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INSIGHTS

2021 – A YEAR IN REVIEW

A YEAR OF GUEST FEATURES

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EDITORS' NOTE

As is our tradition at *Insights*, the December special edition acknowledges the contributions of guest authors throughout the year.

Twenty-three articles written by 36 guest authors appeared in *Insights* in 2021, up from 12 articles in 2020, the year of the COVID-19 virus and resulting lockdowns. Of the 36 guest articles, ten addressed D.A.C.6 implementation in the Netherlands, Spain, Belgium, Ireland, Germany, France, Italy, Luxembourg, Cyprus, and in part, the U.K., six addressed topics in Belgium (challenge to D.A.C.6 implementation law), France (foreign trusts and foreign investment in French real property), Ireland (foreign pensions), and Italy (new transfer pricing regulations and tax competition among member countries, one addressed Swiss tax treatment of foreign trusts, one involved planning for inbound investment in India, two involved Israel (investment funds and individuals with international connections), and three addressed U.S. topics ("tax homes" for pilots, the corporate transparency act, and using New York courts in foreign litigation).

To our guest authors, we extend our heartfelt thanks. To our readers, we wish you all the best in 2022.

Happy Holidays!

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About Us

- **French Treatment of Foreign Trusts.** The French Trust Register was introduced in December 2013 by a law enacted to stop tax fraud and serious economic and financial crimes. In October 2016, the French Constitutional Court ruled that public access to the Trust Register was unconstitutional. In the period since that decision, French authorities have issued two rulings allowing a broad class of persons to gain access to trust data. including tax officers, customs officials, professionals having compliance duties to combat money laundering and terrorist financing, journalists, and N.G.O.'s. Dimitar Hadjiveltchev, Partner, Adea Meidani, Counsel, and Loïc Soubeyran-Viotto, Associate, all of CMS Francis Lefebvre Avocats in Paris, address recent events regarding French tax treatment of foreign trusts and beneficiaries. They begin with the trust register – who must report, what must be reported and who have access – and move on to explain the myriad of taxes that may be imposed on trusts, settlors, and beneficiaries including income tax on distributions, inheritance and gift taxes, and real estate wealth tax.

- **What is the Corporate Transparency Act and What Does it Mean for Business and Incorporators?** The Corporate Transparency Act ("C.T.A.") was signed into law during the waning days of the Trump Administration. When effective, the C.T.A. will require businesses to disclose Beneficial Owner information to FinCEN at the time of company formation and when material changes are made in a subsequent year. Roxana Diaz, Corporate Administrator in the Miami Office of Corpag Registered Agents (USA), Inc., answers the eleven most important questions that affect persons incorporating a business and the professionals providing advice or assistance in the incorporation process.

- **Brace Yourself, Pilots: Your Tax Home Does Not Fly With You.** The concept of a "tax home" is somewhat difficult to explain to persons resident outside the U.S. It has its origin in case law involving taxpayers who work at a temporary location for a finite, but long, period of time. Could the taxpayer deduct living costs incurred in the temporary location when the assignment bears a resemblance to a business trip, albeit for a much longer period of time. From there, it morphed into a requirement for U.S. expats wishing to claim the benefit of the foreign earned income exclusion and its companion provision, the housing deduction. In the case of a pilot who flies between a rotation of airports, and in many instances, between a rotation of countries, what test is used to determine the pilot's tax home? Is it where the pilot happens to be at any time as is the rule for an itinerant worker? Is it where the pilot lives with his family? Is it the starting place for an outbound journey? Is it another place? Gianluca Mazzoni, who holds an S.J.D. '20 and L.L.M. '16 from the University of Michigan Law School, analyzes *Cutting v. Commr*., a case involving a pilot. The article address the terms "*bona fide* resident" and "place of abode," each of which has a meaning for expats claiming the benefits mentioned above.

- **Issue No. 2 – D.A.C.6 Special Report: Mandatory Disclosure Requirements.** On the surface, D.A.C.6 provides a uniform European framework for implementation. In practice, the Directive's national implementation by Member States differs in several key aspects. The rules in ten countries are discussed in the March edition. Each article has a local flavor, reflecting local implementation decisions. Countries covered and the authors include the following:

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- ○ The U.K. (Gary Ashford, of Harbottle and Lewis L.L.P.)
- ○ Belgium (Werner Hayvaert & Vicky Sheikh Mohammad, of AKD Benelux Lawyers)
- ○ The Netherlands (Paul Kraan, of Van Campen Liem)
- ○ Germany (Petra Eckl & Felix Schill, of GSK Stockmann)
- ○ Luxembourg (Sonia Belkhiri & Jiar Al-Zawity, of Wilson Associates)
- ○ Italy (Fabio Chiarenza & Carmen Adele Pisani, of Gianni & Origoni)
- ○ France (Mallaory Labarriere & Anne-Lise Chagneau, of Nexa Avocats)
- ○ Spain (José María Cusí, Juan Roda Moreno, & Cristina Rodriguez Lluch, of Andersen Global)
- ○ Ireland (Martin Phelan, of Simmons & Simmons)
- ○ Cyprus (Nairy Merheje, of Der Arakelian-Merheje, L.L.C.)

- **Private Investment Funds in Israel.** The State of Israel has encouraged foreign investments in Israel for many years. One of its primary tools is the special tax regime applicable to private investment funds. If listed conditions are met, a range of tax benefit benefits are granted to the fund and its investors. These include exemptions from Israeli tax for non-Israeli limited partners with respect to (i) income derived from non-Israeli investments, (ii) capital gains, dividends, and interest form venture capital investments, and (iii) income derived from the realization of Qualified Investments. Anat Shavit, a partner of FBC & Co., Tel Aviv, and Yuval Peled, a senior associate at FBC & Co., Tel Aviv explain the conditions that must be met.

- **New Italian Transfer Pricing Regulations Affect Multinational Enterprises.** Italian transfer pricing documentation rules were introduced in 2010. The system affords taxpayers the possibility of penalty protection for transfer pricing adjustments, provided that qualifying transfer pricing documentation is maintained by the taxpayer. Late in 2020, new regulations were introduced. The new regulations contain several important changes for multinational enterprises based in Italy or having an Italian member. Marco Valdonio, a partner of Maisto e Associati, Milan, and Mirko Severi, an associate of Maisto e Associati, Milan, explain the principal revisions to the Italian rules. They address the changes that broaden the scope of companies required to maintain a master file, reductions in the scope of the exception to annual filing for certain local members of a foreign-based multinational group, and changes to the content of both the master file and the local file.

- **Tax Competition Between Member States of the European Union – An Academic View.** In May, the European Commission lost its second case in the E.U. General Court when Amazon's tax arrangement in Luxembourg was found to be onside as to rules prohibiting illegal state aid among Member States. A companion case was issued the same day in which the penalty asserted by the European Commission was upheld. These cases bring the Commission's record before the Court to two wins and three losses, with three cases in progress. For those readers asking why Commissioner Vestager continues to bring

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these cases, the answer is explained by Professor Pietro Boria, of Sapienza University of Rome. A new electorate has arisen in Europe that is multinational in its scope and led by a governing body answerable to all Member States. Parochial interests that existed through the end of the 20th Century no longer control. Tax policy is no longer the realm of national governments.

- **Taxation in India and the U.S.: Stages in the Life of a U.S.-Owned Indian Company.** When a U.S. corporation expands its operations to India and forms an Indian subsidiary, tax issues need to be addressed in both countries at various points in time – when the investment is first made, as profits are generated, as funds are repatriated, and when the investment is sold. In their comprehensive article, Sanjay Sanghvi, a partner of Khaitan & Co., Mumbai, Raghav Jumar Baja, a principal associate of Khaitan & Co., Mumbai, Stanley C. Ruchelman and Neha Rastogi explain all facets of tax planning in both countries at each stage of the investment and do so in an integrated way.

- **Swiss Update on Trust Regulation and Taxation.** Trusts have been of great importance to advisors all over the world. Even though trusts are mostly found in common law systems, several civil law jurisdictions have implemented the concept of trusts. To date, there is no such thing as a Swiss trust or Swiss trust law. However, Switzerland recognizes the concept of a trust. In their article, Peter von Burg, a partner at Burckhardt Ltd. in Zürich, and Matthias Gartenmann, a Swiss tax lawyer based in Zürich, provide an overview of taxation of trusts in Switzerland. One interesting aspect addressed in the article relates to Swiss administrative assistance in tax matters when the targets of the inquiry are a trust and its beneficiaries.

- **Planning for Nonresident Investment in French Real Estate – The Choice of Company Matters.** Among wealthy Europeans, it is common for those who are not French to own a secondary residence in France, and to do so through a company. Two recurring questions are posed to a French tax adviser representing a non-French client. Should the company be French or foreign? Should the company be subject to corporate tax or not? Sophie Borenstein, a Partner in the Paris office of Klein Wenner explains the variables that must be considered when providing answers. Some work in one set of circumstances and others work in other circumstances. Good advice must be tailored to the anticipated use of the property.

- **Taxation of Foreign Pensions in Ireland – Walking the Tricky Tightrope.** As more individuals relocate to Ireland, the taxation of assets brought with them takes on importance once Irish tax residence is established. Of special concern are pension products that individuals accumulate while living and working outside of Ireland. The taxation of lump sum payments from foreign pensions is a complex affair. Under Irish law, most foreign pensions schemes are considered nonqualifying overseas pension plans. Consequently, lump sum payments from such pension plans should not be taxable in Ireland because no domestic legislation exists to tax lump sums. Lisa Cantillon, a Director in the Dublin office of KTA, explains all, but cautions that the Irish Revenue have a different view, notwithstanding the absence of statutory support.

- **Five Reasons Why the Legal Professional Privilege of Belgian Lawyers is Incompatible With the Mandatory Reporting Under D.A.C.6.** D.A.C.6 in the E.U. requires Member States to impose a disclosure obligation on

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intermediaries who advise on, or are involved in, implementing aggressive cross-border arrangements. This poses a conundrum for tax lawyers involved in a transaction because, whatever they do, rights of taxpayers and duties of attorneys to maintain client confidences may be ignored, or significantly cut back. In Belgium, the approach is to ignore Belgian case law that recognizes the obligations of lawyers to keep confidences and forces attorneys to violate various obligations to clients. Not surprisingly, the Belgian Bar Councils and the Belgian Association of Tax Lawyers have challenged the restrictive interpretation of the L.P.P. before national and European courts. Werner Heyvaert, a partner at the Brussels office of AKD Benelux Lawyers, and Vicky Sheikh Mohammad, an associate at the Brussels Office of AKD Benelux Lawyers, explain the five reasons why Belgian implementation of D.A.C.6 is flawed. The case is currently under consideration by the C.J.E.U.

