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INSIGHTS

A GRETT-ABLE SITUATION: NEW TRENDS IN GERMAN REAL ESTATE TRANSFER TAX ON SHARE DEALS

PORTUGUESE TAXATION OF DISTRIBUTIONS FROM TRUST CAPITAL: A CRITICAL ASSESSMENT

O.E.C.D. UNIFIED APPROACH GARNERS LESS UNIFIED COMMENTS FROM EUROPE'S TECH PRODUCERS AND USERS

AND MORE

Insights Vol. 7 No. 1

TABLE OF CONTENTS

Editors' Note

A gRett-able Situation: New Trends in German Real Estate Transfer Tax on Share Deals 4

Portuguese Taxation of Distributions from Trust Capital: A Critical Assessment 11

O.E.C.D. Unified Approach Garners Less Unified Comments from Europe's Tech Producers and Users 18

Same Same, But Different: Taxation of the Sale of Stock of an Indian Company by a U.S. Person 24

German Supreme Tax Court Rules in Favor of Taxpayer – U.S.-German Repatriation Non-taxable 34

Contacts

EDITORS' NOTE

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

- **A gRETT-able Situation: New Trends in German Real Estate Transfer Tax on Share Deals.** For decades, the German Real Estate Transfer Tax Act ("gRETT Act") has imposed a transaction tax on the sale of real estate in Germany. In recent years, the tax has applied to the sale of shares that indirectly transfer real estate located in Germany. When initially enacted, a sale of all shares was taxable under the gRETT Act. In the year 2000, the triggering percentage was reduced to 95%. Last year, proposed legislation would have reduced the triggering percentage to 90%, but the draft bill was never enacted. In 2020, the triggering percentage may be reduced to as low as 75% or some other percentage whenever new legislation is adopted. Exactly what constitutes an indirect sale of German real estate is surprisingly broad, and unlike comparable taxes in other countries, the sales need not be related nor contemporaneous. In recent years, a populist clamor has arisen to broaden the scope of indirect transfers subject to the tax. Michael Schmidt of Schmidt Taxlaw, Frankfurt am Main, Germany, explains how and when the tax is imposed under current law and how it may be modified in the coming months.

- **Portuguese Taxation of Distributions from Trust Capital: A Critical Assessment.** How does a country adopt a law to tax the income of an entity that generally is not recognized under local law? In Portugal, there is room for improvement. The 2014 reform of the Portuguese Personal Income Tax ("P.I.T.") Code introduced certain taxing provisions that specifically address "fiduciary structures," the Portuguese term for trusts. Two separate categories of payments were established for purposes of imposing tax. Under the first category, all amounts paid or made available to a Portuguese tax resident are taxable. This includes capital distributions. Under the second category, gains realized by the taxpayer who formed the fiduciary structure are taxed at the time of a final distribution incident to the structure's liquidation, unwinding, or termination. Other beneficiaries can receive liquidation distributions without suffering any tax. João Luís Araújo and Álvaro Silveira de Meneses of Telles Advogados, Porto and Lisbon, Portugal, suggest that solid arguments support the view that certain distributions should be seen as outside the scope of the P.I.T. Code, including (i) distributions of trust capital to the settlor during the ongoing existence of a trust and (ii) distributions to non-settlors that are akin to gifts.

- **O.E.C.D. Unified Approach Garners Less Unified Comments from Europe's Tech Producers and Users.** How does a group of experts comment on the indescribable in order to arrive at a consensus? Inconsistently is the answer. As the O.E.C.D. continues its work on the taxation of the digital economy, the O.E.C.D. Centre for Tax Policy and Administration received comments in advance of a public consultation in late November 2019. The public consultation heard input from interested parties on the policy development aspects of a "Unified Approach" to the determination of tax nexus and profit allocation rules relevant to customer-facing corporate participants in the digital economy. From the consultation, a "great divide"

appears to exist on the Unified Approach. The policy interests are clearly inconsistent when looking at (i) tech haves v. have-nots and (ii) consumers v. producers. The broadly North-South partition that caused the demise of the E.U. Commission's significant digital presence and D.S.T. directives continues to be argued in the larger forum of the O.E.C.D. Tech haves and producers appear to share a common view with U.S. tech firms. Michael Peggs explains the divide in quantitative terms and suggests that, with the exception of the U.K., the adage that looks to see "whose ox is being gored" is a useful tool in identifying those jurisdictions that support digital taxes and others that are opposed.

- **Same Same, But Different: Taxing a Sale of Indian Stock by a U.S. Person.** While tax rules generally appear to be similar in India and the U.S., several divergent provisions in the domestic law of each country produce adverse consequences for those who are not well advised. The prime example involves the taxation of gains from the sale of shares of an Indian company by a U.S. person: India sources the gain based on the residence of the target while the U.S. sources the gain based on the residence of the seller. No relief from double taxation is provided, notwithstanding the capital gains and relief from double taxation articles in the U.S.-India income tax treaty. The result is tax that can be as high as 33.8% of the gain. Rahul Jain and Sanjay Sanghvi of Khaitan & Co., Mumbai, India, along with Neha Rastogi and Stanley C. Ruchelman explain the problem and, more importantly, suggest a path forward for U.S. individuals realizing sizable gains.

- **German Supreme Tax Court Rules in Favor of Taxpayer – U.S.-German Repatriation Non-taxable.** In a recent decision, the German Federal Tax Court (*Bundesfinanzhof* or "B.F.H.") held that repayment of capital by a U.S. subsidiary to its German parent company is not taxable in Germany. While this decision is in line with prior caselaw, it is significant because the B.F.H. held that domestic rules apply when determining the extent to which a distribution by a non-E.U. subsidiary to its German parent comes from profits and the extent to which it comes from capital. Because the participation exemption rules under German law exempts only 95% of the dividend through a disallowance of deemed expenses, tax is due on the 5% of the distribution that is attributable to earnings. Under the decision, two factors control the treatment of a distribution from a non-E.U. country: (i) the domestic accounting or corporate law treatment of the residence country and (ii) the ordering rules under German tax law. Beate Erwin and Nina Krauthamer explain the decision and how it interfaces with the ordering rules of U.S. domestic law under which distributions care treated as dividends, return of capital, and capital gains.

We hope you enjoy this issue.

- The Editors

A GRETT-ABLE SITUATION: NEW TRENDS IN GERMAN REAL ESTATE TRANSFER TAX ON SHARE DEALS

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Tags
Germany
Real Estate
Transfer Tax
Share Deals

Michael Schmidt is the founder of Schmidt Taxlaw, a boutique firm in Frankfurt am Main, Germany. Schmidt Taxlaw is focused, in particular, on cross-border tax and legal advice for family-owned businesses and their owners. Michael is qualified as both a lawyer and a certified tax adviser in Germany. Michael advises his German and foreign clients with respect to cross-border investment structures, corresponding corporate work, estate planning, as well as tax defense strategies.

From a historic perspective, German Real Estate Transfer Tax ("gRETT") is a transaction tax triggered by the transfer of title held in real estate located in Germany. For decades, the German Real Estate Transfer Tax Act ("gRETT Act") followed an approach driven by the legal transfer of title pursuant to applicable civil law. This also applied to direct or indirect share deals regarding German or foreign entities holding real estate located in Germany. Because gRETT is a transaction tax originally imposed on the transfer of legal title, commercially driven concepts that commonly appear for income tax purposes were not relevant.

As originally enacted, only the direct or indirect transfer of 100% of either a partnership holding German real estate (a "Real Estate Holding Partnership" or "R.E.H.P.") or a company holding German real estate (a "Real Estate Holding Company" or "R.E.H.C.") was deemed to be similar to an asset purchase of real estate for gRETT purposes.[1]

The terms R.E.H.P. and R.E.H.C. are not limited to legal entities belonging to real estate developers or real estate investors but include all partnerships and companies that own real estate located in Germany. Thus, all direct or indirect transfers of a participation in such legal entities require the assessment of a potential gRETT liability. This applies even if the "transfer" of real estate held by the legal entity is not the main focus of the transaction, such as an M&A transaction involving a manufacturing entity or an intra-group transfer of shares pursuant to a merger or demerger within the group.

gRETT can apply to all share transfers that revise the ownership chain of an R.E.H.P. or R.E.H.C.; it does not matter whether this share transfer involves an R.E.H.P. or an R.E.H.C. only indirectly. Also, a share transfer regarding a foreign direct or indirect shareholder of an R.E.H.P. or R.E.H.C. is relevant. The gRETT debtor is either the R.E.H.P. or R.E.H.C. or the direct or indirect shareholder depending on the gRETT-able event. The taxpayer is obligated to notify the responsible German tax office of the change in ownership. If the notification is not filed, this non-compliant conduct is typically discovered in a tax audit, when the tax officer checks the requested group charts.

NEW COMMERCIAL APPROACH TO INDIRECT SHARE DEALS

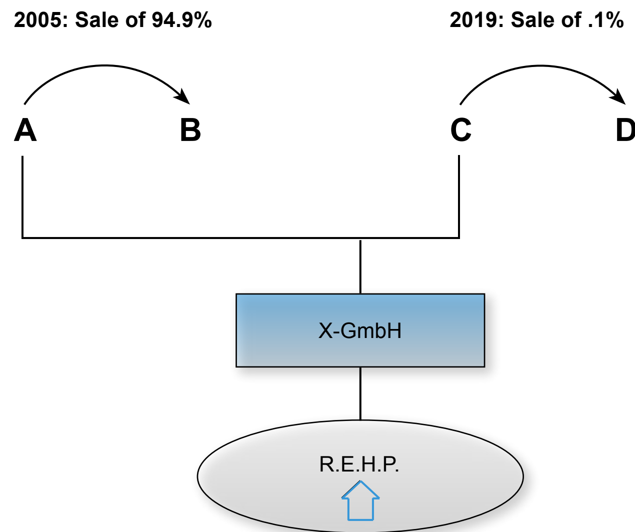
In 2000, the law changed regarding share transfers. From that point, a direct or indirect transfer of a 95% interest in an R.E.H.P. or R.E.H.C. is subject to gRETT.

[1] Sales of shares of an R.E.H.P. holding German real estate have been subject to gRETT since 1996. Sales of interests in a partnership owning German real estate have been subject to gRETT since 1999.

The underlying premise of the change in law is that no significant difference exists between a transfer of a 100% interest in an R.E.H.P. or R.E.H.C. and a transfer of a 95% interest in an R.E.H.P. or R.E.H.C. Consequently, a transfer of a 95% interest in an R.E.H.P. or an R.E.H.C. has become subject to gRETT. This was the beginning of a limited commercial approach to the understanding of what kind of share deal should be subject to gRETT.

From that rather limited beginning, the legislator and the tax authorities have expanded this commercial approach step-by-step. In particular with respect to indirect transfers of participations held by companies in an R.E.H.P., this commercial approach has been expanded significantly. A decree published by the Federal Ministry of Finance on November 12, 2018,[2] (the "Decree") significantly changed the gRETT treatment of share deals indirectly affecting an R.E.H.P. in a tiered ownership structure. The following examples illustrate this tendency:

Example 1:



"No significant difference exists between a transfer of a 100% interest in an R.E.H.P. or R.E.H.C. and a transfer of a 95% interest."

The gRETT Act provides that the direct or indirect transfer of at least 95% of the participation held in an R.E.H.P.'s assets to new partner(s) triggers a gRETT liability only if a participation of 95% in total is transferred within five years to new partner(s).

The Decree modifies the rule in a tiered structure where a corporation owns shares in an R.E.H.P. The five-year limitation no longer applies. Any direct or indirect transfer in X-GmbH triggers gRETT irrespective of this five-year period.

