ongoing investigation, without reference to its admissibility. The phrase is not intended to support a request in which a Contracting State simply asks for information regarding all bank accounts in one state maintained by residents of the requesting state.

The authority to exchange information is not restricted to residents of one or both states. Information may be exchanged for use in all phases of the taxation process including assessment, collection, enforcement, or the determination of appeals. Any information received by a state is to be treated as secret in the same manner as information obtained under the tax laws of that state. Disclosure of the information is limited to authorities, including courts and administrative bodies, involved in

- the assessment or collection of tax,
- the administration and enforcement of tax, or
- the determination of appeals in relation to tax.

Information received in any of the three categories may be disclosed in public court proceedings or in judicial decisions.

If one state requests information, the other state is required to use its information gathering measures to obtain the requested information. The requested state is not permitted to decline to obtain and supply information simply because it has no domestic tax interest in such information. This provision is in Article XXVII. It is intended to preclude the taxpayer argument that the requested state is not authorized to obtain information from a bank or fiduciary that is not needed for its own tax purposes.

Article XXVII does not impose an obligation on the requested state to

- carry out administrative measures at variance with the laws and administrative practice of either state,
- supply information that is not obtainable under the laws or in the normal course of the administration of either state,
- supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or
- supply information the disclosure of which would be contrary to public policy.

Nonetheless, Article XXVII does not prevent a requested state from voluntarily complying with a request on a discretionary basis, provided its internal laws are not violated.

A requested state may not decline to provide information because that information is held by a financial institution, nominee, or person acting in an agency or fiduciary capacity. Thus, domestic bank secrecy laws (or similar legislation relating

to disclosure of financial information by financial institutions or intermediaries) are overridden by the state's obligation to provide information under Article XXVII.

Finally, in a general note that accompanied the signing of the Fifth Protocol, Canada and the U.S. expressly agree that the standards and practices described for the exchange of information are to be in no respect less effective than those described in the *Model Agreement on Exchange of Information on Tax Matters* developed by the O.E.C.D. Global Forum Working Group on Effective Exchange of Information.

MULTILATERAL CONVENTION ON MUTUAL ADMINISTRATIVE ASSISTANCE IN TAX MATTERS

In negotiating income tax treaties, Canada has abstained from adopting provisions that enforce collection of a treaty partner's tax from its citizens. Along with the U.S., it refused to adopt the assistance in tax recovery provisions of the *Multilateral Convention on Mutual Administrative Assistance in Tax Matters* (the "Convention"). The Convention was designed to cover:

> All possible forms of administrative co-operation between States in the assessment and collection of taxes . . . through exchange of information . . . to the recovery of taxes.[13]

The Convention was developed jointly by the O.E.C.D. and the Council of Europe. It was open for signature in 1988 and came into force on April 1, 1995. The Convention was amended by the 2010 Protocol. Although, Canada signed the Convention on April 28, 2004, it did not ratify the Convention until November 21, 2013. The Convention entered into force in Canada in 2014. The U.S. has not ratified the Protocol.[14] Article 6 of the Convention forms the foundation for what is known as the Common Reporting Standard ("C.R.S."). Although only 26 countries signed the 1988 version of the Convention, 130 jurisdictions are signatories at this time.

C.R.S. is an automatic annual financial information exchange for tax authorities and allows a tax authority to inform another tax authority of the financial accounts held by tax residents of other signatory jurisdictions. Beginning July 1, 2017, Canada Revenue Agency ("C.R.A.") shares information with members of the C.R.S. Multilateral Agreement with which C.R.A. has formalized a C.R.S. partnership, including details of bank accounts held by their residents in Canada. In return, C.R.A. receives information on financial accounts held by Canadian residents outside of Canada from its C.R.S. partners. The information exchanged by C.R.A. comes from filings made to C.R.A. by Canadian financial institutions. Exchanged information includes the nonresident account holder's (i) name, (ii) address, (iii) date of birth, (iv) account balance or value at year end, and (v) certain amounts credited or paid into the account during the year. In comparison to F.A.T.C.A. reporting, C.R.S. has no *de minimis* amount for reporting purposes. The U.S. is not a signatory to C.R.S., as F.A.T.C.A. has been successful in uncovering accounts held outside the U.S.

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[13] See O.E.C.D., "Convention on Mutual Administrative Assistance in Tax Matters," last updated October 2019.

[14] See O.E.C.D. and Council Europe (2011), The Multilateral Convention on Mutual Administrative Assistance in Tax Matters: Amended by the 2010 Protocol, O.E.C.D. Publishing.

by U.S. persons. Nonetheless, the U.S. has automatic bank deposit exchange of information programs with more than 85 countries.[15]

CANADIAN EXPERIENCE WITH INFORMATION EXCHANGE OBLIGATIONS

The automatic exchange of information is permitted by Section 2 of the Canada-U.S. Enhanced Tax Information Exchange Agreement Implementation Act (the "Implementation Act"). It states that Article XXVII of the Treaty authorizes the exchange of information for tax purposes. It is this provision of the Treaty that authorizes the intergovernmental agreement ("I.G.A.") for purposes of exchange of information to enforce F.A.T.C.A.[16]

Hillis v. Canada

Article XXVIA prevents C.R.A. from collecting penalties imposed on its citizens by reason of F.A.T.C.A. or its global counterpart, C.R.S. In *Hillis v. Canada*,[17] a motion for summary judgment was brought by two "accidental Americans" against C.R.A. seeking an injunction to prevent the supply of Canadian financial information to the I.R.S. Accidental American is a popular term in Canada for an individual who was born in the U.S. to Canadian citizens, moved to Canada as a child, and has never worked nor lived in the U.S. as an adult. It is the "accident" of birth in the U.S. that makes the individual a U.S. citizen.