- **How New York Courts Provide Broad Support to Parties Engaged in International Arbitration and Litigation.** Why is an international tax journal addressing the broad scope of remedies available to parties in foreign litigation or arbitration? The reason is simple. Clients enter transactions, transactions blow-up, and parties sue or can be sued. Even if the parties, the contract, or the dispute at issue have little or no connection to New York, potential documents, assets, or witnesses may be located within the State. If so, New York courts can provide tools (i) to obtain broad information vital to a pending foreign proceeding, (ii) to attach assets to secure an ultimate recovery or incentivize settlement, or (iii) to enforce final judgments or awards, including seizure of assets and other post-judgment remedies. These are important tools to a litigator. Dan J. Schulman, a commercial litigator based in New York, explains all. He has over 35 years of experience managing complex commercial litigations, arbitrations, and appeals in New York, and shares the tools that are available to parties in a litigation.

- **Israel Tax Authority Proposes Changes for Individuals With Cross-border Connections.** In an age of spectacular liquidity events for Israeli start-up companies, the Israel Tax Authority has proposed significant revisions to the tax law designed to bring more income and gains into the Israeli tax net. In part, this reflects a global trend among governments and to close a perceived tax gap among the wealthy, especially those having one foot at home and a second foot abroad. In Israel, the proposals directed at individuals include (i) adoption of objective rules for determining tax residence with greater certainty, (ii) tightening of exit tax rules to ensure collection of deferred amounts, (iii) expansion of C.F.C. rules to cover more foreign companies, (iv) elimination of foreign tax credit carryovers for unused foreign tax credits, and (v) changes to basis step-up rules for property inherited from foreign decedents. Daniel Paserman, a partner in the Tel Aviv office of Gornitzky, attorneys, and the head of the firm's tax practice, and Inbar Barak-Bilu, a partner in the Tel Aviv Office of Gornitzky, attorneys, caution that the proposals are groundbreaking and are likely to have an influence on persons considering a move to or from Israel.

We hope you enjoy this issue.

- The Editors

FRENCH TREATMENT OF FOREIGN TRUSTS

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Tags
Beneficial Owners
Gift Tax
Income Tax
Inheritance Tax
Public Register
Real Property Wealth Tax
Tax Treatment
Trust
Trust Register
Wealth Tax

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INTRODUCTION

The centuries-old Anglo-Saxon legal concept of trusts, which allows assets to be held by trustees on behalf of beneficiaries, does not exist, *per se*, under French law.

Legal and tax treatment from the French perspective is uncertain since French law identifies one single person as the owner of property, except in the specific case of segregation between a life interest and bare legal ownership. Consequently, assessing taxes has been difficult for the French Tax Administration ("F.T.A.") when dealing with a trust where the settlor does not have the full control of assets, the trustee is managing assets on behalf of the beneficiary, and the beneficiary has an uncertain right to income and capital.

In the view of the F.T.A., legislation was needed to prevent trusts from being used as an instrument for tax avoidance purposes. The Finance Amendment Law no. 2011-900 of July 29, 2011 (the "2011 Law") was enacted to ensure that a taxpayer would be identified who would be responsible for the payment of French taxes. In order to ensure that the F.T.A. would have full knowledge of existing trusts in order to tax income and assets when and as due under the 2011 Law, reporting duties have been implemented and a French Trust Register has been created.

This article provides a general overview of the Trust Register, including access to confidential information, filing duties of the trusts, and the imposition of French tax in various circumstances.

FRENCH TRUST REGISTER

Characteristics of the French Trust Register

Implementing the Trust Register

The French Trust Register was introduced in December 2013 by a law[1] enacted to stop "tax fraud and serious economic and financial crimes." Once the law was enacted, an implementing decree was adopted by the Government on May 10, 2016,[2] making the Trust Register effective.

[1] Law no. 2013-1117, December 6, 2013.

[2] Decree no. 2016-567, May 10, 2016.

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“[O]n October 21, 2016, the French Constitutional Court ruled that public access to the Trust Register was, unconstitutional because it infringed the fundamental right to privacy.”

Information to be Reported in the Trust Register

The Trust Register is managed by the F.T.A.[3] The Trust Register contains information provided in annual returns and returns that are due upon the happening of a specific event. It includes the following information on trusts that file returns:

- The trust’s name and address
- The date of establishment, and where appropriate, the date of termination
- The identification of the settlor, the beneficiary, and the trustee, based on the following standards:
    - If the settlor and the beneficiary are private individuals, the first name, last name, date, place of birth, and where appropriate date of death must be provided for the individual.
    - If the trustee is a private individual, the first name, last name, date of birth, and place of birth must be provided for the individual.
    - If the settlor, beneficiary, or trustee is a legal person such as a corporation, the legal name and the incorporation number must be provided for the corporation.

This information remains in the Trust Register for the duration of the trust’s existence and for ten years thereafter.

No information regarding the market value of the assets owned by the trust or the tax residence of the settlor, beneficiaries, and trustees is mentioned in the Trust Register.

Access to the Trust Register

Public access to the Trust Register originally was scheduled to begin as of July 4, 2016. Persons who were not tax residents of France were to be denied access to the Register. However, on October 21, 2016, the French Constitutional Court ruled that public access to the Trust Register was, unconstitutional because it infringed the fundamental right to privacy.[4] The data used to compile the Trust Register was supplied for tax purposes in good faith by affected persons who gave no permission for the information to be made public. In addition, the French Trust Register was deemed to be a disproportionate measure as it contained no limitations regarding access. No protection was offered regarding details of vulnerable beneficiaries such as children or elderly people.

Consequently, Article 10 of the ruling no. 2016-1635 of December 1, 2016[5] restricted access to the Trust Register to several government agencies authorized to combat money laundering and terrorist financing. Agencies that have access include Tracfin (the anti-money laundering unit), officers of the tax administration and customs officials having tax responsibilities, the Prudential Supervision and Resolution Authority (“A.C.P.R.”), and the Financial Markets Authority (“A.M.F.”).

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[3] The Public Finances Directorate General (“DGFiP”).

[4] Cons. Const. October 21, 2016, no. 2016-951 QPC.

[5] Rules which entered into effect on 3 December 2016.

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Wider Access to the Trust Register and to Information on Beneficial Owners

In ruling no. 2020-115 ("the Ruling"), issued on February 12, 2020, unrestricted access to the Trust Register was given to police officers. In addition, tax and customs officials were given broader access to the Trust Register and can access it within the framework of duties other than tax collection.

The Ruling also provides restricted access to beneficial owner information to a wider range of people. As a result, any person may have access in the following set of circumstances:

- The person files a written request about a trust or any similar legal entity that holds a direct or indirect controlling interest in any company or other legal entity formed outside the European Union; control may exist through the ownership of bearer shares or arrangements of any kind, even if effected by means other than a shareholding.
- The person has a legitimate interest in the combatting money laundering or terrorist financing, such as journalists and non-governmental organizations.
- The person is a professional that is subject to compliance duties in terms of combatting money laundering or terrorist financing. Examples are banks and other financial institutions.

According to the French Tax Code ("F.T"C."), included as beneficial owners are the trustee, settlor, beneficiaries, protectors, and any other person having effective control of the trust, whatever that may mean. Information about beneficial owners include the following:

- Last name, first name, usual name, and alias
- The month and year of birth
- The country of residence
- Nationality
- A description of the beneficial interests held, which is yet to be defined

REPORTING REQUIREMENTS

Scope of Reporting Requirements

The 2011 Law introduced two mandatory reporting obligations for a trustee. One is an annual return and the other is a return triggered by the happening of an event. These returns must be filed in any of the following fact patterns that demonstrate a connection to France:

- The settlor or at least one of the beneficiaries is a French tax resident.
- Some of the assets held in trust are located in France.
- The trustee is established in France.

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Amendments to the Filing Duties as From the Year 2020

The Ruling provides additional reporting duties for trustees established or located outside the European Union. The duties apply in each of the following circumstances:

- The trust purchases real estate located in France.
- The trust enters into a business relationship in France within the meaning of Article L. 561-2 of the French Monetary Code.

The French Monetary Code provides that the term "business relationship" refers to a professional or commercial relationship when the client is a professional that has a responsibility to prevent money-laundering and terrorist financing. and when the business relationship is meant to continue over a certain period of time. The contact may result from the execution of a contract or a pattern of activity that relies on the professional's participation in several transactions or a single transaction that is carried out over time.

Information provided through the annual return or a return upon the happening of an event will make its way to the Trust Register, thereby providing access to a broader class of user.

Yearly Filing

An annual return of the fair market value on January 1 of each year of the assets, rights, and capitalized income of the trust (and not only value of French real estate assets) must be filed by the trustee before June 15 of each year.

The annual return provides updated information[6] relating to the following items:

- The main characteristics of the trust, such as whether it is revocable or irrevocable
- Whether the trust is discretionary or the interests of the beneficiaries are fixed
- The governing law of the trust
- The names of the settlor, the beneficiary, and the trustee
- The allocation of the trust assets among beneficiaries

If the settlor or the beneficiaries are residents in France, all assets of the trust no matter where located must be declared. If none of the settlors or beneficiaries are residents in France, only French assets must be reported.

Filing Upon the Happening of a Specific Event

A return must be filed upon the setting up of the trust and upon any modification or termination of the trust. This return should be filed within one month following the event. Trustee should adopt internal procedures to ensure compliance with this short deadline for filing.

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[6] Art. 369 A of Annex II of the F.T.C.

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The term “modification of the trust” includes, *inter alia*, any changes in (i) the terms of the trust, (ii) the way it is managed, (iii) assets owned, (iv) source of income, and (v) any other item that has an impact on the trust structure.

The obligation to file a return upon the happening of an event is separate from the obligation to file the annual return.[7] The following information must be disclosed in the return triggered by an event:

- The nature and date of the event generating the reporting obligation
- A precise description of assets and rights held in trust
- If the event is the transfer of assets or rights to the trust, the full identity of the contributing
- In the event of a distribution to a beneficiary, the identity of the beneficiary[8]

Penalties

In the event of a failure to comply with the reporting obligations, penalties may be imposed. They include

- the assessed tax may be increased by 80%,[9] and the minimum penalty is €20,000, and
- a penalty of up to €20,000 per year, per return not filed.

The statute of limitations for the reporting obligations is four years following the year of the filing. The settlor is jointly and severally liable with the trustee for the payment of the penalty. The penalties provide a negative incentive for trustees to report information that has a link to France. Trustees should consider the revision of client mandates to allow for compliance.

“Broadly speaking, it appears that distributions of income are taxed, but distributions of the initial capital are not taxed. However, the F.T.A. has not formally addressed the distribution of original capital. . .”