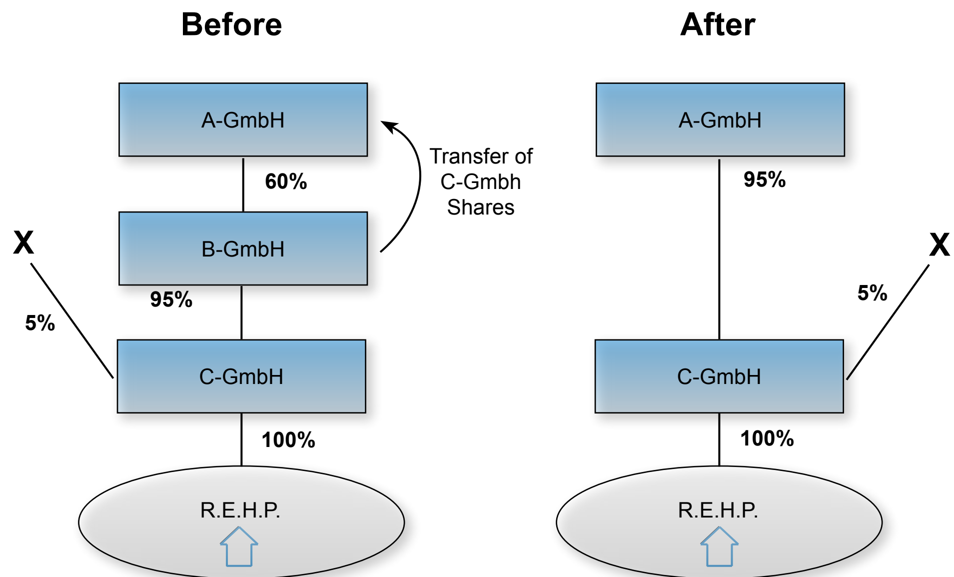
The scope of the decree is illustrated in Example 1. There, X-GmbH was owned until 2005 by A and C. In 2005, B acquired from A 94.9% in X-GmbH and became therefore a new indirect partner of R.E.H.P., while C still held 5.1% in X-GmbH. In 2019, C sells 0.1% of the shares in X-GmbH to D. Since then, B, C, and D hold the entire shares of X-GmbH which owns 100% of R.E.H.P. At all times, A, B, C, and D are unrelated to each other.

Before this Decree. it was the common understanding that the transfer of 0.1% of the shares in X-GmbH from C to D in 2019 would not trigger a gRETT liability,

[2] Decree dated November 12, 2018, Federal Tax Gazette 2018 II, p. 1314 ff.

because B held 94.9% of the shares in X-GmbH for more than five years. However, the Decree changes the result. Under the Decree, the transfer of 0.1% of the X-GmbH shares by C to D in 2019 triggers a gRETT liability. It does not matter that 99.9% of the shareholdings in X-GmbH have been held by the same shareholders in the same percentages for five years or more. The German tax authorities qualify B and D as new (indirect) partners of R.E.H.P. due to the transfer of 95% of the shares held in X-GmbH in two sales, separated by as much as 14 years, among independent parties.

Example 2:

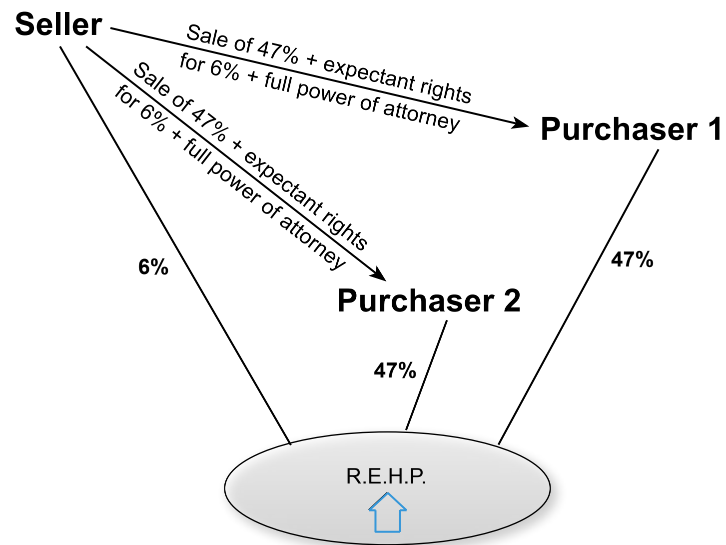


By way of the said Decree, the Federal Ministry of Finance applies a new interpretation that inflicts with the compression of a multi-layer chain of shareholdings in an R.E.H.P. held directly or indirectly by a company. The new approach is based on a commercial view that 95% ownership equates to actual ownership subject to a minority interest.

In the past, a compression of a multi-layer chain of shareholdings in an R.E.H.P. triggered a gRETT liability only when the direct partner of an R.E.H.P. (*i.e.*, C-GmbH in Example 2) was substituted, for example, by a merger. Compression of the ownership chain was not subject to gRETT if the shares of an upper-tier member was removed from the chain of ownership. Consequently, in Example 2, the transfer of shares in B-GmbH to A-GmbH did not trigger a gRETT liability.

According to the tax authorities' new interpretation of the still unchanged gRETT Act, the transfer of shares in B-GmbH to A-GmbH results in a new 95% shareholder of C-GmbH, which redefines C-GmbH as a new partner of R.E.H.P. The transfer of shares in B-GmbH to A-GmbH triggers a gRETT liability for 100% of the real estate held by R.E.H.P. because of the deemed transfer of at least 95% of the participation held in R.E.H.P.'s assets to R.E.H.P.'s deemed new partner C-GmbH.

Example 3:



According to the new interpretation of the still unchanged gRETT Act by the Decree, the transfer of the mere right to enjoy the benefits of a direct or indirect 95% participation in an R.E.H.P. is also treated as a taxable transfer of German real estate owned by an R.E.H.P. The following are examples for possible ways how to enjoy such benefits:

- The grant of an option to acquire (i) the shares held in the direct or indirect partner of the R.E.H.P. or (ii) the interest in the R.E.H.P, which cannot be withdrawn unilaterally from the option holder.
- The voting rights or profits rights held by the title holder of 95% of (i) the shares in the direct or indirect partner of the R.E.H.P. or (ii) the interest in an R.E.H.P. have been transferred to a third party already prior to the transfer of the legal title.
- A deferred transfer of legal title in a transaction that immediately grants to the acquirer the risks and rewards of ownership in 95% of (i) the shares in the direct or indirect partner of the R.E.H.P. or (ii) the interest in the R.E.H.P.

Even the grant of a full irrevocable and open-ended power of attorney could be viewed as a taxable transaction. Under the Decree, both the terms of the power of attorney and the facts surrounding its operation must be taken into account in determining whether the grant triggers a gRETT liability. The result is a lack of certainty as to tax exposure. This is illustrated in Example 3, where the sale of two separate and unrelated transfers of 47%-interests in R.E.H.P. to Purchaser 1 and Purchaser 2 could trigger exposure to a gRETT liability under the Decree, if Seller has granted Purchaser 1 and Purchaser 2 additionally a full joint power of attorney to exercise his partner's rights in R.E.H.P.'s general assembly and to sell his 6% interest for him, even though the Seller has transferred less than 95% of the interests in R.E.H.P.

These new interpretations of the unchanged gRETT Act provisions are controversial, and their validity is questionable. Taxpayers receiving an assessment notice in this context should carefully consider an appeal.

DRAFT BILL EXPANDS SCOPE OF GRETT

Following this administrative expansion of share transfer transactions considered to be subject to gRETT, the German Ministry of Finance published a draft bill[3] (the "Draft Bill"), which proposed changes to the gRETT Act provisions applicable to share deals in a way that further expands the commercial approach to an R.E.H.P. and R.E.H.C. The Draft Bill exposes more share deals to gRETT, which is imposed at the rate between 3.5% and 6.5% of the real estate value. The Draft Bill reflects the government's view that share deals are merely an instrument of illegitimate but legal tax structuring, in particular, in cases of high-volume real estate transactions.

The Draft Bill expands the scope of harmful share deals that are subject to gRETT. The new rules shall apply to the following list of direct or indirect transfers of (i) partnership interests held in an R.E.H.P. and (ii) shares held in an R.E.H.C.:

- A gRETT liability shall be triggered by the transfer of a participation in an R.E.H.P. if, as a result of the transaction, at least 90% of the interests in the R.E.H.P. have been transferred directly or indirectly to new partners within the preceding ten-year period in multiple transactions. In comparison to the existing law, more transactions are covered because the triggering level of share transfer has been reduced by five percentage points and the period looked at has been expanded by five years.
- For the first time, the Draft Bill provides for a provision according to which any transfer of a share held in an R.E.H.C. shall trigger a gRETT liability if, as a result of that transfer, at least 90% of the shares in an R.E.H.C. are transferred directly or indirectly to new shareholder(s) within a period of ten years. This new calculation will include each shareholding at each level, while the current gRETT Act includes only shareholdings of at least 95%.
- In the case of an R.E.H.C., any claim for a legal transfer or any legal transfer of the R.E.H.C. shares, which results either directly or indirectly in a unification of at least 90% (formerly 95%) of an R.E.H.C. in one hand, shall be subject to gRETT.
- In the case of an R.E.H.C., any claim for a legal transfer or any legal transfer of at least 90% (formerly 95%) of an R.E.H.C. – either directly or indirectly – shall be subject to gRETT.
- gRETT is imposed on 100% of the value of the real estate even when the total direct or indirect transfer is limited to as little as 90% of the shares of an R.E.H.C. or the interests in an R.E.H.P.
- The minimum period for holding the participation in an R.E.H.P. shall be extended from five years to ten years after the transfer of the real estate by the partner to an R.E.H.P., which is a precondition for the gRETT exemption applicable to the transfer of real estate to an R.E.H.P. in accordance with the transferor's participation in an R.E.H.P.
- The minimum period for holding the participation in an R.E.H.P. shall be extended from five years to ten years and 15 years, respectively, before the transfer of the real estate to the partner of an R.E.H.P., which is a precondition for

[3] Draft Bill published on the website of the Federal Ministry of Finance on July 31, 2019.

the gRETT exemption applicable to the transfer of real estate from an R.E.H.P. to its partner in accordance with the transferee's participation in an R.E.H.P.

- All these gRETT transactions must be reported on a timely basis to the appropriate German tax authorities.

The Federal government withdrew the Draft Bill on October 24, 2019. It is anticipated that a revised bill will likely be introduced in 2020. The Federal government announced that the Draft Bill will be reworked within the first six months of 2020. High-volume share transactions continue to be viewed by the Federal government as illegitimate, but legal, if they avoid gRETT. In that regard, certain commentators proposed that the trigger that exposes a share transaction to gRETT should be reduced to 75% of the shares of the company. Other commentators cautioned that taxpayers will develop new structures for avoiding gRETT if the government tightens the gRETT anti-abuse rules. Still other commentators suggested that extending the holding period from five years to ten years would be in breach of German constitutional law. Finally, several experts highlighted the negative impact the reform would have on the housing market. According to the information received, a completely new concept for specific real estate holding entities, which at the beginning was in the main focus of the lawmaker, seems to be unlikely, as it is unclear how such specific real estate holding entities shall be defined.

PATH FORWARD

Lobbying Activity

Groups with differing agendas as to gRETT have been lobbying actively, focusing on political parties, the Federal government, the German states, and the legislature. No clear way out of a messy situation is readily apparent. In general, legislators are eager to increase gRETT revenue for the German states.

On the other hand, the real estate industry is lobbying against change. However, it seems unlikely that this gRETT reform can be stopped as the intention to raise the gRETT revenue is backed by the story of so-called fair taxation. The supporters of this gRETT reform point out that ordinary citizens cannot use advantageous share deals when buying a family home. For that reason, they are subject to gRETT, while real estate developers, companies, and wealthy individuals who use share deals can avoid paying gRETT.

It is to be expected that the gRETT Act shall become even more complex and less predictable. Alternatively, it might be worth simplifying the law and reducing the gRETT rates significantly instead. Not long ago, the gRETT rate was 3.5% in all German states. Now, each state is free to set its own gRETT rate. Consequently, the gRETT rates vary between 3.5% in Bavaria and Saxony and 6.5% in other German states. The higher the gRETT rates are, the more attractive share deals become. Regrettably, this approach has not gained traction in political discussions.

Prognostication

At the end of the day, the gRETT reform is not about fairness but only about increasing the gRETT revenue for the German states in times of already well-funded public budgets. From a share deal perspective, it is likely that the gRETT Act will be revised to link the tax to transfers of commercial value of real estate located

in Germany. Under this approach, share deals will become more often subject to gRETT if an R.E.H.P. or an R.E.H.C. is involved.

Structuring real estate acquisitions by way of a share deal has become much more difficult in recent years as a result of decisions made by the German tax authorities. Even though the Draft Bill was withdrawn, there is no political will to retain the status quo. The withdrawn Draft Bill will be reworked by June 2020 and will likely provide lower transfer thresholds for the imposition of tax and longer holding periods to be met in order to escape aggregation of transfers. With the likelihood of new legislative proposals an almost forgone conclusion, the lobbying activity has focused on the adoption of a set of grandfathering rules for existing ownership and structures.