In the *Hillis* case, the appellants argued that the Implementation Act was contrary to the provisions of Article XXVIA. The arguments of the appellants were similar to those who opposed the I.G.A. at the time of enactment. In broad terms, the arguments may be summarized as follows.

The provisions of the Implementation Act

- unduly harm the privacy rights and interests of all Canadians,
- unduly raise compliance costs to all Canadian financial institutions and Canadian taxpayers,
- impede Canada's efforts to enforce its own tax laws, and
- violate the spirit and potentially the letter of a number of Canadian laws and international treaties.

In sum, the appellants argued that by exchanging information under the Implementation Act, C.R.A. was effectively lending assistance to the I.R.S. in collecting tax from Canadian citizens, which is prohibited by Article XXVIA.

The Federal Court disagreed with the plaintiffs' assertions. The authority to exchange information obtained by Canada pursuant to the terms of the Implementation

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[15] See Rev. Proc. 2019-23.

[16] *The Agreement Between the Government of Canada and the Government of the United States of America to Improve International Tax Compliance Through Enhanced Exchange of Information under the Convention Between Canada and the United States of America with Respect on Income and on Capital.*

[17] 2015 F.C. 1082 (September 16, 2015).

Act is derived from Article XXVII of the Treaty. As indicated above, the exchange of information provisions of the Treaty do not expressly prohibit disclosure. The words used in the Implementation Act are explicit and the intention of the two governments was found by the Federal Court to be clear. The intent was that each country agreed to would obtain and exchange, annually and on an automatic basis, all relevant information with respect to reportable accounts, subject to the confidentiality and other provisions of the Treaty.

In reaching its decision, the Federal Court relied on the assurances of C.R.A. that:

> The IRS cannot use such information to administer non-tax laws (such as the US Bank Secrecy Act) or in its dealings with federal entities (such as the Financial Crimes Enforcement Network of the US Treasury Department) who are involved in money laundering repression. Indeed, the CRA will not assist the US in collecting non-tax related penalties such as penalties for failing to file the FBAR [Report of Foreign Bank and Financial Accounts]. Moreover, while the Canada-US treaty says that Canada may assist the US in collecting certain taxes, it also says that the Canadian authorities will not assist the US authorities in collecting a US tax liability if the person was a Canadian citizen when the liability arose. The Federal Court went on to state that, although the Treaty does not prevent the collection and the automatic disclosure of taxpayer information mentioned in Article 2 of the IGA with respect to US reportable accounts, the IRS cannot use such information to administer non-tax laws such as the Bank Secrecy Act in the US or in its operations directed to the suppression of money laundering, such as FinCEN. Consequently, CRA will not assist the U.S. in collecting penalties for failing to file FBAR forms.

"Each country agreed to would obtain and exchange, annually and on an automatic basis, all relevant information with respect to reportable accounts, subject to the confidentiality and other provisions of the Treaty."

As to the argument that the provision lends assistance in the collection of tax in a way this prohibited by Article XXVIA, the Federal Court disagreed, stating:

> Article XXVI A applies only to cases in which tax liability has been determined and is enforceable, and does not apply to the assessment of tax payable, the verification of taxpayer compliance, or related exchanges of information. Accordingly, I find that the automatic exchange of information allowed by the IGA does not amount at the present time to providing assistance in collection, and is thus not captured under this Article. The plaintiffs have conflated the assessment of taxes, verification of compliance, and collection of penalties possibly due by US persons for non-reporting. The arguments made in this respect are not relevant and are premature in any event.

At Paragraph 76 of its decision, the Federal Court concluded that the I.G.A. was not contrary to the Treaty or the Income Tax Act and it was not up to the court to amend the law. The court stated:

> True, a great number of Canadian taxpayers holding US reportable accounts are likely to be affected by a reporting system that in many quarters is considered unjust, costly and ineffective, considering that at the end of the day they are not likely to owe taxes to the US. In the absence of legislative provisions requiring all Canadian financial institutions (provincially and federally regulated) to automatically notify

> their account holders about reporting to the CRA under the IGA and Part XVIII of the ITA, these taxpayers may also be taken by surprise by any consequences that flow from such disclosure. The plaintiffs may find this deplorable, but apart from a constitutional invalidation of the impugned provisions or a change of heart by Parliament or Congress, or the governments of Canada or the US, there is nothing that this Court can judicially do today to change the situation. The impugned provisions have not been held to be ultra vires or inoperative. Judicial courage requires that judges uphold the Rule of Law.

Deegan v. Canada

A similar conclusion was reached in *Deegan v. Canada*.[18] The provisions of the Implementation Act and Sections 263 to 269 of the Income Tax Act, R.S.C. 1985 (5th Supp.), were challenged by individuals who were accidental Americans.

The plaintiffs alleged that those provisions cause Canada to act as an intermediary between Canadian financial institutions and the I.R.S. Those institutions are required to provide C.R.A. with certain information concerning financial accounts belonging to customers whose account information suggests that they may be U.S. persons. C.R.A. then provides that information to the I.R.S. As a result, the plaintiffs alleged that the provisions of the Implementation Act violate the Canadian Constitution,[19] asserting that they constitute an unreasonable seizure of financial information belonging to U.S. persons in Canada. The plaintiffs also alleged that the information exchange under the Implementation Act violated other provisions of the Canadian Constitution because they singled out individuals based on citizenship or national or ethnic origin.[20] Finally, the plaintiffs alleged that the violations do not constitute reasonable limitations on the privacy and equality rights of affected individuals.[21]

The Federal Court disagreed with the allegations and held that the disputed provisions of the Implementation Act are not unreasonable and do not violate the Canadian Constitution.