FRENCH INCOME TAX

Distribution of Trust “Proceeds”

Distributions of proceeds to a French resident beneficiary are subject to a 30% flat-rate tax consisting of a 12.8% income tax and a 17.2% social charge. Broadly speaking, it appears that distributions of income are taxed, but distributions of the initial capital are not taxed. However, the F.T.A. has not formally addressed the distribution of original capital, and might conclude that all distributions by a French resident beneficiary should be taxed even if they represent the initial capital contribution. Official guidance would be helpful. Until guidance is issued, it may be prudent (i) for the trust to maintain separate accounts for income and capital and (ii) for distribution resolutions to specify the source of the distribution.

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[7] The inventory of assets and their respective market value only need to be reported in the annual return.

[8] Art. 369 of Annex II of the F.T.C.

[9] Art. 1729-0 A F.T.C.

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Risk of Application of French C.F.C. Rules

France has enacted rules regarding Controlled Foreign Companies ("C.F'C.'s") that are owned by French resident individuals.[10] These rules apply when

- a French tax resident owns a participation of at least 10% in a foreign entity that may be a company, a trust, or any similar structure;
- the assets of that entity consist mainly of financial assets; and
- the entity benefits from a preferred tax regime. A tax regime is considered to be preferred if it leads to an actual tax burden that is less than 40% of the tax that a corporation would pay in France in the same circumstances.

When these conditions are met, the French tax resident is liable to tax with respect to all profits of the foreign entity, even if not distributed.

When a person is a beneficiary or a settlor of a foreign trust, questions arise as to the way the 10% participation condition applies and whether different results are realized when (i) the trust is revocable or irrevocable or (ii) the interests of the beneficiaries are fixed or discretionary. The Paris Administrative Court of Appeal recently ruled that a person who is a beneficiary of an irrevocable, discretionary trust could not be considered as having a 10% participation pursuant to Article 123 *bis* of the F.T.C.[11]

FRENCH INHERITANCE AND GIFT TAXES

Prior to 2011, the F.T.A. faced difficulty in characterizing transfers made through a trust as a taxable transfers subject to inheritance tax. In certain fact patterns, the transfers of assets were exempt from inheritance tax because they could not be characterized as gifts during life or transfers at death under the rules in effect at the time including applicable case law.

The 2011 Law introduced *sui generis* transfer duties in respect of inheritance tax applicable on the death of the settlor. These *sui generis* transfer duties apply upon (i) the transfer of property, (ii) a modification of rights, or (iii) accumulated income tis allocated to capital.

Inheritance and Gift Tax Rules in France

Regarding inheritance and gift taxes, French law[12] targets assets or rights held in a trust, as well as the income that has been accumulated and allocated to capital in the trust. Subject to applicable inheritance tax treaties, French inheritance tax is imposed on

- all assets and all accumulated income when (i) the settlor is resident in France or (ii) the beneficiaries are residents in France and have been residents during six or more years over the most recent ten years; or
- only assets and accumulated income located in France when the settlor and the beneficiaries are not residents in France.

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[10] Article 123 *bis* of the F.T.C.

[11] Paris Administrative Court of Appeal, 24 June 2020, case no. 19 PA00458.

[12] Art. 750 *ter* F.T.C.

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The 2011 Law identified the death of the French resident settlor as the triggering event. The tax is triggered even if the assets are not actually distributed to beneficiaries. Moreover, where the initial French resident settlor is dead, the French resident beneficiaries become deemed settlors and when the deemed settlors die, the French resident beneficiaries at the time become deemed settlors. In this way, where the assets remain in the trust for several generations, each generation of French resident beneficiaries is subject to inheritance taxes.

Two situations must be distinguished:

- The first involves a transfer from a trust that can be treated as a gift or inheritance under French law. Most advisers are of the opinion that a gift or an inheritance occurs only when assets are distributed outright to the beneficiaries at the time of death. Here, French gift of inheritance taxes apply according to standard rules. The surviving spouse or civil union partner is exempted from death duties. A progressive scale of up to 45% applies to heirs that are descendants of the settlor.

- The second involves a transfer from a trust that cannot be treated as a gift or inheritance under French law. Under that assumption, a *sui generis* transfer tax applies in accordance with the terms of transfer provided for by the trust deed. This is addressed in the appendix to this article.

    - Where a specific share of the trust assets is due to a single designated beneficiary, the inheritance tax is levied according to the family link between the beneficiary and the dead settlor.

    - Where a specific share of the trust assets is payable to a class of persons, such as descendants of the settlor, without any possibility to allocate the assets among such descendants, the gift or inheritance tax will be calculated at the rate of 45%.

    - In all other cases, if the assets pass to a trust whose beneficiaries are unascertainable, the gift or inheritance tax will be calculated at the rate of 60%.

Consequently, it is essential for trustees to pay very close attention when drafting the trust deed specify shares of specific beneficiaries to provide results achieving the lowest possible taxation.

Avoidance of Double Taxation

In fact patterns where the imposition of French inheritance and gift taxes are subject to the France-U.S. Inheritance, Estate and Gift Tax Treaty ("the Treaty"), a question arises whether the *sui generis* transfer duties are covered by the Treaty.

In this respect, the tax authorities have confirmed that whether or not the transmission qualifies as a gift or inheritance, the existence of the trust does not affect the application of international tax treaties[13] in case of juridical double taxation (*i.e.*, the same inheritance is taxed in more than one Member State). The F.T.A. relies on the

[13] Tax treaties on inheritance or gift taxes: BOI-ENR-DMTG-30 no. 40; 16/10/2012. Moreover, the Treaty provides that the latter applies to French inheritance and gift duties and to any *substantially similar taxes* on estates, inheritances, and gifts that either country may subsequently impose.

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concept of juridical double taxation to determine if the elimination of double estate taxation (Article 12 of the Treaty) can apply. As a rule, double taxation can only be eliminated when a person is taxed in respect of the same assets by more than one State.

The Treaty does not contain any specific provisions on trusts. Consequently, many advisers believe that the treaty rules on the allocation of the right to tax must apply in the same way as if the assets were held directly by the settlor. The Treaty provides that immovable and tangible assets (other than cash) should be taxed in the State where physically located. Intangible assets such as securities and cash are taxable in the State of domicile of the decedent.[14] Thus, intangible assets held within a trust should be taxable in the U.S. as long as the settlor was domiciled in the U.S. at the time of death.

FRENCH REAL ESTATE WEALTH TAX

"French wealth tax may be imposed on the settlor or the deemed settlor of the trust. Wealth tax applies only to the value of real estate held directly or indirectly."

French wealth tax may be imposed on the settlor or the deemed settlor of the trust. Wealth tax applies only to the value of real estate held directly or indirectly. Actual taxation occurs if the overall net taxable value of the real estate ultimately held by the individual exceeds €1.3 million.[15] Wealth tax is calculated by applying a progressive scale of up to 1.5%. When the settlor is a French tax resident, wealth tax applies to his real estate assets located in France or abroad, including all real estate assets held directly or indirectly through a trust.

When the settlor is not resident in France, he is liable to French wealth tax only with respect to real estate located in France. When the assets are held in France and abroad, segregation must be made between French and non-French assets.

A settlor who is liable to French wealth tax must file a French wealth tax return on a yearly basis. If the settlor does not comply with these filing duties, a specific tax equal to 1.5% is assessed on the real estate's net market value and is due by the trustee. However, there is no cumulation of the 1.5% tax and the real estate wealth tax on the same assets.

In principle, French real estate wealth tax is subject to applicable tax treaties. In practice, only a few treaties deal with wealth taxes. One such treaty is the France-U.S. Income Tax Treaty.[16] It provides that US citizens that move their residence to France would be liable to French wealth tax in respect to foreign real assets only following five years of residence in France.[17]

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[14] Art. 8 of the France-U.S. Estate, Inheritance and Gift Tax Treaty. Special rules apply to U.S. citizens domiciled in France.

[15] Art. 964 F.T.C.

[16] See paragraph 1(b)(iv) of Article 2 (Taxes Covered) of the France-U.S. Income Tax Treaty.

[17] See paragraph 6 of Article 23 (Capital) of the France-U.S. Income Tax Treaty.

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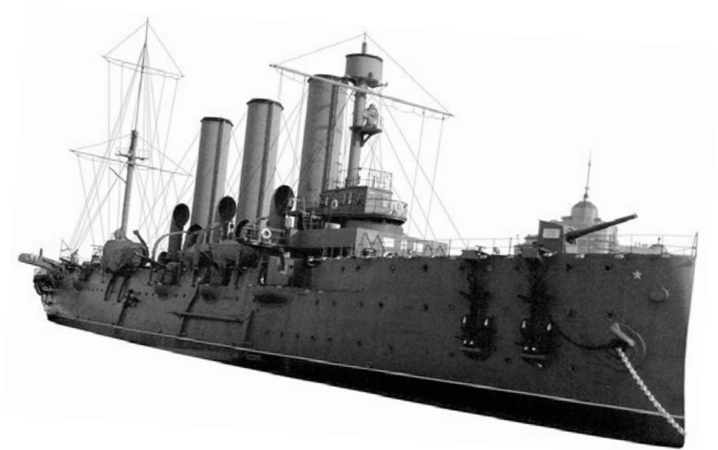
CONCLUSION

For years, French law contained no provision to integrate the concept of a trust into its tax laws. Whether income, inheritance, or wealth taxes, the identities of the settlor and the beneficiaries were held in confidence. This changed beginning in 2011 when France enacted the Trust Resister. In the intervening 10 years, much has happened. Information must be reported, nongovernment persons have access to information, inheritance and gift taxes can be imposed each time property passes from one generation to the next, and wealth taxes were imposed. Clearly, major changes have occurred over a relatively short period of time.



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APPENDIX

Summary
Trust Inheritance Taxation According to French Law

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<tr><th colspan="2">Legal Classification</th><th>Taxation Rate</th><th>Trustees’ Liability for Tax Payment</th></tr>
<tr><td colspan="2">I. Legal classification of gift or inheritance</td><td>Tax rate according to the family ties between the settlor and the beneficiary.</td><td>Not Liable</td></tr>
<tr><td rowspan="3">II. Sui Generis Levy: Applicable when the transfer cannot qualify as gift, or inheritance, or when the assets remain in the Trust after the death of the settlor(s).</td><td>a) Transfer of a defined share of assets, rights, or income capitalized in the trust to a defined beneficiary</td><td>Tax rate according to the family ties between the settlor and the beneficiary.</td><td>Not Liable</td></tr>
<tr><td>b) Global transfer of a defined share of assets, rights, or income to the trust to several descendants</td><td>45%</td><td>Liable</td></tr>
<tr><td>c) Other cases</td><td>60%</td><td>Liable</td></tr>
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WHAT IS THE CORPORATE TRANSPARENCY ACT AND WHAT DOES IT MEAN FOR BUSINESS AND INCORPORATORS?