Although the gRETT reform was originally intended to focus on real estate developers and big real estate investors with high-volume real estate transactions, the anticipated gRETT reform will hit also ordinary companies and partnerships that own real estate used as a business asset. These ordinary companies and partnerships face an increased risk of an additional gRETT burden whenever a reorganization occurs regarding global structures above an R.E.H.C. or an R.E.H.P.

"Ordinary companies and partnerships face an increased risk of an additional gRETT burden whenever a reorganization occurs regarding global structures above an R.E.H.C. or an R.E.H.P."

Existing real estate investment structures should be assessed to confirm their alignment with the new trend set out in the current decrees of the German Federal Ministry of Finance and in the new draft bill expected in 2020.

Monitoring of Ownership

Group structures should be checked for effectiveness in light of anticipated revisions to the gRETT rules. Groups with operations in Germany may wish to consider the establishment of a single real estate company that should own all German real estate used within the group. It would provide facilities to group members and would not be affected by future internal reorganizations.

Real estate investments done by way of a share deal, which were finalized by end of 2019, are still subject to the currently applicable gRETT rules.

Existing call options and put options with respect to a direct or indirect participation in an R.E.H.P. should be reviewed to determine whether measures should be taken to adapt to the new gRETT interpretation found in the Decree. Similarly, existing call options and put options covering shares held directly or indirectly in an R.E.H.C. should be reviewed to determine the effect of likely new gRETT legislation on exercise.

If a direct or indirect participation of less than 90% is held in an R.E.H.C. or an R.E.H.P., it might be worth considering an increase of this participation so that it will exceed the 90% threshold – but not the 95% threshold – while the current gRETT rules are still in effect. This should be done only with the understanding that a retroactive effective date is not off the table.

The intended reduction of the 95% threshold to 90% or less will mean that an R.E.H.P. and an R.E.H.C. with a large number of direct and indirect partners or shareholders will need to monitor changes in the ownership chain of each of their members closely. Those changes may trigger gRETT imposed on the R.E.H.P. and R.E.H.C.

A stock exchange proviso in the new draft bill might help listed companies. However, such a proviso would not help unlisted companies or partnerships that are either an R.E.H.C. or R.E.H.P., or directly or indirectly hold shares in an R.E.H.C. or interests in an R.E.H.P.

PORTUGUESE TAXATION OF DISTRIBUTIONS FROM TRUST CAPITAL: A CRITICAL ASSESSMENT

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Tags
Distributions
Income Tax
Portugal
Trusts

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INTRODUCTION

As a general rule, trusts are alien to Portuguese law, with the exception of the legal framework for the Madeira Free Trade Zone. Foreign trusts are not recognized in Portugal, which may pose practical problems for family and succession planning when individuals who lived abroad come to reside in Portugal and become treated as tax residents. The attractiveness of Portugal has resulted in a substantial number of wealthy immigrants. For these individuals, the taxation of trust distributions has become a significant part of tax planning, both in the pre- and post-immigration stages.

The 2014 reform of the Personal Income Tax ("P.I.T.") Code introduced certain provisions that specifically address "fiduciary structures." The new provisions address two separate classes of payments related to a fiduciary structure. The first class involves amounts paid or made available to the taxpayer by a fiduciary structure. The second class involves amounts received by the taxpayer who formed the fiduciary structure as a result of its liquidation, unwinding, or termination. Since virtually none of the trusts established by new immigrants have been formed under the laws of Portugal[1] and inasmuch as none are deemed to be tax-resident in Portugal under Portuguese tax legislation, the income generated abroad by the trusts generally is not taxed in Portugal, except in the hands of the beneficiary who is tax-resident in Portugal or if controlled foreign company rules apply. The receipt of the trust distribution triggers tax issues for the beneficiary who is deemed or registered as tax-resident in Portugal.

The first class of distributions qualifies as investment income ("*Categoria E*" as named in the law) and is subject to tax in the hands of a Portuguese tax resident. The second class is subject to tax on a capital gain basis (under "*Categoria G*" rules), meaning a taxpayer who, as written in the law, "constituted the structure" is taxed only on the gain when the value received upon the liquidation, unwinding, or termination exceeds the basis in assets transferred to the fiduciary structure during its existence. As such, note that amounts received by a non-settlor beneficiary as part of a liquidation, unwinding, or termination distribution are outside the scope of P.I.T.

All trust distributions are allocated between the two classes above. Hence, they are framed as *Categoria E* (investment income) or *Categoria G* (capital gains). It follows that all distributions arising out of the capital of the trust are prima facie taxable in full as a Class 1 distribution, therefore following *Categoria E* rules. Whether this literal approach is correct is open to question as, in the author's view, it lacks a

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1 See below at note 3 relating to the fact that Portugal has not signed the Hague Convention on the Law Applicable to Trusts and Their Recognition.

sound legal basis under the general principles of Portuguese tax law. In addition, solid technical arguments support the view that a distribution made from the capital of a trust should be deemed outside the scope of Portuguese P.I.T. when made to a non-settlor of the trust or that the capital gains rules should apply when the person receiving the distribution is a settlor of the trust.

OVERVIEW OF DISTRIBUTIONS FROM TRUSTS

The Commentary to Article 1 of the O.E.C.D. Model Convention on Estates and Inheritances and on Gifts states that a trust exists when (i) one person, the "trustee," who is the "legal" owner of property, (ii) holds the property under a legally enforceable obligation (iii) to use it for the benefit of another person or group of persons, the "beneficiary" or "beneficiaries," (iv) who are the "beneficial" owners of the property.

Hence, a trust holds and distributes funds following the terms of the trust deed, which sets forth the purpose of the trust and identifies the beneficiaries. Assets are transferred to the trust by a settlor, with the purpose of designating the management of the assets to a third party and the enjoyment of the trust to the beneficiaries. The trust assets may produce income, which is realized for the benefit of the beneficiaries, or gain, which typically is an accretion to capital and is treated separately from the income. The trust deed generally provides for how the trust income is retained or distributed and how the capital may be held as an endowment or distributed to capital beneficiaries which may differ from income beneficiaries.

Consequently, trust distributions can be divided into two separate baskets. The first basket relates to distributions of the income generated by the trust from the investment of its capital into income producing assets. The second basket relates to distributions of capital – the original capital contributed increased by the net gains from the sale of the assets. Conceptually, capital distributions should not be considered to be income. Rather, they should be viewed as the current value of the capital contributed to the trust, as it may have appreciated over time. Viewed this way, a capital distribution to a person who is not a settlor of the trust could be viewed as a form of gift.

The result should not change even when tax transparency is applied. Income arising at the level of the trust but flowing to the beneficiaries is usually subject to tax in the hands of a beneficiary under income tax provisions in the beneficiary's country of residence. In the off chance that the jurisdiction of residence for the trust imposes a general income on capital gains, typically, the trust pays that tax. Transfers of capital to the trust may be subject to a gift tax[2] payable by the settlor when the trust is not considered to be transparent. Transfers of capital from the trust are, as a general rule, not taxable. If the jurisdiction of residence for the trust imposes a general income tax, capital gains may be imposed when a capital asset owned by the trust is sold at a gain.

INCOME ARISING FROM TRUSTS

Trust law has its origins in English law, and trusts are widespread in common law jurisdictions. Portugal is a civil law jurisdiction that does not recognize trusts.

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[2] See, *e.g.*, Pierre Gillioz and Nicole Fragnière Meyer, "Trusts and Taxation in Switzerland," *IBFD Bulletin for International Taxation* 69, no. 4/5 para. 2.3 (2015).

Portugal is not a signatory to the Hague Convention on the Law Applicable to Trusts and Their Recognition.[3] However, trusts have generated tax issues in Portugal where former nonresidents have migrated to Portugal and retained their status as beneficiaries of foreign trusts.

From the viewpoint of the Portuguese media and, to some extent, the tax authority, the use of trusts is mainly associated with tax evasion and tax avoidance schemes. With the exception of the Portuguese income tax treaties with the U.S. and Canada, neither Portuguese income tax treaties in general nor the O.E.C.D. Model Tax Convention make reference to the allocation of taxing rights in the case of a trust that is tax-resident in a treaty partner jurisdiction. Hence, income tax treaties are usually not useful when individuals that are newly arrived Portuguese residents are settlors or beneficiaries of trusts.[4]

While treaties are silent as to the tax treatment of trusts, the 2014 revisions to the P.I.T. Code specifically addresses fiduciary structures. As mentioned above, the provisions covering the tax treatment of trusts appear straightforward and cover two situations, *viz.*¸ Class 1, involving any amounts paid or made available by the trust, which the author construes as being distributions of income; and Class 2, involving distributions that are incident to the liquidation, unwinding, or termination of a trust. Nonetheless, many practical problems exist, and certain unexpected complications may rise, partly because the legislation does not reflect standard practices followed in jurisdictions where trusts generally are formed and administered. This is understandable in a civil law context where trusts are not commonly used in estate

"Portuguese legislation is not entirely up to speed when compared with international practices and standards."

[3] For an historical overview of the recognition of trusts in Portugal and the tax landscape surrounding a foreign trust, see Francisco de Sousa da Câmara "The Taxation of Trusts in Portugal," *IBFD European Taxation* 57, no. 11 (2017). Article 2, Chapter 1 of the Hague Convention on the Law Applicable to Trusts and Their Recognition states that "for the purposes of the Convention, the term 'trust' refers to the legal relationships created – inter vivos or in death – by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose."

[4] As can be read in "Trusts and the Fundamental Freedoms – The Exit Tax Regime in Trustees of the P Panayi (Case C-646/15)," *IBFD European Taxation* 58, no. 6 (2018):

> The Commentary on the OECD Model mentions trusts in connection with the possibility to claim treaty entitlement, which is dependent on meeting the requirements under the personal scope of a particular treaty, *i.e.* whether a legal vehicle – a trust – can be considered a person that is resident in one or both of the contracting state(s). The Commentary mentions trusts in the context of collective investment vehicles (CIVs), and indicates that CIVs could be considered companies or trusts, simple contractual arrangements or a form of joint ownership. In this sense, trusts are compared to CIVs in terms of their nature. The Commentary states that, 'whether a CIV is a 'resident' of a Contracting State depends not on its legal form (as long as it qualifies as a person) but on its tax treatment in the State in which it is established.' This means that the qualification of a trust, as either a transparent or non-transparent entity, is dependent on its nature under the domestic tax law of the contracting state. The Commentary implies that the domestic tax regime should be decisive.

planning.[5] In this respect, Portuguese legislation is not entirely up to speed when compared with international practices and standards.

With respect to typical distributions from a trust, the P.I.T. Code casts a broad jurisdictional net, providing that all amounts paid or made available to the taxpayer by fiduciary structures are taxed. Under the plain meaning of the statute, all payments received from a trust by a Portuguese resident are subject to tax in Portugal as investment income (*Categoria E*).

This interpretation can lead to inconsistent tax treatment triggered by inconsequential differences in facts. This can be illustrated as follows:

- A liquidation distribution made to a non-settlor is outside the scope of P.I.T.[6] It is not taxed.
- If the liquidation distribution is made to the settlor, the distribution is subject to tax on a capital gains basis. This means the tax base is the amount by which the value received exceeds the cost basis in assets transferred to the trust.
- If the same asset is distributed to a beneficiary in an ordinary trust distribution, the entire distribution would be taxed at the standard rate of 28%, or at 35% if the trust is located in a tax advantaged jurisdiction (within the so-called blacklist published by the Portuguese government).
- Were a nonresident individual to transfer the same asset to a Portuguese resident as a gift, the gift would be outside the scope of P.I.T. No gift or inheritance tax would be due as Portugal does not have a formal gift tax regime.[7]

In sum, a literal interpretation of the statute contains logical flaws, as no single baseline tax is relied on to determine abusive situations, taxable transactions, and gifts that are completely exempt from income tax. The literal interpretation is inconsistent with fundamental principles of Portuguese tax law and the Portuguese Constitution.

TAX TREATMENT OF DISTRIBUTIONS FROM THE CAPITAL OF A TRUST

It can be argued that the guidelines incident to the 2014 P.I.T. reform suggest that income distribution from a trust should be taxed in a manner that is consistent with investment income and other similar gains. The P.I.T. Code defines the term "income" as an amount received that results in an increase in the purchasing power and net worth of the taxpayer (rendimento-acréscimo). Gifts are excluded from giving rise to taxable income.