The information that is obtained by C.R.A. from Canadian financial institutions is not an unreasonable search and seizure. Departing from the approach taken under the revenue rule, the Federal Court determined that an expectation of privacy is appropriate principally when a Canadian statute is criminal or quasi-criminal in nature. Reporting of tax information by Canadian financial institutions to C.R.A., and ultimately to the I.R.S., does not fit into that protected framework. Tax is essentially a regulatory statute, and the information relates to the manner in which income tax is calculated and collected. Hence, a lesser expectation of privacy exists.

The Federal Court also disagreed with the plaintiff's assertion that the information is not of a kind that is regularly obtained under the Income Tax Act and therefore should not be delivered to C.R.A. Following the holding in *Hillis v. Canada*, the banking

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[18] 2019 F.C. 960 (July 7, 2019).

[19] Section 8 of the Canadian Charter of Rights and Freedoms (the "Charter"), Part I of the Constitution Act, 1982, being Schedule B to the Canada Act 1982 (U.K.), 1982, c. 11.

[20] Section 15 of the Charter.

[21] Section 1 of the Charter.

information is foreseeably relevant to U.S. tax compliance and can be obtained by C.R.A. pursuant to a request from the I.R.S. under Article XXVII of the Treaty.

To the extent that the disputed provisions draw a distinction based on national origin and citizenship, they are not discriminatory. In reaching its decisions, the Federal Court took into account the detailed negotiations that were carried on by the Canadian government, attempting to negotiate a carve-out for Canada. When the Canadian government realized that a carve-out was not possible, it realized that entering into an I.G.A. was the only way to avoid a potentially devastating effect on the Canadian financial sector.

The plaintiffs alleged that the purpose of the Implementation Act was to assist the U.S. government in implementing F.A.T.C.A. and finding U.S. tax evaders and cheats, a purpose that cannot be described as pressing and substantial for the Canadian government or Canadian residents. However, at the same time that Canada was negotiating its I.G.A. with the U.S. government, the O.E.C.D. was involved in developing and implementing a common standard for the automatic multilateral exchange of financial account information along the lines of the I.G.A. Hence, the Implementation Act could not be said to be out of line with global expectations of financial privacy.

Finally, the argument that the Implementation Agreement resulted in discrimination based on citizenship and national origin were misplaced. The Federal Court held that a classification based on national origin is a form of discrimination only where it perpetuates ongoing disadvantages or prejudice. That is not the case where compliance with laws of a country of citizenship are in issue.

> The Charter does not require Canada to assist persons resident in this country in avoiding their obligations under duly-enacted laws of another democratic state, nor does it require this country to shelter those living in Canada from the reach of foreign laws. Indeed, as was noted earlier, insulating persons resident in this country from their obligations under duly-enacted laws of another democratic state is not a value that section 15 of the Charter was designed to foster.

Overall, the arguments raised by the plaintiffs paled in comparison to benefits that are derived by the banking industry in Canada. The I.G.A. was necessary for Canadian financial institutions to be deemed compliant with the requirements of F.A.T.C.A. and simplified the related data gathering obligations. In sum, the Implementation Act allowed Canadian financial institutions to avoid 30% withholding taxes on the receipt of capital payments on loans to U.S. residents and simplified the information gathering that would otherwise have been required under F.A.T.C.A.

CANADIAN ACTIVITY IN EXCHANGING INFORMATION

Canada has separate tax collection arrangements with Norway,[22] the Netherlands,[23] and Germany[24] that are similar to Article XXVIA. Each treaty has a minimum balance

[22] Article 28 of the Canada-Norway Income Tax Treaty.

[23] Article XXVIA of the Canada-Netherlands Income Tax Treaty.

[24] Article 27 of the Canada-Germany Income Tax Treaty.

that is required for a referral. The publicly released documentation by C.R.A. blacks out this information. Debts that can be referred arise under the Income Tax Act, the Excise Tax Act, any income or sales taxes collected by Canada on behalf of a province or territory, and all other categories of taxes collected by or on behalf of Canada.

The C.R.A. administrative position on exchanges of information can be found in the *National Collections Manual* (2015). Any referral that is sent to a treaty partner must detail the citizenship of the taxpayer and provide as much information as possible to help the treaty partner. Before it is sent on to a treaty partner, a referral must clear C.R.A.'s Tax Treaty Collection Program. The Tax Treaty Collections Program, upon clearing the request, will forward it to the treaty partner and will be the one that liaises with the treaty partner. Information on this program is not readily available. According to David Sherman, a tax lawyer and author, C.R.A. is reluctant to release any information pursuant to a request made under the Access to Information Act, and only through "tortuous litigation" was he able to obtain the following information[25] – some general statistics, albeit somewhat dated:

- From 1995 to 1999, 177 referrals were made by C.R.A. to the I.R.S. covering $47 million in tax-related debts (amount collected not disclosed) and 87 referrals were made from the I.R.S. to C.R.A. (amount at stake and amount collected not disclosed).
- From 1999 through 2005, 422 referrals were made by C.R.A. to the I.R.S. C.R.A. sent 94 referrals in 2003 and 90 referrals in 2004, covering a total of $96 million. The amounts collected were not disclosed. C.R.A. refused to disclose the number of requests that were received from the I.R.S.
- From 2008 to 2012, annual referrals made by C.R.A. to the I.R.S. ranged between 65 and 115 in number. Collections ranged between $13 million and $69 million. Although all requests were accepted by the I.R.S., no information on the amounts collected was released. During this period, no information was released about collection requests made by the I.R.S. to C.R.A.

PASQUANTINO CASE – FOREIGN CUSTOMS DUTY IS A PROPERTY RIGHT

Pasquantino v. U.S.[26] is a Supreme Court case in the U.S. involving a criminal scheme to defraud Canada of its rightful customs tax revenue. It does not involve a claim by Canada to enforce a customs fraud recovery in the U.S. The defendants attempted to expand the scope of the revenue rule to cover U.S. criminal prosecutions in the U.S. based on smuggling activity into Canada. At first, the defendants succeeded. Ultimately, they lost in the Supreme Court.