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Tags
Beneficial Owner
Corporate Transparency Act
FinCEN

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INTRODUCTION

Businesses and incorporators will be faced with the Corporate Transparency Act ("C.T.A."), which is contained within the National Defense Authorization Act and is designed to take actions against illegal activities conducted through anonymous shell companies by requiring the reporting of the identity of the Beneficial Owners of companies, subject to certain exceptions. This article answers the eleven most important questions that affect clients that are incorporating a business and the professionals providing advice or assistance in the incorporation process.

1. What information must be reported?

Under the C.T.A., businesses will need to disclose the "Beneficial Owner" information to the Financial Crime Enforcement Network ("FinCEN") at the time of the formation of the company and with the annual filings to report ownership changes made during the prior year.

2. What information is required to be reported and when?

The information that must be reported regards the Beneficial Owner of the company. A "Beneficial Owner" is a natural person who

- exercises substantial control over a company,
- owns 25% or more of the equity interests of a company, or
- receives substantial economic benefits from the assets of a company.

3. Where a discretionary trust meets the ownership threshold for a company, how will the ownership of the company's shares be attributed among the beneficiaries?

While no guidance yet exists on the attribution of shares from a discretionary trust to discretionary beneficiaries, the simplest and most effective approach is for the trustee to report on each living beneficiary, including newborn grandchildren. This alternative would match recent experience with K.Y.C. reporting applicable to bank accounts owned by trusts, where information on each beneficiary is provided. However, it would provide a glut of useless information. Other possibilities exist. One example is to look at past distribution patterns. Another might be to look at the intestacy laws that apply in the country of domicile when all beneficiaries are family members. A third is to look at a nonbinding letter of wishes drafted by the settlor. The common problem with such other methods is that all such methods can be gamed by the settlor.

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4. What information must be reported at the time of formation?

At the time of formation, the company must file a list of its Beneficial Owners with FinCEN. The list must include the same information that financial institutions are required to collect under FinCEN's Customer Due Diligence rule. This is for each Beneficial Owner:

- The full legal name
- Date of birth
- Current residential or business address
- Current identification number, such as a driver's license or passport number

The applicant is also required to provide his or her information, even if he or she is not a Beneficial Owner. This means that lawyers, accountants, and others who form reporting companies for clients will be required to report their personal information. To protect themselves, and avoid legal problems in the future, applicants will want to know their clients before forming companies on their behalf.

5. Is information available to the public?

No. FinCEN is a bureau of the U.S. Department of the Treasury. FinCEN's mission is to safeguard the financial system from illicit use and combat money laundering and promote national security through the collection, analysis, and dissemination of financial intelligence and strategic use of financial authorities. Federal, state, local and tribal law enforcement would have access to the information for use in authorized investigations as would financial institutions (with customer consent) that have legally mandated anti-money laundering obligations.

6. What information must be reported annually?

An Annual Report must be filled with FinCEN. The company must report a current list of its Beneficial Owners as well as a list of any changes in the beneficial ownership that occurred during the previous year.

7. Are obligations imposed on States?

Yes. It would be mandatory for the States to inform any applicant seeking to form a company of the obligations to report the information regarding the Beneficial Owners.

8. Who must report?

The type of entities required to report are corporations, limited liability companies, or other similar entities that are

- created by the filing of a document with a secretary of state or a similar office under the law of a state of Indian Tribe, or
- formed under the law of a foreign country and registered to do business in the United States by the filing of a document with a secretary of state or a similar office under the laws of a state or Indian Tribe.

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9. What companies are exempted from reporting?

In several fact patters, companies are exempted from reporting information. The most significant exception is for active businesses. A company will not be required to report the information stated in the C.T.A. if the entity

- employs more than 20 employees on a full-time basis in the United States,
- filed in the previous year Federal income tax returns in the United States demonstrating more than $5 million in gross receipts or sales in the aggregate, including the receipts or sales of (i) other entities owned by the entity and (ii) other entities through which the entity operates, and
- has an operating presence at a physical office within the United States.

While this exception may not exclude small businesses, it will exclude many active businesses from the requirement to report Beneficial Owners to FinCEN on an annual basis. Among the other types of entities that are exempt from reporting are

- public companies under the Securities Exchange Act of 1934;
- churches, charities, nonprofit entities, and any other entity that qualifies for tax-exempt status under sections 501(a), 527, or 4947(a)(1) of the Internal Revenue Code; and
- other companies that already have certain reporting obligations to regulatory bodies. Examples include, insurance companies, banks, Federal or State regulated credit unions, investment companies under the Investment Company Act of 1940, registered public accounting firms, and public utilities.

Although exempt from fling the Beneficial Owners information, an exempt entity must file a written certification with FinCEN identifying the specific applicable exemption, while providing the applicant's information at the same time. Existing entities that qualify for an exemption have two years from the date of issuance of the final regulations to file the required certification with FinCEN stating that it is exempt.

10. When will the C.T.A. become available?

The C.T.A. will not become effective until US Treasury issues regulations, which may not happen until late this year. This will give the business community time to study the C.T.A., consult with their lawyers, and determine how best to comply.

11. What is the penalty for failing to report the information?

It is unlawful under the C.T.A. to

- knowingly file false Beneficial Owner information to FinCEN, or
- willfully fail to provide complete or updated Beneficial Owner information to FinCEN.

Violations are subject to a civil penalty of not more than $10,000 and criminal penalties under title 18 of the U.S. Code, which can include fines and imprisonment for not more than 3 years. Negligent violations are not penalized. Moreover, a waiver process is provided for violations that are due to reasonable cause and not due to willful neglect, which is modeled on the Internal Revenue Service waiver process for

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companies' SS-4 filings. Penalties are also provided for unauthorized disclosures or misuse of beneficial owner.[1]

CONCLUSION

For many years, European bankers and their colleagues in the offshore community have complained that the U.S. is the last holdout among countries when it comes to collecting ownership information for corporations. Whether these statements are accurate is open to debate, as the U.S. uses the banking system to identify owners of companies with accounts in the U.S. Once the C.T.A. reporting system comes online, the U.S. will collect information that will be submitted to FinCEN. However, because information submitted to FinCEN is not disseminated publicly, one might expect the complaints of naysayers to continue, but in modified form.

"For many years, European bankers and their colleagues in the offshore community have complained that the U.S. is the last holdout among countries when it comes to collecting ownership information for corporations."

1 "FACT Sheet: A Brief Summary of The Corporate Transparency Act (Title LXIV of the NDAA, H.R. 6395)," December 17, 2020.

BRACE YOURSELF, PILOTS: YOUR TAX HOME DOES NOT FLY WITH YOU

Author
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Tags
Abode
Bona Fide Resident
Foreign Earned Income
Form 2555
Tax Home

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INTRODUCTION

The Internal Revenue Code (the "Code") provides a foreign earned income and housing cost exclusion to qualified individuals.[1] These benefits are subject to certain ceilings on each of the benefits.[2]

Generally, a U.S. taxpayer can elect to exclude foreign earned income ("F.E.I.") from gross income in two circumstances. The first is that the taxpayer is an individual whose tax home is in a foreign country or countries. The second is that the taxpayer is either (i) a *bona fide* resident of a foreign country or countries for an uninterrupted period that includes an entire tax year or (ii) physically present in a foreign country or countries for at least 330 full days during any period of 12 consecutive months.[3] An individual is not considered to have a tax home in a foreign country for any period in which the individual's abode is in the U.S.[4]

In *Cutting v. Commr.*,[5] the Tax Court addressed the meaning of tax home under Code §911, focusing on the facts that must exist for an individual to be a qualified individual. While only a Memorandum Opinion of the Tax Court,[6] its importance is enhanced because the I.R.S. Large Business and International division ("L.B.&I.") added the foreign earned income exclusion ("F.E.I.E.") to the list of its compliance campaigns,[7] targeting taxpayers who have claimed the benefits of the F.E.I.E. without meeting the L.B.&I. view of the statutory requirements. Taxpayers and their tax advisors should consider this decision in determining the steps required to be compliant with the F.E.I.E.

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1. Code §911(a).
2. As to the earned income exclusion, see Code §911(b)(2); as to the housing cost exclusion, see Code §911(c)(2) (c)(2). In 2021, the maximum amount of the foreign earned income exclusion is $108,700 and the maximum amount of the housing cost exclusion is $17,392 (16% of the maximum exclusion of foreign earned income).
3. Code §911(d)(1).
4. Code §911(d)(3).
5. *Cutting v. Commr.,* T.C., Memo. 2020-158.
6. A Memorandum Opinion is issued when the law is settled or the decision is factually driven.
7. For more information, see the I.R.S. website here.

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FACTS

Mr. Cutting is a U.S. citizen who was employed by Omni Air International ("O.A.I."), a domestic company headquartered in Tulsa, Oklahoma. He worked as a pilot, primarily transporting military personnel and cargo on international routes. In 2005, the same year he began working for O.A.I., he married a woman who lived in Thailand and began to spend most of his days off in Thailand with his wife and stepdaughter. He regularly entered Thailand on a temporary transit and nonimmigrant visa that was granted automatically each time he entered Thailand. It expired after 30 days and on at least two occasions he attempted to extend his visas. Each time, the Thai Government denied his requests. As a temporary visitor to Thailand, he was not allowed to own or lease any real property.

> ***"Code §61(a) broadly defines gross income as 'all income from whatever source derived' except as otherwise provided. One such exception is the F.E.I.E., which allows a qualified individual to exclude F.E.I. from gross income subject to some limitations which are set out in Code §911(b)(2)."***

As a U.S. taxpayer, Mr. Cutting filed Form 1040, *U.S. Individual Income Tax Return*, for each of 2012, 2013, and 2014, listing his filing status as "single" for each year and listing his father's address in Campbell, California, as his mailing address. He also attached Forms 2555, *Foreign Earned Income*., reporting his entire salary from O.A.I. as F.E.I. and claiming the maximum F.E.I.E. allowed for each year. The I.R.S., relying on information submitted by Mr. Cutting, such as his California State income tax returns, and the fact that he used his father's address as his employment address of record and mailing address, disallowed the exclusion in its entirety for each year at issue. Mr. Cutting disagreed and filed a petition with the Tax Court.

ANALYSIS

It is a well-settled rule that U.S. citizens are subject to U.S. income taxation on worldwide gross income unless a specific exclusion applies.[8] Code §61(a) broadly defines gross income as "all income from whatever source derived" except as otherwise provided.[9] One such exception is the F.E.I.E., which allows a qualified individual to exclude F.E.I. from gross income subject to some limitations which are set out in Code §911(b)(2). Code §911(b)(1)(A) defines F.E.I. as "the amount received by such individual from sources within a foreign country or countries which constitute earned income attributable to service performed by such individual."[10]

<u>Tax Home Abroad</u>

To be entitled to the F.E.I.E., a taxpayer must satisfy a two-part test.

- The first part of the test has both a positive and a negative aspect. The positive aspect is that the taxpayer must affirmatively show that he or she has a tax home in a foreign country. The negative aspect is that the taxpayer must show that he or she has not retained an abode within the U.S.