The Portuguese Constitution contains a principle of "taxation following the ability to pay." It follows that the purpose of the P.I.T. is to tax income, not wealth. Hence,

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[5] *E.g.*, in the case of discretionary trusts, see "Dutch Tax Treatment of Discretionary Trusts," *ITSG Global Tax Journa*l, 1, no. 3 (2018).

[6] Article 12.8 of the P.I.T. Code.

[7] However, Portuguese Stamp Duty may be imposed if the operation is deemed within its territorial scope of application. In the case of free transfers, the Stamp Duty rate is 10% and can amount to 10.8% in the case of free transfers of real estate.

distributions from the capital of a trust should not be taxed, as there is no accretion to wealth when all that is received is capital over which the beneficiary held a beneficial interest prior to receipt. In addition, the P.I.T. Code adopts a schedular approach to the imposition of tax. Under this approach, a particular type of income is taxable only if it falls within a specific schedule of taxable income. In general, receipt of capital is not covered by any schedule. The fact that the capital is held in a trust should not be a material factor to prevent application of the general rule.

Distributions of Capital to a Settlor

In principle, distributions of capital to a settlor do not represent a net increase in the settlor's ability to pay, since it is essentially a return of capital previously transferred to the trust. At the same time, and for the same reason, it does not increase the settlor's net worth and purchasing power. In this sense, the receipt of a distribution of capital to the person who settled the trust and contributed capital assets to the trust is not an income event. It was the settlor's capital before it went into the trust, the settlor held a beneficial interest while the capital was an asset of the trust, and it remained the settlor's capital when returned in the form of a contribution.

Nonetheless, in the hard, cold light of day, the law is what the law is; and a capital distribution not incident to the liquidation, unwinding, or termination of a trust potentially is taxable income. If so, how should it be categorized for the schedular tax system in Portugal?

Investment Income?

Investment income may be thought of as income arising from figures akin to civil fruits under Portuguese law, meaning the amounts that are produced by an asset and to which an individual is entitled to under some sort of a legal relationship.[8] In other words, the "fruit" that grows from an investment "tree."

Investment income may be interpreted as any economic advantage acquired directly or indirectly, under whatever of name or designation, in cash or in specie, from patrimonial elements, assets, rights, or juridical situations of a movable nature, including their modification, transmission, or termination whenever not subject to tax in a different category. Article 5.1 of the P.I.T. Code is meant to tax the fact that an individual receives the fruits but not the income that arises from the disposal of the tree.

Therefore, interpreting a return of trust capital to a settlor as falling within a legal provision dealing with investment income is inconsistent with the type of income that is meant to be taxed as investment income for P.I.T. purposes. A distribution of trust capital is not akin to fruit growing on a tree each summer; it is not akin to civil fruit. The taking of the fruit does not diminish the value of the tree, whilst a distribution of capital is, in fact, akin to taking down a major limb and diminishes the growth potential of the trust.

From a technical perspective, taking into account the income that is subject to tax under the Portuguese P.I.T. system, a distribution of capital may not represent an accretion of taxable income in the hands of the beneficiary. Or, even if it does, it is only on a capital gain basis. Taxation following the investment income rules would not take into account the gain that actually may rise: The rules would deem the full

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[8] See Article 212 of the Portuguese Civil Code.

amount received by the beneficiary under a capital distribution to be subject to tax, irrespective the actual gain that can be raised in the hands of the beneficiary. In this light, if a capital distribution is interpreted as investment income in the hands of the Portuguese tax-resident beneficiary, the tax imposed would not follow the actual net gain; it would outweigh the actual "income" received. Hence, such an approach is inconsistent with the constitutional principle of taxation following the ability to pay and other general taxation principles of Portuguese law.

Other Taxable Income?

"When the P.I.T. Code imposes tax on 'amounts paid or made available by fiduciary structures,' the statute was intended to address income distributions and not distributions of capital."

Having established that an eventual net capital gain is income but not investment income, the question remains whether any other provision in the P.I.T. Code subjects that income to tax. Income arising from the disposal of assets is potentially taxed under the category of income pertaining to other asset increases (*Categoria G*), under capital gains (*mais-valias*). Therefore, it is logical for distributions arising from the liquidation, unwinding, or termination of a trust to be outside the scope of P.I.T. when made to a non-settlor or subject to tax as a capital gain if made to a settlor. The same line of reasoning should be applicable to distributions of capital that is not incident to a liquidation or similar event. The positive increase in fair market value may give rise to a taxable gain.

The tax treatment of a capital distribution of a trust should not be materially different from the treatment of a distribution of capital from a company to its shareholders. When a company reduces its share capital, Portuguese tax law treats the capital distribution to the shareholders as return of capital, not as taxable income. It is a simple return of the amount previously invested. It is not income in the sense of *rendimento-acréscimo*, the relevant income for P.I.T. purposes.

In any event, Portuguese law contains a principle under which income that is not of a kind that is addressed under the law should be deemed to be outside the scope of taxation. Following this line of reasoning, the law does not clearly foresee the taxation of the capital gain arising from a distribution of capital to a settlor of a trust as long as the trust is not connected to the individual's business activity. Arguably, the capital distribution is outside the scope of Portuguese P.I.T.

Distributions of Capital to a Non-Settlor

Considering all that has been discussed above, it is clear that, when the P.I.T. Code imposes tax on "amounts paid or made available by fiduciary structures," the statute was intended to address income distributions and not distributions of capital. Hence, when looking at a distribution out of the capital of a trust, the transaction is akin to a gift in the hands of the beneficiary, which is not subject to income tax. This conclusion is supported by the treatment of distributions to non-settlors that are incident to a liquidation, unwinding, or termination of a trust. Those distributions are not taxed under the P.I.T. Code. No policy reason exists to provide different treatment for a distribution of trust capital to a non-settlor that is not incident to the liquidation, unwinding, or termination of a trust.

CONCLUSION

Although untested, solid arguments support the view that distributions of trust capital to the settlor of a trust should be seen as outside the scope of the Portuguese

P.I.T. Code. Only income under P.I.T. concepts should be taxed. Distributions to non-settlors are essentially akin to gifts, which are outside the scope of income taxation in Portugal.

When dealing with a return of trust capital and a distribution arising from the liquidation or termination of the trust, a capital distribution made to the settlor should be construed as a "return" of the capital previously contributed to the trust. No income or gain is generated as long as the value of the distribution does not exceed the basis in assets previously contributed. In addition, a capital distribution made to a person who is not the settlor of the trust should be treated as a gift.

O.E.C.D. UNIFIED APPROACH GARNERS LESS UNIFIED COMMENTS FROM EUROPE'S TECH PRODUCERS AND USERS

Author
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Tags
Digital Economy
O.E.C.D.
Transfer Pricing

As the O.E.C.D. continues its work on the taxation of the digital economy, comments were accepted by the O.E.C.D. Centre for Tax Policy and Administration Secretariat in advance of a public consultation in late November 2019. The public consultation heard input from interested parties on policy development aspects of a "Unified Approach" to the determination of tax nexus and profit allocation rules relevant to customer-facing corporate participants in the digital economy.

The motivation for the O.E.C.D. to seek consensus on profit allocation, and separately on the development of a global base erosion mechanism, is the avoidance of controversy between jurisdictions that impose non-uniform digital services taxes ("D.S.T.'s") in the manner of recent U.K., French, Austrian, Spanish, and Italian legislation.

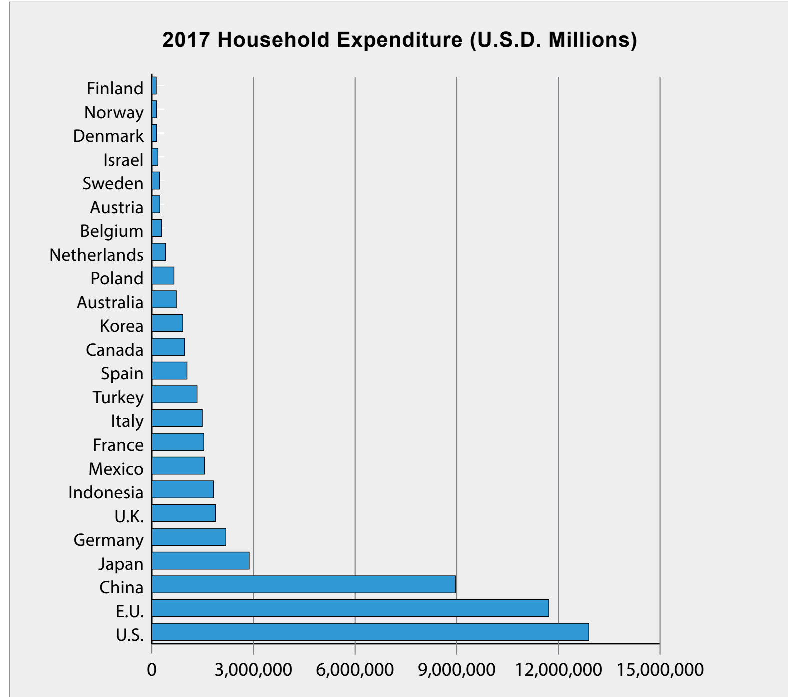
In November's Insights, we looked forward to reading the comments submitted by organizations with different points of view owing to the extent of their participation in the digital economy. This would be the first opportunity to evaluate how the anti-trust spat between U.S. public tech firms and European market-state governments has spilled over into tax policy. But most importantly, we wanted to read the comments of those that share our general analytical bewilderment over the O.E.C.D. proposal and the positions of states that have adopted D.S.T.'s.

The best developing subplot is the global policy struggle to tax the digital economy within the O.E.C.D. and the E.U., where the policy interests of tech haves v. have-nots and consumers v. producers battle head to head. The broadly North-South partition that caused the demise of the E.U. Council's significant digital presence and D.S.T. directives continues to be argued in the larger forum of the O.E.C.D., finding common cause with U.S. tech firms.

DIGITAL CONSUMERS AND PRODUCERS

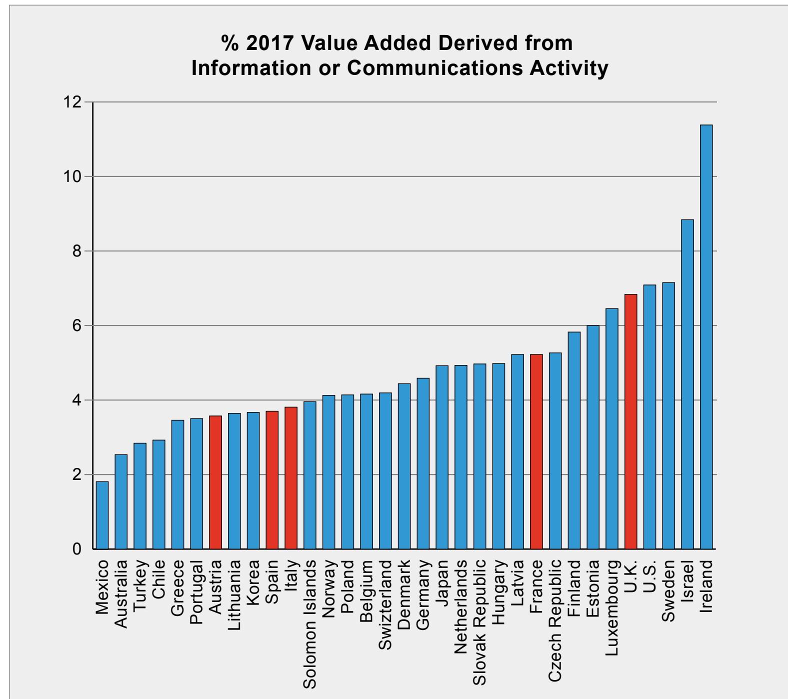
The E.U. and the O.E.C.D. membership is divided between producers of digital economy assets and services, and consumers or users of digital economy services. Given the focus of the Unified Approach is customer-facing businesses, those states with large consumer bases that shop online and produce data used by digital businesses to target marketing and advertising opportunities are generally proponents of policies that result in greater corporate tax payable by digital businesses. The graph on the following page shows that together, the E.U. is a large consumer base, second only to the U.S. and larger than China at 2017 levels. The E.U. countries with D.S.T.'s in place account for about 53% of the E.U. total.