Facts and Prior History

Canada imposes substantial sin taxes on alcohol and cigarettes. As a result, a black market exists for those items. Capitalizing on the situation, petitioners David

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[25] David Sherman, "David Sherman's Notes – Canada – United States Income Tax Convention, 1980, Article XXVI-A," TaxnetPro (October 2019).

[26] 544 U.S. 349 (2005).

and Carl Pasquantino, both residents of Niagara Falls, New York, began smuggling cheap liquor into Canada.

Their business began in 1996 and continued through May 2000. Their general procedure was to arrange by telephone to purchase liquor from a discount liquor shop in Maryland. They would drive from Niagara Falls, New York, to Hagerstown, Maryland, to purchase the liquor that would be transported to New York and ultimately smuggled into Canada in hidden compartments in the trunks of cars.

The petitioners were indicted and convicted of wire fraud, in violation of 18 U.S.C. §1343, which provided:

> **§ 1343. Fraud by wire, radio, or television**
>
> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, transmits or causes to be transmitted by means of wire, radio, or television communication in interstate or foreign commerce, any writings, signs, signals, pictures, or sounds for the purpose of executing such scheme or artifice, shall be fined under this title or imprisoned not more than 20 years, or both. If the violation affects a financial institution, such person shall be fined not more than $ 1,000,000 or imprisoned not more than 30 years, or both.

Upon appeal, the U.S. Court of Appeals for the Fourth Circuit[27] reversed the convictions because a scheme to defraud a foreign government of tax revenues was not recognizable under the wire fraud statute due to the application of the revenue rule. The Fourth Circuit acknowledged that Canada's right to collect taxes was a property right for wire fraud purposes but then concluded that the determination of whether Canada was entitled to the tax revenues involved an inquiry into the validity and operation of a foreign revenue law – an inquiry barred by the principles underlying the revenue rule. In so ruling, the Fourth Circuit joined the First Circuit in holding that a scheme to defraud a foreign nation of tax revenues did not violate the wire fraud statute.[28] The Second Circuit previously upheld wire fraud convictions for schemes to defraud a foreign government of tax revenues.[29] Upon motion of the government, the Court of Appeals granted rehearing *en banc* in *Pasquantino*, vacated its prior decision, and affirmed the petitioners' convictions.[30]

U.S. Supreme Court Ruling

The U.S. Supreme Court affirmed the petitioners' convictions for violating the wire fraud statute.

Wire Fraud Statute

The Supreme Court ruled that the two elements of the wire fraud – (i) a scheme or artifice to defraud and (ii) the object of the fraud being money or property in the victim's hands – were present in this case.

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27 *U.S. v. Pasquantino*, 305 F.3d 291 (4th Cir. 2002).

28 *U.S. v. Boots*, 80 F.3d 580 (1st Cir. 1996).

29 *U.S. v. Trapilo*,130 F.3d 547 (2d Cir. 1997).

30 *Supra* note 27.

The petitioners' plot was a "scheme or artifice to defraud" Canada of its valuable entitlement to tax revenue. The evidence showed that the petitioners routinely concealed imported liquor from Canadian officials and failed to declare those goods on customs forms.

"Odd as it may seem for the Federal government to prosecute a U.S. citizen for smuggling cheap liquor into Canada, the broad language of the wire fraud statute authorized such prosecution."

In addition, Canada's right to uncollected excise taxes on the liquor imported into Canada was "property" in its hands, given the economic equivalence between money in hand and money legally due. The fact that the victim of the fraud happened to be the government, rather than a private party, did not lesson the injury.

Revenue Rule

Having found that wire fraud requirement existed, the Supreme Court next moved to determine whether Congress intended to exempt the prosecution from the wire fraud statute under the common law revenue rule, which clearly barred a prosecution for violating a foreign tax law. The Supreme Court found that no common-law revenue rule cases decided as of the enactment of the wire fraud statute in 1952 barred the U.S. from prosecuting a fraudulent scheme to evade foreign taxes. Odd as it may seem for the Federal government to prosecute a U.S. citizen for smuggling cheap liquor into Canada, the broad language of the wire fraud statute authorized such prosecution, and no canon of statutory construction permitted the Supreme Court to read the statute more narrowly. The Supreme Court affirmed the judgment of the Court of Appeals.

The Supreme Court differentiated this case from the classic example of actions traditionally barred by the revenue rule – this case was not a suit to recover a foreign tax liability. Instead, this was a criminal prosecution brought by the U.S. in its sovereign capacity to punish domestic criminal conduct. A prohibition on the enforcement of foreign penal law did not plainly prevent the U.S. government from enforcing U.S. domestic criminal law.

The petitioners argued that the matter inherently involved a collection of tax because a conviction automatically provided restitution rights to the victim – the government of Canada – under the Mandatory Victims Restitution Act of 1996. The Supreme Court, however, adopted a different view. Under this view, restitution and tax enforcement are one and the same. However, the Supreme Court found that the purpose of the Mandatory Victims Restitution Act is merely to award restitution, not to collect a foreign tax. Restitution metes out appropriate punishment for the criminal conduct. If awarding restitution to foreign sovereigns were to be contrary to the revenue rule, the proper resolution would be to construe the act in a way that would not allow such awards, rather than to implicitly repeal the wire fraud statute when the defrauded party is a foreign sovereign.

The Supreme Court acknowledged that the criminal prosecution enforced Canadian revenue law in an attenuated sense but stated that the line the revenue rule drew between impermissible and permissible enforcement of foreign revenue law had always been unclear and no cases yielded a rule sufficiently well established to narrow the wire fraud statute in the context of the criminal prosecution of the petitioners.