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[8] *Cook v. Tait,* 265 U.S. 47, 56 (1924); *Specking v. Commr.,* 117 T.C. 95, 101102 (2001); *Haessly v. Commr.,* 68 F. App'x 44 (9th Cir. 2003); *Huff v. Commr.,* 135 T.C. 222, 230 (2010).

[9] Code §61(a).

[10] Code §911(b)(1)(A).

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- The second part of the test is satisfied by showing that the taxpayer is either: (i) a "*bona fide* resident" of one or more foreign countries,[11] or (ii) physically present in such country or countries during at least 330 days in a 12-month period.

Code §911(d)(3), which defines tax home as applied to the F.E.I.E., incorporates the travel business expense provision of Code §162(a)(2). It provides as follows:

> The term tax home means with respect to any taxpayer such taxpayer's home for purposes of section Code §162(a)(2) (relating to traveling expenses while away from home).

Thus, under Code §162(a)(2), a taxpayer's home is generally considered to be the location of taxpayer's regular or principal place of business.[12]

In this case, the court considered whether Mr. Cutting had a tax home in Thailand. Mr. Cutting argued that because he was a pilot flying international routes all over the world, he had no regular or principal place of business, and hence, his tax home

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[11] Code §911(d)(1)(A). *Prima facie*, the *bona fide* residence test applies only to U.S. citizens. However, resident aliens of the United States who are citizens of foreign countries that have an income tax treaty with the United States may qualify for the §911 exclusions under the *bona fide* residence test by application of the non-discrimination article found in most of the bilateral income tax treaties to which the United States is a party. See also Rev. Rul. 91-58, 1991-2 C.B. 340 which held that nationals of the United Kingdom who are residents of the United States within the meaning of Code §7701(b) may qualify for the exclusions and deduction provided by §911 by establishing to the satisfaction of the Secretary that they have been *bona fide* residents of a foreign country or countries under the residency rules of Treas. Reg. §1.871-2(b) for a period that includes an entire taxable year. The conclusions reached in Rev. Rul. 91-58 are also applicable to citizens of all countries which had an income tax treaty with the United States in effect as of the date of the ruling (11/4/1991).

[12] Treas. Reg. §1.911-2(b) provides as follows:

> For purposes of paragraph (a)(i) of this section, the term "tax home" has the same meaning which it has for purposes of section 162(a)(2) (relating to travel expenses away from home). *Thus, under section 911, an individual's tax home is considered to be located at his regular or principal (if more than one regular) place of business* or, if the individual has no regular or principal place of business because of the nature of the business, then at his regular place of abode in real and substantial sense * * * .

However, court decisions are split on the meaning of the term home in Code §162(a)(2). Some courts have adopted the I.R.S. view that a taxpayer's home for Code §162(a)(2) purposes is the location of the taxpayer's regular or principal place of business. See *e.g.*, *Markey v. Commr.,* 490 F2d 1249 (6th Cir. 1974); *Daly v. Commr.,* 72 T.C. 190 (1979); Rev. Rul. 75-432, 1975-2 CB 60. Other courts have taken the view that a taxpayer's home for Code §162(a)(2) purposes is the taxpayer's place of abode. See, *e.g.*, *Wallace v. Commr.*, 144 F2d 407 (9th Cir. 1944).

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should be determined by reference to his regular place of abode,[13] which he argued was in Thailand.

Mr. Cutting's Facts

The Tax Court noted how it consistently rejected this argument in the past by citing several cases, such as *Wojciechowski v. Commr., Sislik v. Commr.,* and *Swicegood v. Commr.,* where the Tax Court consistently held that the principal place of business for a pilot or other individuals in similar profession is his or her base/duty station.[14] In particular, the Tax Court noted how Mr. Cutting's employment arrangement with O.A.I. was similar to the employment arrangements in *Sislik* and *Swicegood*. In each case, a U.S. commercial airline pilot flew international routes, designated his home base at a domestic airport (John F. Kennedy Airport ("J.F.K.")), and chose to live abroad for personal reasons. Despite the fact that not all of the flights originated from or terminated at J.F.K., the Tax Court still held that the base station was the principal place of employment for each airline pilot. Hence, each pilot's tax home was J.F.K. near New York City, where each pilot was responsible to report, not the foreign country in which each chose to spend personal time.

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[13] *Bujol v. Commr.,* T.C. Memo. 1987-230, provides in pertinent part as follows:

> Abode has been variously defined as one's home, habitation, residence, domicile, or place of dwelling. Black's Law Dictionary 7 (5th ed. 1979). While an exact definition of abode depends upon the context in which the word is used, it clearly does not mean one's principal place of business. Thus, "abode" has a domestic rather than vocational meaning, and stands in contrast to "tax home" as defined for purposes of section 162(a)(2) * * * .

Harrington v. Commr., 93 T.C. 297 (1989), provides in pertinent part as follows:

> In prior section 911 cases, we have examined and contrasted the taxpayer's domestic ties (*i.e.* his familial, economic, and personal ties) to the United States with his ties to the foreign country in which he claims a tax home in order to determine whether his abode was in the United States during any particular period. * * * Even though a taxpayer may have some limited ties to a foreign country, if his ties to the United States remain strong, we have held that his abode remained within the United States, especially where his ties to the foreign country were transitory or limited.

See also *Qunell v. Commr.*, T.C. Summary 2016-86. For a discussion of these cases, see Rusudan Shervashidze & Philip R. Hirschfeld, "Tax Home v. Abode – Are They the Same for Code §911 Purposes?" Vol. 4 *Insights* No. 4, at p. 47.

[14] *Sislik v. Commr.*, T.C. Memo, 1989-495; *Swicegood v. Commr.,* T.C. Memo. 1989-467 (citing *Folkman v. U.S.*, 615 F.2d 493, 496 (9th Cir. 1980); *Wojciechowski v. Commr.,* T.C. Memo. 1991-239; *Dougherty v. Commr.,* T.C. Memo. 1991-442. In *Folkman v. United States,* the 9th Circuit considered the situation of a taxpayer who was employed as an airline pilot out of San Francisco and was also a member of the Air National Guard in Nevada. As a membership condition, the Nevada Air National Guard required its members to reside in the Reno, Nevada area. On the basis that the airline employment constituted the taxpayer's primary source of income and that most of his workdays were spent in San Francisco, the court determined that the taxpayer's tax home was in San Francisco irrespective of the fact that his employment in Nevada required the taxpayer to establish residence in that state.

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Mr. Cutting's employment with O.A.I. was governed by a collective bargaining agreement ("C.B.A.") between O.A.I. and the International Brotherhood of Teamsters. While O.A.I. did not require that Mr. Cutting live in the U.S., the C.B.A. required him to a have a "home base," *i.e.* a primary residence as listed on O.A.I.'s personnel and benefit records and to designate a gateway travel airport in the U.S. Mr. Cutting chose San Jose, California, to be his home base and designated San Jose Airport ("S.J.C.") as his gateway travel airport because his parents and brother lived in the area. Those selections came with substantive rights and obligations under the terms of the C.B.A., the Tax Court said. Specifically, under the C.B.A., O.A.I. was responsible for providing "deadhead" travel for Mr. Cutting from S.J.C. to a domestic duty assignment or to a domestic airport of departure for an international assignment and from the domestic airport where the duty period ends to S.J.C. On the other hand, Mr. Cutting was responsible for getting to S.J.C. to start his duty assignments and for returning from S.J.C. to wherever he wished to spend personal time when he was finished. In addition, the C.B.A. required Mr. Cutting to have a certain amount of training per year done in the U.S. Mr. Cutting also spent time each year on reserve for work. During short-call reserve, he had two hours to report for duty, if called. During long-call reserve, he had at least 12 hours to report for duty.

"Based on the above reasons, the Tax Court held that Mr. Cutting's principal place of business, and thus his tax home, was in San Jose, his home base and the location of his gateway travel airport, S.J.C."

Based on the above reasons, the Tax Court held that Mr. Cutting's principal place of business, and thus his tax home, was in San Jose, his home base and the location of his gateway travel airport, S.J.C. Accordingly, he was not a qualified individual and was not entitled to exclude any income under Code §911.

Bona Fide Residence Abroad Not Established

Having determined that Mr. Cutting's tax home was not in Thailand, the Tax Court stated that it did not need to apply the *bona fide* residence or physical presence test to determine that Mr. Cutting was not entitled to the F.E.I.E.

Nonetheless, the Tax Court addressed whether Mr. Cutting was a *bona fide* resident of Thailand during each year in issue. The statute itself does not define the term "*bona fide* resident." The Tax Court in *Nelson v. Commr.*,[15] has described it as an elusive expression and one so peculiarly related to the facts in any given case that each new case must be decided on the basis of its own unique attendant circumstances. Moreover, the Ninth Circuit in *Weible v. U.S.,*[16] in highlighting the differences between "domicile" and "residence," aptly characterized it when it said the following:

> Residence * * * has an evasive way about it, with as many colors as Joseph's coat. It reflects the context in which it is found, whereas "domicile" controls the context. Residence is physical, whereas domicile is generally a compound of physical presence plus an intention to make a certain definite place one's permanent abode, though, to be sure, domicile often hangs on the slender thread of intent alone, as for instance where one is a wanderer over the earth. Residence is not an immutable condition of domicile.

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15 *Nelson v. Commr.*, 30 T.C. 1151, 1153 (1958).

16 *Weible v. United States*, 244 F.2d 158, 163 (9th Cir. 1957).

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Per the regulations issued under Code §911, the Tax Court looked to the principles of Code §871,[17] to the extent practical, when determining whether an individual is a *bona fide* resident of a foreign country. Consequently, to determine whether Mr. Cutting was a *bona fide* resident of Thailand, the Tax Court applied the 11 factors set forth by the Seventh Circuit Court of Appeals in *Sochurek v. Commr*.:

- The individual's intent
- The establishment of his or her home temporarily in the foreign country for an indefinite period
- The extent of the individual's assimilation into the life and society of the foreign country
- The physical presence in the foreign country consistent with his or her employment
- The nature, extent and reasons for temporary absences from his or her temporary foreign home
- The payment of income taxes to the foreign country
- The status as resident contrasted to that of transient or sojourner
- The way the employer treated the individual's income for income tax purposes

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[17] Treas. Reg. §1.871-2(b) provides the following in pertinent part as to the hallmarks of residence:

> An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but, if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned. An alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States within the meaning of this section, in the absence of exceptional circumstances.

In addition, Treas. Reg. §1.871-5 provides the following in pertinent part:

> An alien who has acquired residence in the United States retains his status as a resident until he abandons the same and actually departs from the United States. An intention to change his residence does not change his status as a resident alien to that of a nonresident alien. Thus, an alien who has acquired a residence in the United States is taxable as a resident for the remainder of his stay in the United States.