> ***"States with large consumer bases that shop online and produce data used by digital businesses to target marketing and advertising opportunities are generally proponents of policies that result in greater corporate tax payable by digital businesses."***



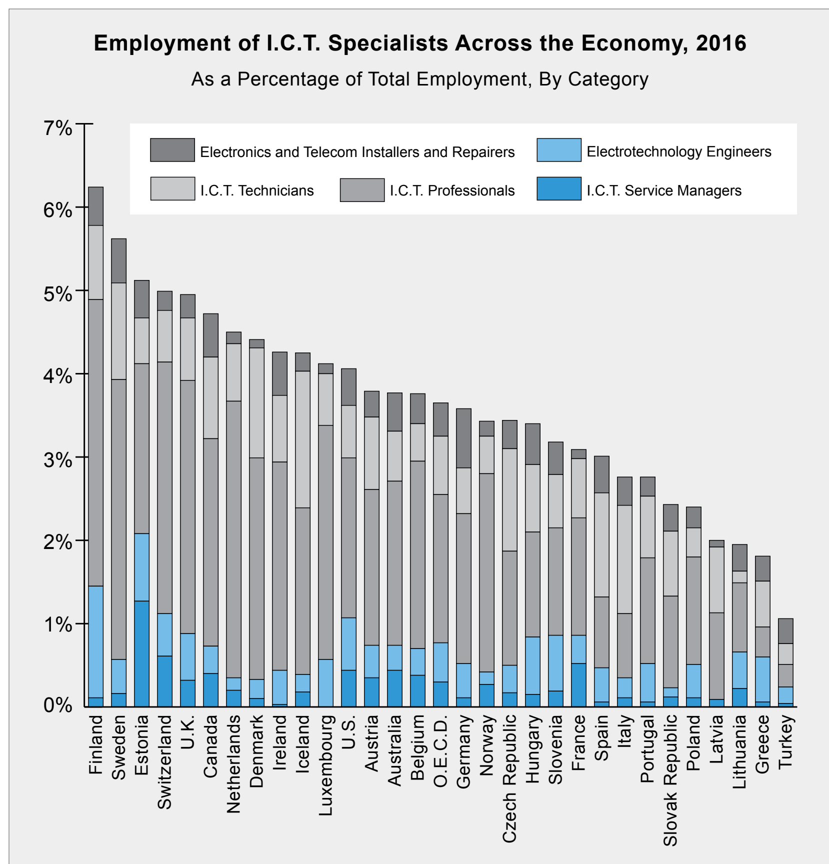
Source: O.E.C.D.

Digital consumers and producers are often not the same country. The graph below shows shares of value added from the national accounts of O.E.C.D. Member States via information and communications activity. Where most digital business is classified though, efforts to better measure the digital economy are currently underway. Relatively high value-added shares are reported by Ireland, Sweden, the U.K., Finland, and Estonia; lower shares are reported by three of the five states with D.S.T.'s.



Source: O.E.C.D.

Like other policy questions, jobs play a critical role. The measure of value added for the digital economy may be somewhat murky when we consider output measurement methods, but counting employed people is relatively uncomplicated. Using 2015 B.E.P.S. Action data that do not account for the considerable increase in activity in online platform, app, and gaming development over the last four years, we can see from the graph below that the digital economy participants based in high-employment countries have more to lose from an expanded nexus standard and a tax imposed on sales by the country in which users or subscribers reside. We should, therefore, expect a different policy approach from, for example, Finland, Sweden, and Ireland than from Spain, France, Italy, Austria, and Portugal. The U.K. is the outlier here, as it imposes a D.S.T. and rates high in I.C.T. employment.



Source: O.E.C.D.

Informal support for this idea comes from a quick scan of the labor market for software developers. In addition to serving as a resource that contributes to the expansion of the home-country tech industry, skilled developers are also hired by foreign companies that incorporate subsidiaries where skilled people live. A *TechRepublic* review[1] used the Diffbot Knowledge Graph A.I. and 2.5 million records of identified skills to rank the best E.U. locations with developer talent. The resulting ranking of countries was as follows:

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1 "10 Countries with the Most Software Developer Talent," *TechRepublic*, July 30, 2019.

1.	Sweden	6.	Denmark
2.	Netherlands	7.	Belgium
3.	U.K.	8.	France
4.	Ireland	9.	Italy
5.	Finland	10.	Portugal

This list generally supports the idea that we should see companies and governments with top-five rankings dissenting or urging caution over unintended policy consequences of the Unified Approach. At the same time, lower ranked countries should be more willing to make trade-offs between corporate tax collections from companies exploiting their markets without establishing a physical presence and the fiscal effects of lost jobs or less tech company investment in local skilled labor. Migration of skilled labor within the E.U. from low-ranked countries to high-ranked countries should be relatively less of a policy concern in low-ranked countries.

THE NORTH REMEMBERS

Not all tech companies submitted written comments to the O.E.C.D. on the Unified Approach proposal. European company commentators were generally located in countries where tech employment and investment are expanding and generally not in countries that might be thought of as net consumers or providers of personal data used to train the Google and Facebook prediction machines.

Part of the algebra of the Unified Approach involves a routine return to a digital permanent establishment in a market country and consolidated non-routine accounting profit attributable to consumer-country market intangibles. Spotify and other commentators noted the potential cash flow hardship that this approach might cause for digital economy participants either in startup mode or with substantial losses from early research and development ("R&D") activity. Others suggested measuring group profit after interest expense, highlighting the need for final financial transactions pricing guidance from the O.E.C.D. to encourage consensus or to better measure the economic impact of the Unified Approach as proposed. Taxing notional profit before a net return to intangible asset development is achieved at a consolidated level. This is viewed to significantly distort the expectations of founders and investors in startup companies. The concern is magnified by the O.E.C.D. proposal to collect tax on the allocated residual profit through a withholding mechanism in cases where sales are made directly to customers, as a withholding tax may bias consumer choices between alternative digital products. These appear to be valid and practical concerns in regions where tech entrepreneurs and venture capitalists are resident.

The general principle of "value creation" in consumer markets is questioned by several commentators, and Spotify indicates that its value creation activities occurred and continue to occur within R&D teams in Sweden and the U.S. Likewise, Finnish game developer Supercell attributes more than 90% of its value creation to innovation that occurs in game studios. This ongoing vague yet crucial term may continue to perpetuate the differing policy views of tech maker and consumer groups and governments.

Other commentators, noting the complexity of the Unified Approach, advocate for expansion of a well-functioning E.U. value-added tax ("V.A.T.") system and a more detailed review of V.A.T. rates. This offering is not likely to satisfy the political imperative in many E.U. market countries with developed V.A.T. regimes. These comments highlight the trade off in the current policy debate between the complexity required to achieve the political objective and the more mundane public finance concern of raising tax revenue at a suitable level while minimizing the cost of administration.

High global consolidated revenue can be earned in high-growth tech companies with a relatively little in-house tax capability. A number of commentators pointed out the significant difference between the compliance capabilities and resources of very large multinational tech companies and high-growth, high-revenue multinational tech companies when considering the cost of complying with the new proposed nexus and profit allocation standard. In addition to the obvious concerns about double tax dispute resolution, this is again a practical problem that approaches the core requirement of earnings and cashflow forecasting for growing companies and their shareholders.

It would also appear as though there are clear views on the level of routine profit in a tech producer jurisdiction that are structurally higher than the consensus view in tech consumer jurisdictions. All signs point to this being an item of contention in an era of continued low interest rates, demanding principled O.E.C.D. guidance rather than G-20 political calculus.

The allocation of non-routine profit by jurisdiction according to sales, as has been proposed, will likely involve the collection and storage of personal data of consumers in B2C businesses. The irony of this data privacy conundrum is not lost on several commentators.

Finally, while many industry commentators argue that their industry should be exempted from the proposed standards, tech industry commentators point out that greater prevalence of Internet of Things and Artificial Intelligence technologies in products and services traditionally considered "bricks and mortar" or B2B involve collecting consumer satisfaction or behavioral data. This continued evolution of corporate business models requires the O.E.C.D. definition of a "consumer facing" business to be both clear and robust to technological development. Some commentators as a result called for partial adoption of the Unified Approach with more investigation to precede a full policy adoption, while others favor making aspects of the policy subject to opt-in or country tax authority discretion.

NO DOUBLE TAX PLEASE, WE'RE BRITISH

People may disagree on tax policy for the digital economy, but they will likely find common ground and agree that the recent policy environment in the U.K. has been beset by extraordinary uncertainty of historical proportions. The comments from U.K. tech organizations, which operate in a country of both makers and users of digital technology and have felt the first waves of D.S.T., were particularly interesting, as expected.

The industry association techUK advocated for a globally coordinated approach with fewer exemptions for small companies and carveouts for particular business sectors. Specific mention was made of the rapidly evolving fin-tech sector as an

industry to which the rules should apply, thereby narrowing the exemption or carve-out for financial institutions. With knowledge of the compliance burden imposed by the U.K. D.S.T., techUK advocated, like many other commentators from Northern Europe, for a single regulator or compliance body. This concept, known as the "one-stop shop," is an alternative to the compliance mechanism introduced by B.E.P.S. Action 13 to manage Country-by-Country Reporting data collection that mimics many of the attributes of the E.U. V.A.T. mini one stop shop ("M.O.S.S.").

It was pointed out that measurement problems relevant to the location of customers or consumers that were familiar at the time of the H.M.R.C. D.S.T. consultations have returned to the discussion of the Unified Approach. Data privacy, consumer use of virtual private networks that obscure location, and the systemic shortage of consumer data that would inform the division of non-routine profit were cited as practical problems that must be overcome to achieve an administrable global system that results in minimal dispute between treaty partners.

"Data privacy, consumer use of virtual private networks that obscure location, and the systemic shortage of consumer data that would inform the division of non-routine profit were cited as practical problems that must be overcome."

Commentary from the retail industry represented by the British Retail Council had a different perspective on the digital economy than the tech industry, firmly situating itself as a retailer of goods as opposed to a consumer-facing business under the Unified Approach. Like other tech industry commentators, the retail industry views sales taxes or consumption taxes as the appropriate policy response.

The extent and depth of industry commentary should provide a well-rounded view of the key policy questions as the O.E.C.D. shepherds its tax administration flocks toward consensus.

SAME SAME, BUT DIFFERENT: TAXATION OF THE SALE OF STOCK OF AN INDIAN COMPANY BY A U.S. PERSON

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Tags
Capital Gain
Double Taxation
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INTRODUCTION

This article explains the U.S. and Indian tax considerations that apply to the sale of shares of an Indian company by an individual who is a U.S. Person holding the shares for investment purposes. It provides a holistic analysis for U.S. Persons investing in shares of an Indian company. The important takeaway is that while tax rules generally appear to be similar in India and the U.S., several different provisions in the domestic law of each country produce adverse consequences for those who are not well-advised.

Notably, both jurisdictions take into account the residency status of the seller and the source of the gain from the sale of shares of stock to determine taxation rights. As an experienced global investor may anticipate, while the principles appear to be the same, the results are very different.

RESIDENCY STATUS OF THE SELLER

U.S. – A U.S. Person Is Subject to Tax on Worldwide Income

The U.S. taxes individuals who meet the definition of a "U.S. Person" on a worldwide basis. An individual is treated as a U.S. Person[1] if the individual is a U.S. citizen or a U.S. resident. A U.S. resident includes a lawful permanent resident ("Green Card Holder") and an individual who meets the "Substantial Presence Test"[2] in the year for which residence is at issue.

For an individual who is a U.S. Person because of citizenship or the issuance of a Green Card, gain from the sale of shares in an Indian company will be subject to U.S. tax regardless of physical residence.

India – A Nonresident Is Taxed on Indian-Source Income

Indian tax law follows residence-based taxation for Indian tax residents and source-based taxation for nonresidents. Income of a nonresident is sourced in India only

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1 Code §7701(b)(30).

2 Code §7701(b)(1)(A)(ii). An individual is said to meet the Substantial Presence Test in the current year if the individual is physically present in the U.S. on at least 31 days during the current year and 183 days during the three-year period that ends with the year in issue. In applying the 183-day test, days in the current year are given full weight. Those in the preceding year are given one-third weight. Days in the second preceding year are given one-sixth weight.

if the income is received, or deemed to be received, in India or it accrues or arises, or is deemed to accrue or arise, in India.[3]

"Income deemed to accrue or arise in India" has been defined to include income derived by a nonresident from the transfer of a "capital asset" situated in India. "Capital asset" means property of any kind held by a taxpayer, and hence, shares of an Indian company are regarded as a capital asset situated in India unless the taxpayer is a dealer in securities and the shares are treated as the equivalent of inventory. Therefore, any income derived by a nonresident from the transfer of shares of an Indian company is deemed to accrue or arise in India and, hence, is subject to capital gains tax in India.