The purposes of the revenue rule did not bar its application here:

- The prosecution posed little risk of causing international friction through judicial evaluation of the policies of foreign sovereigns.

- The prosecution embodied the policy choice of the two political branches of our government – Congress and the executive – to free the interstate wires from fraudulent use, irrespective of the object of the fraud. Such a reading of the wire fraud statute gave effect to the policy choice and posed no risk of advancing the policies of Canada illegitimately.
- The Supreme Court's interpretation of the wire fraud statute did not give it extraterritorial effect – the petitioners' offense was complete the moment they executed the scheme inside the U.S. The wire fraud statute punished frauds executed in interstate or foreign commerce and it was not a statute in which Congress had only domestic concerns in mind.

Dissenting Opinion

Justice Ginsburg wrote a dissenting opinion.

The dissent contended that the decision failed to take account of Canada's primary interest in the matter. U.S. citizens who have committed criminal violations of Canadian tax law can be extradited to stand trial in Canada, and Canadian courts are best positioned to decide whether and to what extent the defendants have defrauded the governments of Canada and Ontario out of tax revenues owed pursuant to their own, sovereign excise laws.

The defendants' convictions of wire fraud could not have been obtained without proof of their intent to violate Canadian revenue laws. The fact that the bulk of the defendants' sentences were related, not to the American crime of wire fraud, but to the Canadian crime of tax evasion showed that this case was primarily about enforcing Canadian law. The wire fraud statute contains no reference to foreign law as an element of the domestic crime of wire fraud. By construing the wire fraud statute to encompass violations of foreign revenue laws, the Supreme Court ignored the absence of anything signaling Congress' intent to give the statute such an extraordinary extraterritorial effect.

The opinion disregarded the recognized principal that "Congress legislates against the backdrop of the presumption against extraterritoriality." Notably, when Congress explicitly addresses international smuggling under 18 U.S.C. §546, it provides for criminal enforcement of the customs laws of a foreign nation only when that nation has a reciprocal law criminalizing smuggling into the U.S. At the time of the case, Canada had no such reciprocal law.

The tax treaty between the U.S. and Canada handles the request for assistance for collection of taxes, and the treaty required certification by the requesting nation that the taxes owed had been finally determined. However, the assistance-in-collection provisions did not apply here because such provisions did not apply to a revenue claim relating to a taxable period in which the individual taxpayer is a citizen of the requested state.

The defendants' conduct arguably fell within the scope of the wire fraud statute only because of their purpose to evade Canadian customs and tax laws; short of that purpose, no other aspect of their conduct was criminal in the U.S. The application of the Mandatory Victims Restitution Act of 1996 to wire fraud offenses is corroborative. The fact that the government effectively invited the district court to overlook the mandatory restitution statute out of concern for the revenue rule was revealing and demonstrated that the government's expansive reading of the wire fraud

statute warranted the Supreme Court's disapprobation. Congress has expressed with notable clarity a policy of mandatory restitution in all wire fraud prosecutions while in contrast, is quite ambiguous concerning the wire fraud statute's coverage of schemes to evade foreign taxes. Justice Scalia and Justice Souter join this portion of the dissent.

Finally, the rule of lenity would counsel against adopting the Supreme Court's interpretation of the wire fraud statute as the Supreme Court has long held that, when confronted with two rational readings of a criminal statute, one harsher than the other, the harsher one is to be chosen only when Congress has spoken in clear and definite language. (Justice Scalia and Justice Souter join this portion of the dissent.)

RECENT CASES REGARDING ASSISTANCE IN COLLECTION

As previously discussed, the Treaty contains an article calling for the assistance in collection of taxes of the treaty partner jurisdiction. Two cases in the U.S. illustrate that Canada and the U.S. have similar approaches to the application of Article XXVIA.

Dewees v. U.S.[31]

This case involves a U.S. citizen residing in Canada who, to his chagrin, decided to come into compliance with his U.S. tax obligations only to find that he was denied a refund of Canadian tax.

Facts

Mr. Dewees moved from the U.S. to Canada in 1971 and has continued to reside in Canada through the years in issue. He is the owner of a consulting business that was incorporated in Canada. He paid his Canadian taxes annually, but he did not file his U.S. Federal income tax returns in the U.S.

Mr. Dewees was concerned that the I.R.S. was actively investigating U.S. persons living abroad who did not pay taxes and did not report financial interests in foreign financial accounts. These are persons who did not file F.B.A.R.'s with FinCEN. The penalties for not filing an F.B.A.R. were severe. In 2009, the I.R.S. announced the 2009 Offshore Voluntary Disclosure Program ("O.V.D.P."). It offered taxpayers an opportunity to avoid criminal prosecution and a settlement of a variety of civil and criminal penalties in the form of single miscellaneous offshore penalty. It was based on existing voluntary disclosure practices used by I.R.S. Criminal Investigation. Generally, the miscellaneous offshore penalty for the 2009 program was 20% of the highest aggregate value of the unreported offshore accounts in the period beginning 2003 and ending in 2008. Participants were also required to file amended or late returns and F.B.A.R.'s for those years.

Mr. Dewees applied to participate in O.V.D.P. and was preliminarily accepted into the program. Ultimately, the I.R.S. asserted a miscellaneous offshore penalty in the amount of $185,862. Viewing the penalties to be excessive, Mr. Dewees withdrew from O.V.D.P. This led to an I.R.S. examination in which $120,000 in penalties were assessed. These penalties were related to the failure to file Form 5471, *Information*

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[31] 767 F. App'x. 4 (D.C. Cir., April 9, 2019).

Return of U.S. Persons with Respect to Certain Foreign Corporations, with regard to multiple years.

Mr. Dewees administratively challenged the assessment of penalties through the I.R.S. Taxpayer Advocate's Office, and then through the I.R.S. Appeals Office. Neither succeeded. Dissatisfied, Mr. Dewees refused to pay the penalty.