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- Whether the individual's spouse and children also resided in the foreign country
- The nature and duration of his employment, and in particular, whether the assignment abroad could be promptly accomplished within a definite or specified time
- The existence of a good faith element in making the trip abroad or whether it is for purpose of tax evasion[18]

As with all facts and circumstances determinations, no one factor is determinative by itself. In addition, not all of the above factors need be present for a taxpayer to establish *bona fide* residence in a foreign country. However, courts typically consider and weigh the appropriate factors in each situation. Here, six factors weighed against Mr. Cutting claim of *bona fide* residence in Thailand, two factors weighed in favor of Mr. Cutting, and two factors were neutral. According to the Tax Court, the most significant factors preventing Mr. Cutting from being a *bona fide* Thai resident were

- Mr. Cutting relied on temporary transit and nonimmigrant visas and did not pursue residency,
- Mr. Cutting provided a statement to the Thai Government that he was not a resident of Thailand,
- Mr. Cutting did not pay any income taxes to Thailand,
- Mr. Cutting was not a tenant under the terms of his wife's lease, and
- Mr. Cutting's testimony contradicted his Forms 1040 in several aspects.

Regarding the last point, the inconsistencies were as follows:

- Mr. Cutting testified that he was married and lived with his wife and stepdaughter in Thailand, but filed his Forms 1040 as "single" for each year in issue and indicated on his Forms 2555 that he did not live with any family members abroad, by checking "No" on line 12a.
- He stated on each Form 2555 that he was subject to taxes to Thailand, by checking "Yes" on line 13b, but stipulated that he did not pay any income taxes to Thailand during any of the years in issue.
- He indicated on each Form 2555 that he submitted a statement to the Thai Government that he was "not a resident of that country," by checking "Yes" on line 13a. Instructions to Form 2555 provide that if a taxpayer submits a statement of nonresidence to the authorities of a foreign country in which income is earned and the authorities hold that the taxpayer is not subject to income tax laws by reason of nonresidence as to that country, the taxpayer is not considered a *bona fide* resident of that country.
- Mr. Cutting stated on his Forms 2555 that his visa did not limit the length of his stay or employment in Thailand, by checking "No" on line 15c, but testified that he relied solely on temporary transit and nonimmigrant visas that expired after 30 days.

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[18] *Sochurek v. Commr.*, 300 F.2d 34, 37 (7th Cir. 1962).

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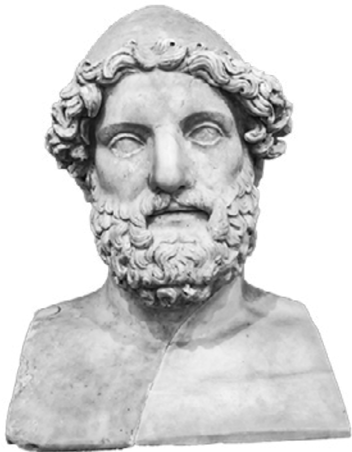
Based on the above factors, the Tax Court held that Mr. Cutting was not a *bona fide* resident of Thailand during the years in issue. Therefore, he was not a qualified individual as defined by Code §911(d)(1) because his tax home was in San Jose and because he did not show that he satisfied the *bona fide* residence test. Accordingly, Mr. Cutting was not entitled to exclude any of his income as an O.A.I. pilot under the F.E.I.E. for the years in issue.

The Tax Court pointed out in a footnote that, even if Mr. Cutting was not a *bona fide* resident of Thailand, he could still be a qualified individual if he were physically present in Thailand and elsewhere outside the U.S. for a certain number of days. However, Mr. Cutting did not assert in his returns, petition, or on brief that he satisfied the physical presence test. Indeed, he did not provide any information with respect to the physical presence test on any Form 2555.

LESSONS TO BE LEARNED



The decision in the *Cutting* case teaches a useful lesson about what it takes to be a qualified individual. *Prima facie*, it might seem that U.S. airline pilots flying international flights who are obligated by the terms of the employment agreement to designate a domestic airport as their home base and choose to live abroad for personal reasons are ineligible to claim Code §911 exclusion. However, it has been shown that the question of *bona fide* residence raises a highly fact-specific issue, which requires case-by-case determination. In at least two cases, taxpayers were successful in arguing that they were *bona fide* residents of a foreign country.[19]

In *Schoneberger v. Commr.,*[20] the Tax Court held that a U.S. airline pilot was a *bona fide* resident of France, despite the fact that he was based in New York for employment purposes, he did not pay any French income taxes, and his stay in France was limited by French immigration laws. The Tax Court held that the taxpayer adequately demonstrated "strong proof" of *bona fide* residency in France. According to the Tax Court, the most significant factors which weighed in favor of taxpayer were the following:

- The taxpayer's efforts to become assimilated into the French environment.
- Most of the taxpayer's off-duty hours were spent in France.
- The taxpayer's intent to remain in France for an extended period, evidenced by his rental of an apartment in Paris.
- The taxpayer studied the French language, had French as well as American friends, and dated a French woman whom he thought he might marry and who wanted to remain in France.
- The taxpayer participated in activities with the family of the French woman, which were an important aspect of French social life.

The Tax Court did not draw negative inferences from the fact that taxpayer did not join any French civic or social organizations, as he never belonged to such

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[19] See also *Cobb v. Commr.,* 62 T.C.M. (CCH) 408, T.C. Memo. 1991-736, Court Opinion and *Jones v. Commr.,* 927 F. 2d 849 (5th Cir. 1991).

[20] *Schoneberger v. Commr.*, 74 T.C. 1016, 1024 (1980).

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organizations in the U.S. The Tax Court also placed little weight on the nominal restrictions as to the taxpayer's residency status under French immigration laws.

In *Linde v. Commr.*,[21] a helicopter pilot did not have his abode in the U.S. even though he maintained a marital home in Alabama, to which he returned when his overseas assignment was completed. The taxpayer was a U.S. Army veteran working as a helicopter pilot for a government contractor in Iraq. Evidence indicated that he desired to remain in Iraq indefinitely, and to that end made efforts to create a domestic and personal life in that country. In those facts, the Tax Court held that the ties to Iraq were stronger than the ties to the U.S. during the years in issue. As he did not have an abode in the U.S., his tax home could be in Iraq. The Tax Court further held that the taxpayer met the *bona fide* residence test for the years in issue and was a qualified individual within the meaning of Code §911(d)(1).

CONCLUSION

Based on the above cases, Mr. Cutting should have established a more substantial relationship with Thailand by proactively seeking to obtain a residency visa instead of exclusively relying on 30-day transit visas. Such residency visa would have allowed him to lease or own interests in real property in Thailand and would have showed that his intent was to make a home in Thailand for an indefinite period of time. He should also have presented evidence of his assimilation into the Thai community, social and cultural activities, such as learning the Thai language, enrolling into Thai civic or social organizations, renting an apartment in Thailand, obtaining a Thai driver's license, opening a checking or savings account in Thailand and acquiring Thai credit cards. He also could have reviewed the entries on Form 2555 to ensure that they were consistent with his lifestyle.

"Simply living or working abroad does not mean that a taxpayer's tax home or abode is in a foreign country."

As more evidence is submitted, the easier it is for taxpayers to objectively demonstrate that their familial, economic and personal ties are stronger to the foreign country than to the U.S.[22] Simply living or working abroad does not mean that a taxpayer's tax home or abode is in a foreign country. Taxpayers wishing to take advantage of the F.E.I.E. should seek professional advice to ensure they can comfortably rely on the F.E.I.E. based on the way their lives are lead.

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[21] *Linde v. Commr.*, T.C. Memo 2017-180.

[22] Some insight into issues pertinent to Code §911 that the I.R.S. may raise on examination is provided by the F.E.I.E. – Audit Techniques L.B.&I. Process Unit that it has made public. See in particular the list of items the I.R.S. will request and review for purposes of establishing whether the taxpayer had a tax home in a foreign country and determining the location of the taxpayer's abode – *i.e.*, where the familial, economic, and personal ties were strongest, at pp. 18 – 19. International Practice and Process Units ("I.P.U.'s") are prepared to provide I.R.S. staff with explanations of general tax concepts and specific transactions. They are not official pronouncements on law or practice and cannot be relied on or cited as authority. However, I.P.U's provide insight on how I.R.S. examiners will audit taxpayers who made a F.E.I.E election. If a taxpayer is being audited by the I.R.S., tax advisors may be able to anticipate the I.R.S.'s next steps or question an approach that does not follow the guidance in an I.P.U.

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CONTINUED D.A.C.6 REPORTING OBLIGATIONS AFTER BREXIT

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Tags
Category D
DAC6
Hallmark
Mandatory Disclosure Reporting

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INTRODUCTION

At midnight on the December 31, 2020, the U.K. left the E.U., having secured a Free Trade Agreement ("F.T.A."). This occurred in the context of four years of political discussion, several Parliaments, two Prime Ministers and what amounted to two Withdrawal Agreements (but eventually only one F.T.A.). There is no doubt that Brexit has significant implications on the U.K. International V.A.T. rules. Prior to the U.K. exit, V.A.T. was essentially an E.U. administered tax by virtue of the V.A.T. Directive, and continues for the 27 Member States remaining in the E.U. However, the headline grabber relates to the E.U. Directive of Administrative Cooperation ("D.A.C.") known as D.A.C. 6.

E.U. DIRECTIVE OF ADMINISTRATIVE COOPERATION ("D.A.C.")

Rules Through December 31, 2020

The E.U. D.A.C. is one of the key tools E.U. membership countries use to exchange information automatically. Over the years, six different directives have been issued by the European Commission. All of them relate to mandatory exchanges of information designed to shine a light on aggressive tax planning.

- The first D.A.C. (2011/16/E.U.) was introduced in 2013 and provided for automatic exchange of investment interest information by financial institutions where a resident of one Member State held an investment account in another. This D.A.C., now referred to as D.A.C.1, was updated in 2015 to allow for the automatic exchange of information of employment income, directors fees, pensions, life insurance products and immovable property.
- D.A.C.2 (2014/107/E.U.) was introduced in 2016 to effectively implement the O.E.C.D. Standard for Automatic Exchange of financial account Information in Tax Matters, commonly known as the Common Reporting Standard ("C.R.S.").
- D.A.C.3 (2015/2376/E.U.) introduced the automatic exchange of advance cross border tax rulings and advance transfer pricing arrangements in 2017.
- D.A.C.4 (2016/881/E.U.) was also introduced in 2017. It introduced automatic exchanges of country-by-country reporting, the method by which headcount, assets, and income must be reported by large corporate groups.

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- D.A.C.5 (2016/2258/E.U.) brought in the mechanism to hold and exchange information regarding beneficial ownership of vehicles used in cross border tax plans. In the U.K. there are registers on both corporate and trust beneficial ownership.