Conflict of Laws

Because the capital gain is taxed in the U.S. under concepts of residence-based taxation and, at the same time, the gain is taxed in India under concepts of source-based taxation, each country claims the right to impose tax on the capital gain derived from the sale of the stock of an Indian company by a U.S. Person.

"Each country claims the right to impose tax on the capital gain derived from the sale of the stock of an Indian company by a U.S. Person."

SOURCE OF THE GAIN AFFECTS FOREIGN TAX CREDIT RELIEF

In order to avoid double taxation, U.S. domestic tax law allows a taxpayer to claim a foreign tax credit to reduce the U.S. tax due on the same stream of foreign-source income.[4] Domestic law is augmented by the terms of the India-U.S. Income Tax Treaty (the "Treaty").[5]

Briefly, U.S. tax law allows taxpayers to claim the benefit of the foreign tax credit to reduce the U.S. tax liability on the same gain only if both of the following conditions are satisfied:

- The income is considered to be foreign-source income under the provisions of U.S. tax law.[6]
- The foreign tax is an income tax in the U.S. sense.[7]

Therefore, U.S. tax law requires another layer of analysis to ascertain whether the Indian income taxes paid on the capital gain on the sale of the stock of an Indian company can reduce the U.S. tax liability on the capital gain.

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3 Section 5 read with Section 9 of Indian Income tax Act, 1961 ("I.T. Act").

4 Code §901.

5 Article 26 (Relief from Double Taxation) of the Treaty.

6 If the income is considered to be U.S.-source income for U.S. tax purposes, the foreign tax credit provides no relief (Code §904(a)). Unused foreign taxes may be carried back one year and carried over ten years (Code §904(c)) and may provide relief if excess limitation exists in the year to which the tax is carried.

7 Under paragraph 1(b) of Article 2 (Taxes Covered), the term "Indian Tax" means the income tax, the surcharge, and the surtax. It also includes o any identical or substantially similar taxes which are imposed after the date of signature of the Treaty. Under paragraph 1 of Article 25 (Relief from Double Taxation) those taxes are considered to be income taxes for foreign tax credit purposes.

Source of the Gain Depends on the Residence of the Seller

The source of the gain controls how much of the U.S. tax can be reduced by the foreign tax credit. If none of the gain is deemed to be foreign-source income, no portion of the U.S. tax on that gain can be reduced by a credit for Indian tax in the year of the sale. Of course, if the U.S. taxpayer reports other items of foreign income that fall in the passive basket or the high-tax basket, as the case may be, the Indian tax paid on the sale of the stock of the Indian company can be used to reduce the U.S. tax on that other foreign income.

The U.S. follows the common law principle of *mobilia sequuntur personam* in determining its right to tax the capital gain arising from the sale of a personal property. The Latin phrase "*mobilia sequuntur personam*" literally means "movable things follow the person." In other words, it holds the situs of a property to be the domicile of the owner.

Code §865 incorporates the general theme of *mobilia sequuntur personam* and provides that the taxation of the gain on the sale of a personal property depends on the residence of the seller. Any gain from the sale of a personal property by a U.S. resident is a U.S.-source income and is therefore subject to U.S. Federal income tax.[8] On the other hand, any gain from the sale of a personal property by a U.S. nonresident is a foreign-source income.[9] In other words, the source of the gain is in the taxpayer's country of residence. The place of sale, place of execution, place of the taxpayer's activities with respect to the property, and location of the property are irrelevant.

Special Definition of "U.S. Resident" for Foreign Tax Credit Purposes

The definition of the term "U.S. resident" under general U.S. tax principles, discussed above, is adjusted when determining the source of income under Code §865. An individual is a U.S. resident for foreign tax credit purposes in any of the following circumstances:[10]

- Any individual who is a U.S. citizen or a resident alien (*i.e.*, a Green Card Holder or an individual who meets the Substantial Presence Test) who does not have a "tax home"[11] in a foreign country
- A nonresident, non-citizen individual who has a tax home in the U.S.

Subject to one major exception, all other individuals are nonresidents under Code §865.

The exception is relatively straightforward. No person can be considered to be a nonresident with respect to a particular sale of property unless that individual

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8 Code §865(a)(1).

9 Code §865(a)(2).

10 Code §865(g).

11 Code §911(d)(3) and Treas. Reg. §301.7701(b)-2(c)(1). An individual has a tax home at a particular place if it is the individual's regular place of business or, if there is more than one regular place, if it is the principal place of business. If an individual does not have a principal place of business, the tax home is at the person's regular place of abode in a real and substantial sense.

actually pays a foreign income tax of at least 10% of the gain[12] on the sale in question.[13] Since (i) the tax rate in India on the capital gain from a sale of corporate stock is 10% or more under all circumstances and (ii) no special set-offs, such as increases to basis to offset reduce the effect of inflation, are allowed, this issue is not discussed further.

Thus, two types of individuals are nonresidents for foreign tax credit purposes:[14]

- A nonresident alien individual (*i.e.*, an individual who is not a U.S. citizen, Green Card Holder, nor non-citizen individual who is a resident under the Substantial Presence Test) who does not maintain a tax home in the U.S.
- A U.S. citizen or resident for tax purposes who maintains a tax home in a foreign country or a U.S. possession and pays a foreign income tax of at least 10% on the gain in question

Because the definition of a U.S. resident is qualified by the requirement that the individual must not have a tax home outside the U.S., if a U.S. citizen or Green Card Holder has been living in India for a considerable period of time with a permanent business or employment located in India, the individual should not fall within the definition of a U.S. resident for foreign tax credit purposes. Consequently, the gain from the sale will be treated as a foreign-source income.

Example 1: A Green Card Holder with a Tax Home in India

Mr. X, an Indian citizen, arrives in the U.S. in the 1980's and obtains a Green Card. He returns to India in 1990, when he is offered a lucrative full-time job from an Indian employer. He retains his Green Card after departing the U.S. Through 2019, he invests in shares of several Indian companies. He sells the stock at a substantial gain in 2019 and is subject to Indian tax at the rate of 10%. That tax is fully paid.

"If a U.S. citizen or Green Card Holder has been living in India for a considerable period of time with a permanent business or employment located in India, the individual should not fall within the definition of a U.S. resident for foreign tax credit purposes."

- **Residence for Foreign Tax Credit Purposes: Code §865**

  Mr. X is a U.S. Green Card Holder (*i.e.*, a lawful permanent resident). However, his principal place of employment is in India in 2019, the year in which the gain is recognized. Therefore, it appears that he does not have a tax home in the U.S. Also, the tax liability in India is equal to or more than 10% (20% in this example). Consequently, he is treated as a U.S. nonresident for Code §865 purposes. The gain will be treated as foreign-source income.

- **Residence for Purposes Other than Foreign Tax Credit: Code §7701(b)(30)**

  Merely because Mr. X is a U.S. nonresident for purposes of Code §865 does not mean that he is a nonresident for other purposes of the Code. In the absence of a treaty election to be treated solely as a resident of India under the Treaty's dual-resident tiebreaker provision,[15] Mr. X will continue to be treated as a U.S. resident under Code §7701(a)(30). Consequently, he is a

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[12] Code §865(g)(2).

[13] To determine whether the foreign tax paid meets the 10% hurdle, the amount paid is divided by the gain determined under U.S. tax concepts.

[14] Code §865(g)(1)(B).

[15] Paragraph 2 of Article 4 of the Treaty.

U.S. Person and is taxed on his worldwide income, including gains from sales of stock of Indian companies.

The foregoing example indicates that the relevance of Code §865 is to ascertain the source of the gain to determine whether a portion of Mr. X's U.S. tax liability is attributable to net foreign-source income. In the facts presented, Mr. X's tax return will report foreign-source gain. Within the limitations of Form 1116, the Indian tax should be available to reduce taxable income.

The above is an example of a perfect fact pattern that allows Mr. X to benefit from the credit. That would not be so if Mr. X were a resident of the U.S. under Code §865(g)(2), as discussed below.

Example 2: A Green Card Holder with a Tax Home in the U.S.

Mr. Z, an Indian citizen, arrives in the U.S. in the 1980's and obtains a Green Card. He remains in the U.S. with his family where he runs a successful business. Over the years, he invests in shares of several Indian companies. He sells the stock at a substantial gain in 2019 and is subject to Indian tax at the rate of 10%. That tax is fully paid.

- **Residence for Purposes Other than Foreign Tax Credit: Code §7701(b)(30)**

  Mr. Z is a U.S. resident under Code §7701(a)(30) for purposes other than the foreign tax credit. He is a Green Card Holder (*i.e.*, a lawful permanent resident in the U.S.). As a result, Mr. Z is taxed on his worldwide income including the gain on the sale of stock of the Indian companies.

- **Residence for Foreign Tax Credit Purposes: Code §865**

  Mr. Z is a U.S. Green Card Holder (*i.e.*, a lawful permanent resident). His principal place of employment is in the U.S. in 2019, the year in which the gain is recognized. He is treated as a U.S. resident for Code §865 purposes. The capital gain recognized by Mr. Z is U.S.-source gain. No portion of Mr. Z's U.S. tax liability relates to foreign-source income or gain. As a result, no portion of Mr. Z's tax can be offset by the foreign tax credit.

CAPITAL GAIN COMPUTATION

In both jurisdictions, the computation of the quantum of the capital gain is a function of the adjusted basis and the sale price.

U.S. – Adjusted Basis of Stock Depends on Form of Acquisition

Typically, the purchase price of the stock is the starting point for determining the adjusted basis in the shares. Additional capital contributions increase the basis. Distributions in excess of earnings and profits and redemptions of shares reduce the basis. If the shares are received as a gift, the recipient of the gift takes a carryover basis from the person making the gift. This means that the adjusted basis in the hands of the person making the gift becomes the adjusted basis for the recipient. If the shares are inherited from a relative or another person, the basis equals the fair market value of the shares on the date of death of the relative or other person. Once the adjusted basis is determined, the gross capital gain is the excess of the selling price over the adjusted basis. Expenditures made to effect the sale, such as

commissions and fees, reduce the net sales proceeds, which in turn reduce the net capital gain.

India – Capital Gain Is the Excess of Selling Price Over Cost of Acquisition

As in the U.S., the purchase price paid for shares forms the adjusted basis in the shares. In a plain vanilla transaction, the taxable capital gain is the excess of the sales price over the adjusted basis, essentially the price originally paid by the seller to acquire the shares. The net capital gain is then reduced by the expenses that are incurred wholly and exclusively in connection with the sale.[16] Typically, the commercially agreed price between unrelated parties is considered as the sale consideration. However, where the shares transferred are unquoted, minimum price requirements are applicable.

- The fair market value for tax purposes ("Tax F.M.V.") is determined pursuant to specified tax rules[17] that form the minimum sale consideration for the seller.
- The excess of the Tax F.M.V. and the acquisition price is taxed as ordinary income in the hands of the purchaser.[18]

In addition, where the transaction is between related parties, the consideration is subject to the arm's length tests under Indian transfer pricing rules. As a result, the sale consideration for computation of capital gains in a related-party transaction is the highest of the following three values: (i) the commercial price, (i) the Tax F.M.V., and (ii) the arm's length transfer pricing value.

IMPACT OF HOLDING PERIOD ON THE TAX RATE

U.S.

Short-Term v. Long-Term Capital Gains

The tax rate imposed on an individual selling shares depends on the length of the holding period for the shares that are sold.

Gain from the sale of an asset held for at least 12 months and one day is subject to reduced tax rates of 0%, 15%, or 20%, depending on the taxable income and gain reported in the tax return for the year of the sale as well as the filing status of the taxpayer.

The gain from the sale of an asset held for not more than 12 months is characterized as short-term capital gain. It is taxed at ordinary income rates of up to 37%.

Tax Rates

For 2020, the tax rate brackets are as follows for a married individual who files a joint tax return with a spouse.

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[16] Section 48 of the I.T. Act.

[17] Section 50CA of the I.T. Act read with Rule 11UA of the Income Tax Rules, 1962.

[18] Section 56(2)(x) of the I.T. Act read with Rule 11UA of the Income Tax Rules, 1962.