In 2014, the I.R.S. introduced another program to encourage taxpayers to voluntarily disclose offshore assets – the Streamlined Filing Compliance Procedures (the "Streamlined Procedures"). The Streamlined Procedures differ from the O.V.D.P. in several respects. The Streamlined Procedures involve less paperwork and impose lower penalties than the O.V.D.P.. or no penalties, and only cover three years of noncompliance. In addition, the Streamlined Procedures do not offer immunity from criminal prosecution. Transferring between the two programs is generally disfavored, but taxpayers who are otherwise eligible for the Streamlined Procedures and made their O.V.D.P. submissions before July 1, 2014, were offered the opportunity of remaining in O.V.D.P. while requesting the more favorable terms available under the Streamlined Procedures.

In 2015, the I.R.S. sought assistance from C.R.A., and in 2015, the 2014 Canadian tax refund requested by Mr. Dewees was held back until the I.R.S. penalty was paid in full. This international collection assistance is permitted by Article XXVIA.

Contentions in Litigation

Mr. Dewees promptly sent C.R.A. a check in the amount of $134,116.34, representing the $120,000 penalty plus interest. In September 2015, he filed a claim with the I.R.S. seeking a refund of that amount. The claim was rejected in May 2016. Shortly thereafter, he brought a claim in the District Court for the District of Columbia ("D.C. District Court"),[32] asserting the Treaty provision was unconstitutional under the Excessive Fines Clause of Eighth Amendment, the Due Process Clause of the Fifth Amendment, and the Equal Protection Clause of the Fifth Amendment. The D.C. District Court granted the government's motion to dismiss the case failure to state a claim upon which relief can be granted.

The D.C. District Court granted the motion to dismiss, reaching the following holdings as to the three claims made by Mr. Dewees:

- The Excessive Fines Clause of the Fifth Amendment was not applicable because a tax penalty is considered to be remedial. The clause applies to penalties intended to punish an individual.
- The Due Process Clause of the Fifth Amendment was not violated merely because Mr. Dewees could not appeal the penalty to the Tax Court. The availability of a refund action in U.S. Federal district court afforded him with an adequate opportunity to be heard at a meaningful time and in a meaningful manner.[33]
- The Equal Protection Clause of the Fifth Amendment could not be addressed by the D.C. District Court because Mr. Dewees never applied for the Streamlined Procedures.

[32] 272 F. Supp. 3d 96 (D.D.C. 2017).

[33] *Mathews v. Eldridge*, 424 U.S. 319, 333 (1976).

Decision

On appeal, two issues were presented. Mr. Dewees claimed the D.C. District Court erred when it ruled that he was not denied rights under the Due Process and Equal Protection Clauses of the Fifth Amendment.

As to the Due Process claim, Mr. Dewees argued that he was denied the opportunity of challenging the penalties prior to payment. The court disagree, pointing out that Mr. Dewees had two opportunities to appeal the penalty asserted in the I.R.S. examination and was unsuccessful. The denial of an opportunity of a third appeal prior to payment does not amount to a constitutional flaw in the process.

As to the Equal Protection claim, Mr. Dewees argued that he was denied the opportunity of lower or no penalties that were subsequently allowed to participants in the Streamlined program. The appellate court agreed that, at a surface level, others were afforded more favorable treatment than he received regarding the penalties for failing to file Form 5471. Thus, he had standing to challenge the denial of entry. However, as a matter of substantive constitutional law, differences in government classification are allowed in there is a rational relationship between the disparity of treatment and a legitimate governmental purpose. In the case, a rational basis existed for different treatment. The Streamlined Procedures were designed to encourage taxpayers that were unknown to the I.R.S. as of June 18, 2014, to come forward. Mr. Dewees came forward previously. Moreover, he was not treated any differently than others with similar facts.

Retfalvi v. Commr.[34]

Retfalvi involves a claim for assistance in collection of Canadian tax made by C.R.A. to the I.R.S. The issue that was framed by Mr. Retfalvi was that Article XXVIA of the Treaty is an unconstitutional provision because it amounts to the adoption of a tax provision that did not originate in the House of Representatives.

Facts

Dr. Retfalvi, is a medical doctor who was born in Hungary. He moved to Canada in 1988 under a restricted work permit, and he became a Canadian citizen in 1993. That same year, Dr. Retfalvi came to the U.S. on a J-1 visa to participate in a medical residency program. After Dr. Retfalvi completed his residency in 1997, he returned to Canada.

The following year, Dr. Retfalvi returned to the U.S. under an H1-B visa. To ensure that he would have a place to live if his H1-B visa was not renewed, Dr. Retfalvi purchased a small condominium in Vancouver and signed a pre-construction contract to purchase a larger one.

In 2005, Dr. Ratfalvi was granted permanent resident status in the U.S. As Dr. Retfalvi was no longer planning to reside in Canada, he sold both condominiums in Canada. Dr. Retfalvi reported the sales on a U.S. Federal income tax return.

In 2008, the C.R.A. sent Dr. Retfalvi a summary of the audit adjustments, finding that he had improperly reported the sale of the condominiums. In 2009, the C.R.A.

[34] F. 3rd. (4th Cir. Docket No. 18-2158, July 16, 2019) reported unofficially at 124 AFTR 2d 2019-5160.

sent him a Notice of Assessment. Dr. Retfalvi filed an untimely objection in February 2010. In March 2010, he filed a timely administrative appeal. C.R.A. denied his appeal and provided him 90 days to file a petition for review by the Canadian Tax Court. However, Dr. Retfalvi did not challenge the proposed deficiency by the deadline of October 3, 2011. As a result, the Canadian tax liability became final on that date.

Notably, on June 23, 2010, Dr. Retfalvi had become a U.S. citizen.