- D.A.C.6 (2018/822/E.U.) implements B.E.P.S. Action12, relating to Mandatory Disclosure Reporting ("M.D.R.") by Intermediaries.[1] The implementation of D.A.C.6 has been postponed a number of times because of COVID19. The current U.K. reporting deadlines are as follows.

  - For reportable arrangements where the first step was implemented between June 25, 2018, and June 30 ,2020, the deadline February 28, 2021.

  - For arrangements made available or implemented between July 1, 2020, and December 31, 2020, the deadline is January 30, 2021.

  - For arrangements which become reportable after January 1, 2021, the deadline is 30 days from the triggering event. E.U. intermediaries are required to identify and report upon cross-border arrangements which fall within Hallmarks A to E., some of which are reportable only where obtaining a tax advantage is the main purpose for entering an arrangement.

INFORMATION REPORTING UNDER D.A.C.

Under D.A.C.6, an arrangement will be reportable if it meets at least one of several hallmarks. The hallmarks are delineated by category. Some hallmarks within the various categories must meet a main benefit test; others not. Briefly, the categories of hallmarks that trigger D.A.C.6 reporting are as follows:

Category A

- *Confidentiality* – Arrangements where the participant or taxpayer enters into a confidentiality agreement that prevents disclosure to other intermediaries or tax authorities of information describing how the arrangement could result in a tax advantage. This hallmark is subject to the main benefit test.

- *Premium Fee Arrangements* – Arrangements where the intermediary fee is based on the tax saved or a similar advantage gained. This hallmark is subject to the main benefit test.

- *Standardized Documentation* – Arrangements involving standardized documentation without substantial customization. This hallmark is subject to the main benefit test.

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[1] See Ashford, Gary, "U.K. Mandatory Disclosure Regime (DAC6)," *Insights* 7, no. 3 (2020): p.11.

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Category B

- *Loss Buying – Arrangements* involving buying a loss-making company to reduce the tax liability. This hallmark is subject to main the benefit test.

- *Conversion of Income to Capital* – Arrangements which have the effect of converting income into capital gains or another type of income that is taxable at lower rates. This hallmark is subject to the main benefit test.

- *Circular Transactions* – Arrangements involving circular transactions with little or no commercial function. This hallmark is subject to the main benefit test.

Category C

- *Cross Border Arrangements with Abusive Facts* - Transactions between associated enterprises where any of the following facts exist:

    - The recipient has no tax residence. Here, the hallmark is not subject to main benefit test.

    - The country of tax residence has a zero or close to zero corporation tax rate. The hallmark is subject to main benefit test.

    - The country is included in the O.E.C.D. list as being a non-cooperative jurisdiction. The hallmark is not subject to main benefit test.

    - The payment is exempt from tax in the hands of the recipient in the jurisdiction of receipt. The hallmark is subject to main benefit test.

    - The payment benefits from a preferential tax regime in the jurisdiction of receipt. The hallmark is subject to main benefit test.

- *Double Deduction Arrangements* – Arrangements involving deductions in more than one jurisdiction. The hallmark is not subject to the main benefit test.

- *Double Reliefs from Double Taxation* – Arrangements involving the claiming of relief from double taxation on the same item in more than one jurisdiction. The hallmark is not subject to the main benefit test.

- *Inconsistent Values for Same Transaction* – Arrangements involving the transfer of assets where there is a material difference in the amount treated as payable in consideration for the assets in the jurisdictions involved. The hallmark is not subject to the main benefit test.

Category D

- *Transactions to Evade Reporting* – Arrangements which have the effect of undermining the rules on beneficial ownership or any other equivalent agreement on automatic exchange of financial account information or arrangements structured to take advantage of the absence of such automatic exchanges of information. The hallmark is not subject to main benefit test.

- *Hidden Ownership* – Arrangements involving a nontransparent legal or beneficial ownership chain with the use of persons, legal arrangements, or structures that

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- ○ do not carry on a substantive economic activity supported by adequate staff, equipment, assets, and premises; and
- ○ are incorporated, managed, resident, controlled or established in any jurisdiction other than the jurisdiction of residence of one or more of the beneficial owners of the assets held by such persons, legal arrangements, or structures.

This hallmark is not subject to the main benefit test.

Category E

- *Abusive Transfer Pricing* – Arrangements concerning transfer pricing, including the use of unilateral safe harbors in one of the jurisdictions, or the transfer of hard-to-value intangible assets when no reliable comparable transactions exist, and the projection of future cash flows or income are highly uncertain. This hallmark is not subject to the main benefit test.

CHANGE IN U.K. RULES AS OF JANUARY 1, 2021

Brave New World

On December 29, 2020, H.M.R.C. announced that reporting under D.A.C.6 will be limited to Hallmark D. That hallmark involves fact patterns that are patently designed to hide ownership. Under the F.T.A., the U.K. undertook an obligation to avoid weakening or reducing the level of protection below the level provided for by the standards and rules which have been agreed in the O.E.C.D. in relation to the exchange of information concerning potential cross-border tax planning arrangements. The standard referred to is the O.E.C.D.'s model M.D.R.

While the U.K. has not implemented the O.E.C.D. M.D.R. in domestic legislation, existing rules that were designed to transpose D.A.C.6 into U.K. domestic law were in existence on December 31, 2020. Those rules will be revised so that they are limited to reporting Category D transactions. In principle, by retaining Category D reporting, the U.K. will meet the requirements of the F.T.A.

H.M.R.C. has announced that it will announce a period for consultation on draft legislation designed to implement the O.E.C.D. M.D.R.

Continued Reporting Under Category D Hallmark

Hallmark D is not linked to the main benefit test. If arrangements come within the Hallmark D, they are reportable regardless, regardless of the importance to the arrangement.

As mentioned above, the O.E.C.D. standard for M.D.R. must be part of the anticipated U.K. legislation. The O.E.C.D. introduced guidance on March 9, 2018, in relation to mandatory reporting. The M.D.R. effectively requires the reporting of two arrangements. One relates to the avoidance of C.R.S. reporting. The other relates to opaque structures.

C.R.S. Avoidance Arrangements

Here, reporting involves the automatic exchange of financial account information to countries having a contact with participants. This includes C.R.S. reporting, but potentially could go further into other automatic exchange of information ("A.E.O.I.") agreements regarding financial accounts.

According to the O.E.C.D. guidance,[2] arrangements that come within the scope of continued reporting include the following:

- The use of an account, product or investment that is not, or that purports not to be, a financial account, but has features that are substantially similar to those of a financial account.
- The transfer of financial accounts or assets to, or the use of entities based in, jurisdictions that are not bound by the automatic exchange of financial account information with the State of residence of the relevant taxpayer.
- The reclassification of income and capital into products or payments that are not subject to the automatic exchange o financial account information.
- The transfer or conversion of a financial institution or a financial account or the assets therein into a financial institution or a financial account or assets that are not subject to reporting under the automatic exchange of financial account information.
- The use of legal entities, arrangements or structures that eliminate or purport to eliminate reporting of one or more account holders or controlling persons under the A.E.O.I.
- Arrangements that undermine, or exploit weaknesses in, the due diligence procedures used by financial institutions to comply with their obligations to report financial account information, including the use of jurisdictions with inadequate or weak regimes of enforcement of anti-money-laundering legislation or with weak transparency requirements for legal persons or legal arrangements.[3]

"The M.D.R. Report states that the test of a reportable arrangement is whether it is reasonable to conclude that the arrangement is a C.R.S. avoidance arrangement."

The M.D.R. Report states that the test of a reportable arrangement is whether it is reasonable to conclude that the arrangement is a C.R.S. avoidance arrangement. Presumably, this will be based on reasonable conclusions in light of all the facts and circumstances. Of course, the standard likely is to be judged by compliance officers and regulators. Hence, it may be more accurate to describe the standard as whether it is reasonable from the viewpoint of a compliance officer or regulator to conclude that the arrangement is designed to have, or is marketed as having, the effect of circumventing C.R.S. legislation? If yes, the transaction is reportable.

Note, however, that the M.D.R. Report states the following regarding conversion of accounts:

> The simple fact that an Arrangement has the effect of non-reporting is not sufficient for it to be considered to have the effect of circumventing

[2] O.E.C.D. Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures (2018) ("O.E.C.D. M.D.R. Report").

[3] M.D.R. Report, p.14.

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> CRS Legislation. This will only be the case where it is reasonable to conclude that the Arrangement undermines the intended policy of the CRS Legislation. The mandatory disclosure rules are not intended to second guess clear policy choices that were made in the design of the CRS. For instance, real estate is an asset class that is not within the intended scope of the CRS. As a result, an Arrangement to withdraw funds from a reportable Depository Account to purchase an apartment will not constitute a CRS Avoidance Arrangement despite the fact that the Arrangement results in non-reporting of the funds that are used for the purchase. Similarly, the CRS expressly provides for categories of Excluded Accounts and Non-Reporting Financial Institutions that are excluded from reporting to minimize compliance burdens and because, on balance, they do not pose a substantial risk of non-compliance. Accordingly, a transfer of funds from a reportable Depository Account into a pension product that qualifies as an Excluded Account, will, in normal circumstances, not be considered to have the effect of circumventing CRS Legislation.[4]

The same provision of the M.D.R. Report proceeds with illustrations of reportable conversion transactions. They tend to focus on marketing and moving from the C.R.S. reporting system to the F.A.T.C.A. reporting system where full U.B.O. reporting does not occur.

> However, the marketing of a scheme that makes use of such an exclusion in ways that undermine the policy rationale for providing that exclusion would be considered a CRS Avoidance Arrangement. An Arrangement does not have the effect of circumventing CRS Legislation if the Financial Account(s) information is exchanged under a FATCA Model 1A Intergovernmental Agreement with the jurisdiction(s) of tax residence of the Reportable Taxpayer. For example, if a Reportable Taxpayer that is tax resident in jurisdiction X transfers a Financial Account to the United States, that transfer would not have the effect of circumventing CRS Legislation, provided the account information is exchanged by the Competent Authority of the United States with jurisdiction X.[5]

In terms of the test of reasonableness, the M.D.R. Report states:

> The test of "reasonable to conclude" is to be determined from an objective standpoint by reference to all the facts and circumstances and without reference to the subjective intention of the persons involved. Thus, the test will be satisfied where a reasonable person in the position of a professional adviser with a full understanding of the terms and consequences of the Arrangement and the circumstances in which it is designed, marketed and used, would come to this conclusion.[6]

In practice, the standard likely is to be judged by compliance officers and regulators. Hence, it may be more accurate to describe the standard as whether it is reasonable

[4] Paragraph 1.1.5, M.D.R. Report, p. 25.

[5] *Id.*

[6] Paragraph 1.1.6, M.D.R. Report, p. 25.

from the viewpoint of a compliance officer or regulator to conclude that the arrangement is designed to have, or is marketed as having, the effect of circumventing C.R.S. legislation? If yes, it would be prudent for a professional adviser assess the transaction as reportable.