Total Taxable Income (Married Filing Jointly)	Long-Term Capital Gains Tax Rate
Up to $78,750	0%
$78,750 to $488,850	15%
Above $488,850	20%

Total Taxable Income (Married Filing Jointly)	Short-Term Capital Gains Tax Rate
Above $0	10%
Above $19,750	12%
Above $80,250	22%
Above $171,050	24%
Above $326,600	32%
Above $414,700	35%
Above $622,050	37%

Net Investment Income Tax

Additionally, a U.S. resident is also subject to net investment income tax ("N.I.I.T.") at the rate of 3.8% on net investment income and gains. For a married individual who files a joint tax return with a spouse, the N.I.I.T. is imposed if the taxpayer's return reports $250,000 or more of modified adjusted gross income. Investment income includes interest, dividends, capital gains, rental and royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments or commodities, and income from businesses that are passive activities to the taxpayer.

India

Short-Term v. Long-Term Capital Gains

The applicable tax rate on capital gains earned by a nonresident individual is dependent on whether the gains are characterized as short-term or long-term capital gains.

Where the shares of the Indian company are listed on a recognized stock exchange in India, capital gains are treated as long-term when the shares are held for a period of at least 12 months and one day before the date of transfer.[19] If the holding period is less, the gain is characterized as short-term capital gain.

[19] Section 2(42A) of the I.T. Act.

Where the shares of the Indian company are unlisted, capital gains are treated as long-term when the shares are held for a period of 24 months and one day. If the holding period is less, the gain is characterized as short-term capital gain.[20]

Tax Rates

For listed shares, the tax on long-term capital gains is 10%.[21] The tax on short-term capital gains is 15%.[22]

For unlisted shares, the tax on long-term capital gains is 10%.[23] Short-term capital gains are taxable at ordinary income tax rates.

The foregoing tax rates do not include the applicable surcharge and educational cess.

TAX PAYMENT MECHANISM

U.S. – Payment of Federal Income Tax Net of Foreign Tax Credit Due by Tax Return Filing Date

The individual will be liable to report the gain on the sale of the stock on Schedule D of Form 1040, *U.S. Individual Income Tax Return*, for the year in which the sale took place. Estimated tax is generally due in four installments throughout the year, and 90% of the ultimate tax due must be paid by the original due date of the return if an extension of the filing date is requested. In broad terms, the estimated tax payments must equal the lower of 100% of the prior year's tax or 90% of the tax that will be due ultimately for the year of the sale.

In Example 1, Mr. X will be subject to a U.S. tax of 20% (assuming the highest capital gain tax rate) and the N.I.I.T. at 3.8%. He will be able to claim the credit of the Indian taxes paid (10%) against his U.S. tax liability. He must file Form 1116, *Foreign Tax Credit*, with Form 1040. He will be liable to pay the N.I.I.T. thereby bringing his total U.S. and India tax liability on the sale to 23.8%.[24]

In Example 2, Mr. Z will be subject to a tax of 20% (assuming the highest capital gain tax rate) and the N.I.I.T. at 3.8%. No portion of his U.S. Federal income tax can be offset by a credit for the Indian taxes paid (10%). As a result, his net global income tax liability arising from double taxation will amount to 33.8%.[25] Mr. Z will also be subject to state and local taxes, if any.

In both instances, the total cost will be increased by a surcharge and an educational cess, which combined range from 2% to 5% depending on the total taxable income in India.

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[20] Section 2(42A) of the I.T. Act.

[21] Section 112A of the I.T. Act.

[22] Section 111A of the I.T. Act.

[23] Section 112 of the I.T. Act.

[24] The surcharge and the educational cess, if applicable, should also be allowed as credit against Mr. X's U.S. tax liability because the cess is typically treated as "tax" in a U.S. sense and, therefore, meets the foreign tax credit eligibility requirement.

[25] The surcharge and the educational cess, if applicable, will be an additional cost to Mr. X.

As explained in greater detail below, the Treaty will not provide any relief from double taxation.

India – Obligation on Purchaser to Withhold Tax

Indian income tax law imposes a withholding tax obligation on Indian residents making payments to nonresidents.[26] Generally, the seller provides a computation of capital gain realized, and on that basis, the purchaser withholds taxes from the payments to the seller.

Where the purchaser does not withhold and deposit applicable taxes, it is treated as a taxpayer in default of its tax obligations.[27] The tax authorities can seek to recover the applicable taxes along with the interest and penalties. Alternatively, the purchaser may be treated as a representative assesse.[28] As the seller's representative, the purchaser is at risk for all taxes, penalties, and interest owed by the seller.

IMPACT OF THE TREATY – TWO STEPS FORWARD AND THREE STEPS BACK

Article 13 (Gains) of the Treaty provides that each country may tax capital gains in accordance with its domestic tax law. The Treaty establishes the taxing rights of both countries. Paragraph 3 of Article 25 (Relief from Double Taxation) of the Treaty provides rules for determining the source of income for purposes of the foreign tax credit. It provides as follows:

> (3) For the purposes of allowing relief from double taxation pursuant to this Article, income shall be deemed to arise as follows:
>
> (a) income derived by a resident of a Contracting State which may be taxed in other Contracting State in accordance with this Convention (other than solely by reason of citizenship in accordance with paragraph 3 of Article 1 (General Scope)) shall be deemed to arise in that other State . . . . Notwithstanding the preceding sentence, the determination of the source of income for purposes of this Article shall be subject to such source rules in the domestic laws of the Contracting States as apply for the purpose of limiting the foreign tax credit.

At first glance, Article 25(3)(a) appears to provide that income derived by Mr. Z in Example 2, who is a U.S. resident (since he is a Green Card Holder), will be deemed to arise in India because it is taxed in India. However, this change in the source of income is immediately reversed, as the provision goes on to state that U.S. rules for determining the source of income for foreign tax credit purposes will control if they differ from the general rules stated in the Treaty. In other words, Article 25(3)(a) gives with one hand but takes away with the other. Consequently, going back to Mr. Z in Example 2, U.S. domestic tax law continues to apply, and as a result, the gain continues to be a U.S.-source income. As is apparent, the Treaty does not come to Mr. Z's rescue.

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[26] Section 195 of the I.T. Act.

[27] Section 201 of the I.T. Act.

[28] Section 160 read with Section 163 of the I.T. Act.

In these circumstances, the only possible remedy would be for Mr. Z to manage his facts to cause the gain to be foreign-source gain under both U.S. tax law and the Treaty. This can be achieved if Mr. Z were to dispose of his U.S. place of residence and move to a foreign country that either provides for a step-up in basis upon the establishment of residence, such as Canada, or that does not impose tax on offshore income of arriving residents or non-domiciled residents, such as the U.K., Switzerland, Portugal, Italy, and Cyprus. In these instances, careful planning is required to ensure that no hidden traps exist in the new place of residence that might prevent Mr. Z from enjoying the expected tax benefit. A re-entry permit should be obtained from U.S. Citizenship and Immigration Services.

Note, the goal is not to relinquish U.S. tax residence or renounce citizenship. It simply is to establish that Mr. Z in a nonresident within the meaning of Code §865(g)(2) for foreign tax credit purposes. The gain will continue to be taxable in the U.S. but will be treated as foreign-source gain because of the move. The Indian tax will continue to be imposed. However, since the tax rate should exceed the 10% threshold provided in Code §865(g)(2), Mr. Z can be treated as a nonresident for purpose of the sourcing rule under that provision. Mr. Z cannot have a place of abode available in the U.S. That is why the abode in the U.S. should be disposed of.

CONCLUSION

Like Mr. X, there are numerous taxpayers who are left with no relief at all and are subject to tax in both countries without any foreign tax credit. This is a classic example of what the tax treaties intend to avoid, yet the governments of the two countries have failed to address the issue. Therefore, given the varying tax implications in the U.S. and India for capital gains on the sale of stock of an Indian company, it is pertinent to undertake an in-depth analysis to evaluate the most tax efficient structure and to have certainty on the overall tax impact. The need to undertake analysis becomes more relevant considering that credit of taxes paid in India may not be available in the U.S., thereby resulting in double taxation. From an Indian tax perspective, one may consider investing through corporate structures in countries having favorable tax treaties with India.

GERMAN SUPREME TAX COURT RULES IN FAVOR OF TAXPAYER – U.S.-GERMAN REPATRIATION NON-TAXABLE

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Tags
Distributions
Germany
Tax-Free Transfer

In upholding a lower tax court's decision, the German Federal Tax Court (Bundesfinanzhof or "B.F.H.")[1] held that repayment of capital by a U.S. subsidiary to its German parent company would be non-taxable under German tax law. This decision is in line with a prior, similarly taxpayer-favorable decision by the same court.[2] However, the importance of this decision extends beyond prior jurisprudence. More specifically, the B.F.H. clarifies that domestic rules apply in determining to what extent a distribution by a non-E.U. subsidiary to the German parent company is made from profits versus capital (the so-called ordering rule).

The distinction is critical – distributions of profits would be subject to German tax for the German parent, whereas a repayment of capital would, under certain conditions, not be taxable. If the non-E.U. subsidiary does not have any earnings and profits ("E&P"), this decision is clear on the non-taxable event for the German recipient parent company. When the subsidiary does have E&P, however, the tax implications are less distinct.

The following describes the case and decision as well as potential discrepancies arising for cross-border repatriations. As will be shown, taken a step further, this decision is exemplary for the mismatch of rules and concepts under civil law and common law as well as corporate and tax law.

THE CASE

The case dealt with a German-resident corporation ("German Parent" or also referred to as the "Taxpayer") that was a 100% shareholder of a U.S. subsidiary ("U.S. Sub" or "B Inc."). From 2004 onwards, German Parent made capital contributions to B Inc. Importantly in this context, the contributions were not made to U.S. Sub's nominal capital.[3] In 2008, the year at issue, U.S. Sub made a distribution to German Parent. At that time, U.S. Sub did not have accumulated earnings, profit carryforwards, or capital reserves from prior year profits. Accordingly, the distribution was

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1. B.F.H. dated April 10, 2019, I R 15/16, issued on September 12, 2019. The B.F.H. is the supreme court in tax and customs matters within German jurisdiction. It is one of the five Federal supreme courts, established according to Article 95 of the *Grundgesetz* (constitutional law promulgated for historic reasons as German Fundamental Law) and has its seat in Munich.
2. B.F.H. dated July 13, 2016, VIII R 47/13.
3. Tax-free treatment of repayments from nominal capital (decrease of capital) has been unequivocal, see B.F.H. dated October 21, 2014, IR 31/13. For E.U.-based subsidiaries, this is set forth by law; absent an explicit rule for non-E.U. subsidiaries, this follows decisions by the B.F.H. (B.F.H. dated July 13, 2016, VIII R 47/13, BFHE 254, 390; VIII R 73/13, BFHE 254, 404; B.F.H. dated October 20, 2010, I R 117/08, BFHE 232, 15), referenced in the decision.

treated as a non-taxable return of capital[4] for U.S. tax purposes. U.S. Sub's tax return, which reflected this tax position, was not challenged by the I.R.S. German Parent treated the distribution as a non-taxable repayment of capital under German tax law.

The German tax authorities contested the Taxpayer's tax return position and classified this payment as a taxable dividend assessing additional tax on 5% deemed non-deductible business expenses (so-called deemed add-back (*Steuerhinzurechnung*)). The German tax authorities argued that a tax-free repayment of capital would require formal approval, which, under German tax law, is available only for subsidiaries based within the E.U.

THE LAW – GERMAN TAXATION OF DIVIDENDS V. REPAYMENT OF CAPITAL

The German dividend exemption applies to dividends received from domestic and foreign participations.[5] For corporate tax purposes, no minimum holding period is set forth. However, the dividend exemption applies only if the corporation holds a minimum participation of 10%.[6] Below that threshold, the entire dividend payment is subject to tax at a rate of about 30%.[7]

The German dividend exemption is, however, limited to 95% of the dividend received. This is achieved by means of an add-back of deemed business expenses (*Hinzurechnungsbesteuerung*).[8] More specifically, 5% of the tax-exempt gross dividends received are treated as non-deductible expenses. In principle, this applies regardless of the amount of effective business expenses related to the dividend.[9] In comparison, payments relating to the tax capital contribution account (*steuerliches Einlagekonto*), *i.e.*, a tax-specific account that evidences contributions by the shareholder for German tax purposes, are excluded from the term "tax-exempt income" for purposes of the dividend exemption. Thus, they are not subject to the 5% deemed business expenses add-back and can be received tax-free by the German parent company.