On October 27, 2015, C.R.A. referred the assessment to the U.S. for collection, pursuant to Article XXVIA. On November 16, 2015, the I.R.S. issued a Final Notice – Notice of Intent to Levy and of Your Right to a Hearing (the "Notice"), instructing Dr. Retfalvi to pay $124,286.83 in U.S. currency to satisfy the Canadian revenue claim. In the Notice, the I.R.S. advised that it intended to use its collection procedures if Dr. Retfalvi did not pay the assessment within the allotted period. The Notice indicated that Dr. Retfalvi had 30 days to seek a hearing before the I.R.S. Office of Appeals regarding the proposed levy. In addition, the Notice stated that the I.R.S. had no authority to adjust the underlying Canadian tax liability.

Dr. Retfalvi objected to the Notice on January 13, 2016, and requested a hearing. On February 23, 2016, he sought a hearing before the I.R.S. Office of Appeals under the Collection Due Process Program, pursuant to Code §6330. In response, Dr. Retfalvi was informed that he was not entitled to a hearing under that program, but he was entitled to a limited hearing under the Collection Appeals Program. Dr. Retfalvi then filed for that hearing. On March 24, 2016, the I.R.S. denied Dr. Retfalvi's Collection Appeal Request because it did not have the authority to adjust a foreign tax liability.

Contentions in Litigation

Dr. Retfalvi filed suit for a declaratory judgment and injunctive relief, but the court dismissed the suit for lack of jurisdiction pursuant to the Anti-Injunction Act.[35] Shortly thereafter, he paid the tax assessment and filed a refund claim with the I.R.S. When the claim was denied, Dr. Retfalvi filed a complaint in Federal district court. Several counts in support of recovery were asserted. Among them are the following:

- Article XXVIA violates the Constitution's Origination Clause, as a revenue raising measure that did not originate in the House of Representatives. The Origination Clause provides that all bills for raising revenue must originate in the House of Representatives. Dr. Retfalvi asserted that Article XXVIA is a bill that raises revenue.

- Article XXVIA does not have the force of law because it is not a self-executing treaty provision. Only Congress has the power to lay and collect taxes. Giving Article XXVIA legal effect absent implementing legislation unconstitutionally encroaches on congressional authority.

- The I.R.S. is not authorized to collect taxes because Article XXVIA has no legal force. The I.R.S. lacked statutory authority to use its domestic enforcement powers to collect a foreign assessment on behalf of Canada.

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[35] *Retfalvi v. Commr.*, 216 F. Supp. 3d 648 (E.D.N.C. 2016).

Decision

The district court rejected Dr. Retfalvi's contentions and dismissed the case. On appeal, the Fourth Circuit Court of Appeals affirmed the decision of the district court.

In broad terms, the court reached the following conclusions:

- The Canadian tax collected by the I.R.S. from Dr. Rafalvi was not a tax within the meaning of the Origination Clause. A law does not fall within the Origination Clause if it raises revenue for a specific purpose instead of the obligations of government, generally.
- While the taxing power is granted to Congress, that grant of power is not exclusive. The mere fact that a congressional power exists does not mean that the power is exclusive so as to preclude the making of a self-executing treaty within the area of that power.[36]
- In broad terms, a self-executing treaty provision is equivalent to an act of the legislature.[37] This rule does not apply to a treaty when (i) its text manifests an intention that implementing language is necessary; (ii) the Senate, in giving consent, or Congress, by resolution, requires implementing legislation; or (iii) implementing legislation is constitutionally required. Here, Article XXVIA relies on each country's existing tax laws and procedures for assessment and collection, and requires no additional legislation to operate effectively.
- Article XXVIA authorizes the I.R.S. to employ the procedures created under Code §§6201 and 6301 to pursue and collect Canadian revenue claims. It specifically provides that a revenue claim shall be collected by the requested state as though such revenue claim were the requested state's own revenue claim that has been finally determined in accordance with the laws applicable to the collection of the requested state's own taxes. Consequently, if the U.S. accepts a request from Canada to collect a revenue claim, the U.S. must collect the revenue claim as if it were its own revenue claim.

CONCLUSION

While the revenue rule is not dead within the common law, the world has changed since the time it was first enunciated. Today, treaties, multilateral agreements, and domestic criminal law have reduced the effectiveness of the doctrine. Whether the concept is F.A.T.C.A., C.R.S., the Convention, or criminal enforcement, tax authorities around the world speak with each other, provide information to each other, and provide assistance in collection of taxes. Governments realize that failure to pay tax that has properly been assessed is an activity that should not be supported. In particular, the U.S. and Canada have adopted a working relationship that benefits administrators in both countries. Tax cheats can no longer look with confidence to the revenue rule.

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36 *Edwards v. Carter*, 580 F.2d 1055 (D.C. Cir. 1978).

37 *Medellin v. Texas*, 552 U.S. 491 (2008).

APPENDIX I

Today, Article XXVIA provides as follows:

1. The Contracting States undertake to lend assistance to each other in the collection of taxes referred to in paragraph 9, together with interest, costs, additions to such taxes and civil penalties, referred to in this Article as a 'revenue claim'.

2. An application for assistance in the collection of a revenue claim shall include a certification by the competent authority of the applicant State that, under the laws of that State, the revenue claim has been finally determined. For the purposes of this Article, a revenue claim is finally determined when the applicant State has the right under its internal law to collect the revenue claim and all administrative and judicial rights of the taxpayer to restrain collection in the applicant State have lapsed or been exhausted.

3. A revenue claim of the applicant State that has been finally determined may be accepted for collection by the competent authority of the requested State and, subject to the provisions of paragraph 7, if accepted shall be collected by the requested State as though such revenue claim were the requested State's own revenue claim finally determined in accordance with the laws applicable to the collection of the requested State's own taxes.