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4 The term typically used in a U.S. tax context "return of capital" is equivalent to "repayment of capital" and will be used throughout this article interchangeably.

5 *Körperschaftsteuergesetz* ("KStG," or the German Corporation Tax Act), §8b, ¶1. *Cf.* Dr. Wolf-Georg von Rechenberg, "Germany," 2019 Holding Companies of Europe, pp. 282, 284, and 285.

6 KStG, §8b, ¶4. The minimum shareholding must be met at the beginning of the calendar year.

7 The dividend exemption also applies for trade tax purposes. Depending on the subsidiary's jurisdiction, thresholds vary. In the case of non-E.U. foreign dividends received, a participation of at least 15% is required for an uninterrupted period since the beginning of the tax year and the foreign company must pass an activity test. For participations in E.U. subsidiaries, a participation of 10% qualifies for the dividend exemption and no activity test is required.

8 While draft legislation on the implementation of the E.U. Anti-Tax Avoidance Directive (A.T.A.D.) ("*A.T.A.D. Umsetzungsgesetz*") provides for changes to transfer pricing provisions, it maintains the concept of add-back tax, with modifications mainly relating to tiered structures. The draft law was released by the German Ministry on December 10, 2019, and is pending parliamentary approval.

9 Dr. Wolf-Georg von Rechenberg, "Germany," p. 284.

In accordance with an ordering rule under German tax law, dividends generally are deemed to be first funded out of E&P.[10] In other words, a company generally must distribute all of its E&P before a repayment of capital can take place. The starting point for this determination is the tax balance sheet for the recipient parent company, prepared in accordance with German tax rules. Differences between accounting and tax rules are taken care of by additions and subtractions, *e.g.*, relating to differences of periods for amortization and depreciation and timing differences in realization of income.[11] While this ordering rule is set forth under German tax law for domestic and E.U.-based subsidiaries,[12] no rule exists for non-E.U. subsidiaries in the German tax code.

"The complex and time-consuming procedure for determinations in the context of repayment of capital, which is applicable to repatriations made by E.U. corporations (including the cut-off period), is not applicable to repatriations by non-E.U. subsidiaries."

THE B.F.H. DECISION

The B.F.H. disagreed with the German tax authorities' view. Notwithstanding the absence of a tax capital contribution account (*Einlagekonto*), the repayment of capital by non-E.U. subsidiaries should be eligible for non-taxable treatment.

While, in a first instance, the determination of distributable profits by the subsidiary should follow local accounting or corporate law,[13] the ordering rules under German tax law should subsequently apply. Accordingly, a non-E.U. subsidiary should be allowed to provide evidence on repayment of capital (other than from nominal capital). Otherwise, this would constitute an infringement of the freedom of capital which extends to non-E.U. corporations under Article 56 E.G. (Treaty on the European Union) (now Article 63 A.E.U.V. (Treaty on the Functioning of the European Union)).[14]

In the case at issue, this is further supported by the U.S.-German income tax treaty (the "Treaty"), which provides for comprehensive exchange of information between the tax authorities of the contracting states under Article 26(1).

According to the B.F.H., repatriation payments qualify as non-taxable income, if two conditions are met:

- The determination of the repatriated amount is based on the domestic accounting or corporate law of the country of residence of the non-E.U. distributing subsidiary.
- Pursuant to ordering rules under German tax law, no profit is available to be distributed by the non-E.U.-resident subsidiary.

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10 KStG, §27(1) 3rd sentence; applicable to E.U.-based subsidiaries under certain circumstances in KStG, §27(8) introduced in 2006.

11 Hence, while the terms differ, conceptually the determination of E&P in Germany does not deviate from U.S. principles.

12 *Id.* E.U. subsidiaries are subject to a formal approval procedure prior to applying this rule on treatment as (tax free) repayment of capital.

13 In line with B.F.H. dated October 20, 2010, I R 117/08, BFHE 232, 15; B.F.H. dated July 13, 2016, VIII R 73/13, BFHE 254, 404. Note that the term used by the B.F.H. was "*Handelsrecht/Gesellschaftsrecht*," literally translated as Commercial Law or Company Law. In Germany (and likewise in other civil law countries such as Austria), this includes accounting rules.

14 *Cf.* BFHE 254, 390; European Court of Justice, C-685/16, EU: C: 2018: 743, BStBl II 2019, 111 (September 20, 2018).

Further, the court held that the complex and time-consuming procedure for determinations in the context of repayment of capital, which is applicable to repatriations made by E.U. corporations (including the cut-off period), is not applicable to repatriations by non-E.U. subsidiaries.

The B.F.H. decision confirms the decision by the tax court of first instance (*Finanzgericht Muenster* ("F.G.")). Note that in the case at issue, the F.G. pointed out that (i) the repayment related to contributions that were not made towards nominal capital; (ii) U.S. Sub did not have distributable profits, profit carryforwards, or capital reserves from profits; (iii) under U.S. tax law the classification as dividend is subject and limited to the company's E&P; and (iv) the payment was declared as "repayment of capital" and 100% non-taxable in U.S. Sub's tax return, which was not challenged by the I.R.S.

IMMEDIATE IMPLICATIONS

It is unclear whether the B.F.H.'s decision may trigger a revision of the German tax rules. However, in light of the court's decision, it is possible that the tax law could be amended and that a formal approval procedure could be introduced for non-E.U. cases. Alternatively, albeit less likely, the formal procedure that currently is mandatory for E.U. cases could be abolished, with the result that cross-border repayments of capital could be deemed taxable dividends in the future and be subject to the 5% add-back rule for German tax purposes.

Affected taxpayers that were subject to a 5% add-back in connection with a repayment of capital made by a non-E.U. subsidiary should carefully revisit the facts of their case. They may consider filing an objection against the assessments, claiming a non-taxable repayment of capital, based on the B.F.H.'s decision.

FURTHER PROSPECTS – THE U.S. PERSPECTIVE

Notably, for determining whether a distribution constitutes a repayment of capital the B.F.H. deferred to accounting or corporate law under the non-E.U. subsidiary's jurisdiction before applying the German ordering rule. In the case that the non-E.U. subsidiary has E&P, two questions arise: How does one deal with mismatches between the term "E&P" under accounting or corporate law as compared to tax law; and would a differing tax treatment under local tax law impact the treatment for German tax purposes? In the specific case of a U.S. subsidiary of a German parent company, the answers from a U.S. perspective present themselves as described in the following.

Determination of Distributable Profits Under U.S. Law

Capital rules including rules on amounts allowed for distribution are set forth under corporate law. Corporate law in the U.S. is state law.[15] There is no general Federal corporate law and no Federal common law.[16] Thus, contrary to German (civil) law, while common accounting standards under U.S. Generally Accepted Accounting Principles ("G.A.A.P.") exist, capital rules vary widely between states. Some states require a formal balance sheet conforming to U.S. G.A.A.P. and limit payments of

15 See Richard A. Booth, Capital Requirements in United States Corporation Law.

16 *Id.*

dividends to either retained earnings or certain threshold of assets (*e.g.*, California), whereas other states permit dividends without reference to a balance sheet (*e.g.*, Delaware).[17] Hence, reference by the B.F.H. to accounting or corporate law rules under the non-E.U. subsidiary's local law relates to differing standards and sets of rules. From a practical point of view, it appears reasonable to interpret the B.F.H. deferring to contributions and, more specifically, the determination of distributable profits according to the balance sheet prepared in accordance with U.S. G.A.A.P. or similar accepted accounting standards such as I.F.R.S. (International Financial Reporting Standards). One advantage of this approach is that minority shareholders of U.S. subsidiaries would be in a position to provide evidence in this regard based on publicly available information.[18]

Ordering Rules – U.S. Taxation of Dividends

Together with other passive type income, dividends are treated as fixed or determinable, annual or periodic payments (also commonly referred to as F.D.A.P.) which are subject to 30% withholding tax. This tax is levied on the gross amount. For dividends, that income is considered to arise from U.S. sources because of the tax residence of the payer. Under certain conditions, this tax may be reduced or eliminated under an applicable income tax treaty. Note that under U.S. income tax treaties in general and the Treaty in particular, this, in addition, requires that residency[19] and one of the tests under the limitation on benefits ("L.O.B.") article[20] are met.

However, for U.S. tax purposes, not all amounts of distributions received by a person in its capacity as shareholder constitute dividends. The Code sets forth the following ordering rule:

1. A distribution constitutes a dividend to the extent of available current-year or accumulated E&P.[21]

2. The amount in excess of those earnings reduces the shareholder's basis in the stock.[22] This is also referred to as return of capital. Note that this amount does not necessarily correlate to the capital under accounting standards.

3. The amount in excess of basis, if any, is treated as a gain from the sale or exchange of property and is taxable as such.[23]

In principle, the U.S. tax rules are thus comparable to the German ordering rule. A difference may result from the specific provisions on determining E&P for U.S. tax

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[17] Delaware allows dividends to the extent that going concern value exceeds long-term debt and stated capital. *Id.*

[18] Roland Wacker, Repayment of Capital by Non-E.U. Companies According to B.F.H.-Decision Dated April 10, 2019 – I R 15/16, FR 2019, 907 ("*Einlagenrueckgewaehr durch Drittstaatengesellschaften nach dem B.F.H.-Urteil v. 10.4.2019* – I R 15/16, FR 2019, 907") in FR 21/2019, 979 (989).

[19] Article 4 of the U.S.-German income tax treaty.

[20] Article 28 of the U.S.-German income tax treaty.

[21] Code §301(c)(1). A distribution will be treated as a dividend to the extent of a corporation's current-year E&P, even if the corporation has an accumulated E&P deficit.

[22] Code §301(c)(2).

[23] Code §301(c)(3).

purposes as compared to the tax balance sheet in accordance with German domestic tax rules. Taxpayers should consult with their U.S. and German tax counsels to determine the deviations, if any.

Though referenced in various sections, E&P is not defined in the Code. Essentially, it can be described as a company's economic ability to pay dividends to its shareholders without returning paid-in capital. In broad terms, current E&P is approximately equal to the corporate taxable income minus the Federal income tax assessed on it with certain statutory adjustments.[24] These statutory adjustments include deductions that reduce taxable income but do not reduce the corporation's ability to pay dividends or vice versa. Any amounts retained by the corporation increase accumulated E&P, which is the earnings and profits that have been retained by the corporation from previous tax years. Accumulated E&P is a tax term for what, under financial accounting, would be referred to as retained earnings with certain adjustments for tax purposes. Hence, in a U.S. context, E&P is a tax concept that is not similar to profits determined under financial accounting and capital rules.

U.S. Tax Treatment of Repayment (Return) of Capital

To the extent a distribution is a return of capital, it is not gross income as defined under Code §61. Consequently, it is not F.D.A.P.[25] and as such not subject to 30% U.S. withholding tax on F.D.A.P.

Based on the foregoing, because accounting standards deviate from tax rules, the subsequent determination of the extent of a (taxable) dividend and (non-taxable) return of capital that follows tax law may result in differing amounts. In addition, because the latter will be based on German tax rules, this may lead to further discrepancies between the U.S. and German tax. This mismatch will, however, only be relevant for shareholders that do not meet the criteria for exemption from U.S. dividend withholding tax under Article 10, paragraph 3 (direct ownership of 80% or more of voting rights for a 12-month period meeting certain tests under the L.O.B. article) of the Treaty.

CONCLUSION

The takeaway of this decision is twofold: In light of the foregoing, taxpayers should be able to succeed in claiming a non-taxable repayment of capital as long as the aforementioned circumstances, in particular a lack of E&P by the distributing non-E.U. subsidiary, are met. However, in view of the German tax authorities' position special attention should be applied in scenarios that are deviating, in particular if the distributing non-E.U. subsidiary has E&P.

Notwithstanding the clear view the B.F.H. expressed in this decision on the treatment of a distribution by a non-E.U. subsidiary that is not profitable to its German parent as non-taxable repayment of capital, legislative changes may follow. In any event, it will be interesting to see what the future holds for German parent companies with profitable U.S. subsidiaries in otherwise similar circumstances.

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[24] *E.g.*, Code §§301, 312, and 316 and regulations promulgated thereunder. Examples include depreciation and tax-exempt income.

[25] Preamble to Prop. Treas. Reg. 140206-06.

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