4. Where an application for collection of a revenue claim in respect of a taxpayer is accepted

   a. By the United States, the revenue claim shall be treated by the United States as an assessment under United States laws against the taxpayer as of the time the application is received; and

   b. By Canada, the revenue claim shall be treated by Canada as an amount payable under the Income Tax Act, the collection of which is not subject to any restriction.

5. Nothing in this Article shall be construed as creating or providing any rights of administrative or judicial review of the applicant State's finally determined revenue claim by the requested State, based on any such rights that may be available under the laws of either Contracting State. If, at any time pending execution of a request for assistance under this Article, the applicant State loses the right under its internal law to collect the revenue claim, the competent authority of the applicant State shall promptly withdraw the request for assistance in collection.

6. Subject to this paragraph, amounts collected by the requested State pursuant to this Article shall be forwarded to the competent authority of the applicant State. Unless the competent authorities of the Contracting States otherwise agree, the ordinary costs incurred in providing collection assistance shall be borne by the requested State and any extraordinary costs so incurred shall be borne by the applicant State.

7. A revenue claim of an applicant State accepted for collection shall not have in the requested State any priority accorded to the revenue claims of the requested State.

8. No assistance shall be provided under this Article for a revenue claim in respect of a taxpayer to the extent that the taxpayer can demonstrate that

    a. Where the taxpayer is an individual, the revenue claim relates either to a taxable period in which the taxpayer was a citizen of the requested State or, if the taxpayer became a citizen of the requested State at any time before November 9, 1995 and is such a citizen at the time the applicant State applies for collection of the claim, to a taxable period that ended before November 9, 1995; and

    b. Where the taxpayer is an entity that is a company, estate or trust, the revenue claim relates to a taxable period in which the taxpayer derived its status as such an entity from the laws in force in the requested State.

9. Notwithstanding the provisions of Article II (Taxes Covered), the provisions of this Article shall apply to all categories of taxes collected, and to contributions to social security and employment insurance premiums levied, by or on behalf of the Government of a Contracting State.

10. Nothing in this Article shall be construed as:

    a. Limiting the assistance provided for in paragraph 4 of Article XXVI (Mutual Agreement Procedure); or

    b. Imposing on either Contracting State the obligation to carry out administrative measures of a different nature from those used in the collection of its own taxes or that would be contrary to its public policy (ordre public).

11. The competent authorities of the Contracting States shall agree upon the mode of application of this Article, including agreement to ensure comparable levels of assistance to each of the Contracting States.

APPENDIX II

Today, Article XXVII provides as follows:

1. The competent authorities of the Contracting States shall exchange such information as may be relevant for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes to which this Convention applies insofar as the taxation thereunder is not contrary to this Convention. The exchange of information is not restricted by Article I (Personal Scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the taxation laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the administration and enforcement in respect of, or the determination of appeals in relation to the taxes to which this Convention applies or, notwithstanding paragraph 4 , in relation to taxes imposed by a political subdivision or local authority of a Contracting State that are substantially similar to the taxes covered by this Convention under Article II (Taxes Covered). Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions. The competent authorities may release to an arbitration board established pursuant to paragraph 6 of Article XXVI (Mutual Agreement Procedure) such information as is necessary for carrying out the arbitration procedure; the members of the arbitration board shall be subject to the limitations on disclosure described in this Article.

2. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own tax purposes. The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitations be construed to permit a Contracting State to decline to supply information because it has no domestic interest in such information.

3. In no case shall the provisions of paragraph 1 and 2 be construed so as to impose on a Contracting State the obligation:

   a. To carry out administrative measures at variance with the laws and administrative practice of that State or of the other Contracting State;

   b. To supply information which is not obtainable under the laws or in the normal course of the administration of that State or of the other Contracting State; or

   c. To supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy (ordre public).

4. For the purposes of this Article, this Convention shall apply, notwithstanding the provisions of Article II (Taxes Covered):

a. To all taxes imposed by a Contracting State; and

b. To other taxes to which any other provision of this Convention applies, but only to the extent that the information may be relevant for the purposes of the application of that provision.

5. In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.

6. If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall provide information under this Article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings).

7. The requested State shall allow representatives of the requesting State to enter the requested State to interview individuals and examine books and records with the consent of the persons subject to examination.

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Contacts

If you have any questions regarding this publication, please contact the authors or one of the following members.

NEW YORK

150 EAST 58TH STREET, 22ND FLOOR, NEW YORK, NY 10155

Name	Email	Phone
Galia Antebi	antebi@ruchelaw.com	+1 212.755.3333 x 113
Andreas Apostolides	apostolides@ruchelaw.com	+1 212.755.3333 x 127
Beate Erwin	erwin@ruchelaw.com	+1 212.755.3333 x 116
Nina Krauthamer	krauthamer@ruchelaw.com	+1 212.755.3333 x 118
Jennifer Lapper	lapper@ruchelaw.com	+1 212.755.3333 x 124
Denisse Lopez	lopez@ruchelaw.com	+1 212.755.3333 x 133
Simon H. Prisk	prisk@ruchelaw.com	+1 212.755.3333 x 114
Neha Rastogi	rastogi@ruchelaw.com	+1 212.755.3333 x 131
Stanley C. Ruchelman	ruchelman@ruchelaw.com	+1 212.755.3333 x 111

TORONTO

130 KING STREET WEST, SUITE 2300, TORONTO, ON M5X 1C8

Name	Email	Phone
Michael Peggs	peggs@ruchelaw.com	+1 212.755.3333 x 232

Editorial Staff

Jennifer Lapper .... Managing Editor, Art Director

Denisse Lopez ....Copyeditor

WITH PHOTOS BY:

Galia Antebi, Jennifer Lapper, Simon Prisk, Stanley C. Ruchelman, and Francesca York.

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