Finally, the M.D.R. Report states that for reporting to be required, an "intent" standard must be met by the intermediary.

> The fact that an Arrangement is a CRS Avoidance Arrangement will not, on its own, make that Arrangement subject to disclosure by the Intermediary under these model rules. For this to be the case, there must also be an Intermediary operating within the reporting jurisdiction that is either responsible for the design or marketing of that Arrangement or that provides Relevant Services and can reasonably be expected to know that the Arrangement is a CRS Avoidance Arrangement. The test of what an Intermediary "can reasonably be expected to know" is to be determined from an objective standpoint by reference to all the facts and circumstances and without reference to the subjective intention of the persons involved. Thus, the test will be satisfied where a reasonable person in the position of a professional adviser would be aware of this information. * * * [7]

Opaque Offshore Structures

The second reporting category is for arrangements involving a passive offshore vehicle that is held through an Opaque Structure. The M.D.R. Report describes a passive offshore vehicle as a Legal Person or Legal Arrangement that does not carry on a substantive economic activity supported by adequate staff, equipment, assets, and premises in the jurisdiction where it is established or is tax resident.[8] An opaque structure is a structure that meets three tests:

- It is reasonable to conclude that the structure (i) is designed to allow, (ii) is marketed as allowing, or (iii) has the effect of allowing a natural person to be a beneficial owner of a passive offshore vehicle.
- It is reasonable to conclude that the structure (i) does not allow for the accurate determination of such beneficial ownership or (ii) creates the appearance that such person is not a beneficial owner.
- It is reasonable to conclude the obfuscation of beneficial ownership is achieved through (i) the use of nominee shareholders with undisclosed nominators, (ii) the use of means of indirect control beyond formal ownership, (iii) the use of arrangements that provide a beneficial owner to have access to assets without being identified as a beneficial owner, (iv) the absence of any requirement or mechanism to obtain basic information as to the identity of beneficial owners, as defined in the latest Financial Action Task Force recommendations, or (v) the absence of any requirement or mechanism for a trustee to obtain information on the beneficial ownership of trust income and assets.

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[7] Paragraph 1.1.7 of the M.D.R. Report, p. 25.

[8] Paragraph 1.2.

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REPORTING BY U.K. INTERMEDIARIES WHEN CATEGORY D HALLMARK EXISTS

For outside advisers categorized as intermediaries to a cross border arrangement possibly containing a Category D Hallmark, the reporting obligations of D.A.C.6 remain applicable. Consequently, an outside adviser must go through the normal routine applicable under D.A.C.6.

"Under D.A.C. 6, an intermediary is any person that designs, markets, organizes or makes available for implementation, or manages the implementation of a reportable cross border arrangement."

Adviser as an Intermediary

Under D.A.C. 6, an intermediary is any person that designs, markets, organizes or makes available for implementation, or manages the implementation of a reportable cross border arrangement.

Covered by the above definition is any person that knows or can reasonably be expected to know that it has undertaken the performance of the foregoing services, knows or could be reasonably expected to know that they have undertaken to aid, assist, or provide advice with respect to the design, marketing, organizing, or managing the implementation of a reportable cross border arrangement. This latter group of intermediaries is sometimes referred to as service providers.

Lack of Knowledge as a Defense

In the event of noncompliance with reporting obligations, a claim of reasonable lack of knowledge is a defense for service providers. Access to the defense is lost when a service provider deliberately structures matters to avoid having knowledge even though standards of performance generally knowledge of the customer. If access to the defense is denied, civil and criminal penalties may be imposed by H.M.R.C.

Reporting Based on U.K. Nexus

Reporting is required if the taxpayer involved in the cross border transaction has a U.K. nexus and for that reason is relevant U.K. taxpayer. This occurs in any of the following circumstances:

- The U.K. is the jurisdiction where the relevant taxpayer is resident for tax purposes.
- The U.K. is the jurisdiction where the relevant taxpayer maintains a permanent establishment benefiting from the arrangement.
- The U.K. is the jurisdiction where the relevant taxpayer receives income or generates profits, even though the relevant taxpayer is neither a resident for tax purposes in an E.U. member State nor maintains a permanent establishment in an E.U. Member State.
- The U.K. is the jurisdiction where the relevant taxpayer carries on an activity, although the relevant taxpayer is neither a resident of the U.K. for U.K. tax purposes nor maintains a permanent establishment in the U.K.

The U.K. leaving the E.U. on December 31, 2020 will open up a number of potential challenges for clients and advisers.

CONCLUSION

Many advisers in the U.K. and other jurisdictions are delighted that the U.K. has significantly limited the scope of the reporting under D.A.C.6. Beginning this year, such reporting is limited to transactions covered the Category D hallmark – C.R.S. avoidance transactions and opaque overseas structures. U.K. advisers and advisers in third country advisers where the U.K. is the only connection to Europe should be able to benefit from limited D.A.C.6 coverage. The reduction is not a total reduction. In line with broader international obligations the U.K. will likely continue to hold beneficial ownership registers for corporations and trusts, and will be a leading participant on O.E.C.D. initiatives and those of the Financial Action Task Force.

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EUROPEAN UNION'S NEW REPORTING OBLIGATIONS FOR TAX INTERMEDIARIES: KEY FEATURES OF THE BELGIAN ADMINISTRATIVE GUIDANCE – D.A.C.6

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Intermediaries
Participants
Reportable

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INTRODUCTION

The E.U.'s Directive 2018/822/E.U. introduced mandatory disclosure rules for aggressive cross-border arrangements for tax intermediaries ("D.A.C.6" or "the Directive").[1] On the surface, the Directive is a uniform European framework. In practice, however, the Directive's national implementation by Member States differs in several key aspects, such as the exclusion of purely domestic arrangements, the level and type of penalties, and the application of professional privilege. Likewise, the Directive's broad and vague terminology leads to differing interpretations among Member States.[2]

As a result, intermediaries and taxpayers are left in a quandary. They must chart their reporting path as to the interpretation of the Directive, while being under the threat of high penalties if the path ultimately results if a finding of noncompliance. Surprisingly, over-reporting is not a solution, as it may contravene data protection and professional secrecy obligations. In light of the situation, many Member States are currently publishing their own administrative guidance on the interpretation of the Directive.

In this article, the authors discuss the key features of the Belgian administrative guidance. They focus on the Explanatory Memorandum of the Belgian Law implementing

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1 Council Directive (E.U.) 2018/822/E.U. of 25 May 2018 as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements, OJ L 139/1. The acronym "D.A.C." stands for "Directive on Administrative Cooperation."

2 See B. Peeters and L. Vanneste, "European Union/International – DAC 6: An Additional Common EU Reporting Standard?", World Tax Journal, 2020, Vol. 12, n° 3, p. 502:

> As DAC 6 applies a broad (and thereby vague) terminology, substantial differences in domestic application will appear. Different domestic implementations not only already reveal these differences in material, subjective and temporal scope, but the formal implementation is also far from uniform

For a comparative view of D.A.C.6's implementation in different Members States, see K. Resenig, "European Union - The Current State of DAC-6 Implementation in the European Union", European Taxation, 2020, Vol. 60, n° 12, pp. 527-535.

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the Directive[3] and the list of Frequently Asked Questions ("F.A.Q.") recently published by the Belgian Revenue Service.[4]

REPORTABLE CROSS-BORDER ARRANGEMENTS

The Directive does not require intermediaries to reveal all tax tricks to the national tax authority. The reporting obligation covers only "reportable" (2.C.) "cross-border" (2.B.) "arrangements" (2.A.).

What is an "Arrangement?"

The Directive and the Belgian Law deliberately stop short of defining the term "arrangement" (*dispositif* in French, *constructie* in Dutch). In this fashion, the reporting obligation remains wide-ranging and covers continuously evolving tax-planning schemes.[5]

At first glance, the F.A.Q. follows a similar all-encompassing approach and indicates that

> The concept of "arrangement" is extremely broad and covers any agreement, act, contract, convention, plan, scheme, project, structure, process of incorporation, transaction, or any combination of these elements, express or implied, written or oral, aiming to achieve a particular purpose or implementing a particular idea.[6]

Nonetheless, the F.A.Q. provides various helpful examples of what would and would not qualify as arrangements.[7]

- Transactions qualifying as arrangements include the migration of a company, the incorporation of a subsidiary, and the conclusion of a contract.
- Transactions not qualifying as arrangements are the mere application of a Belgian tax incentive, such as the Belgian innovation income deduction

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3 Law of 20 December 2019, Belgian State Gazette, 30 December 2019 (hereinafter: "the Belgian Law"); For further details on the Belgian Law, see D.-E. Philippe et E. Yuksel, "Mandatory Disclosure of Aggressive Cross-Border Tax Planning Arrangements : Implementation of DAC 6 in Belgium", European Taxation, 2020, vol. 60, n° 4, pp. 121-128 ; J. Malherbe, "*La déclaration obligatoire des dispositifs transfrontières – Directive DAC 6 du 25 mai 2018 et loi du 20 décembre 2019*", *Revue Générale du Contentieux Fiscal*, 2020/1-2, pp. 29-40.

4 Belgian Circular Letter, "F.A.Q.: DAC 6 - *Déclaration des dispositifs transfrontières*", available in French and Dutch at www.myminfin.be.

5 F.A.Q., no. 3.1.; See also Belgian Parliamentary Documents, House of Representatives, 2019-2020, n° 55-791/001, p. 8 (hereinafter: "Explanatory Memorandum").

6 F.A.Q., no. 3.1 (our translation); See also Explanatory Memorandum, p. 8 (our translation):

> Although the directive does not define the concept of 'arrangement', it refers to tax planning structures that allow shifting taxable profits towards more beneficial tax regimes or reducing the taxpayer's overall tax bill.

7 F.A.Q., no. 3.1; Explanatory Memorandum, p. 7.

regime, the performance of certain services provided by intermediaries, such as the filing of tax returns, performing benchmark studies, providing accounting services or assisting the taxpayer during a tax audit or a tax due diligence review. In general, there is no arrangement where the relevant intermediary, participant or taxpayer remains passive.

What is a "Cross-Border" Arrangement?

Under the Directive and the Belgian Law, an arrangement is a cross-border arrangement when it concerns (i) more than one E.U. Member State or one E.U. Member State and a third country[8] and (ii) one or more participants are tax resident in different jurisdictions or carries out activities in different jurisdictions.

In contrast with certain other Member States, such as Poland or Portugal, Belgium does not cover purely domestic arrangements.[9] For arrangements with a cross-border aspect, the F.A.Q. specifies that an arrangement is not a cross-border arrangement in any of the following circumstances:[10]

- An entity in an E.U. Member State has a foreign shareholder
- An intermediary is located in a jurisdiction that is different from the participants' jurisdiction, unless the intermediary qualifies as a participant, within the meaning explained below
- The taxpayer and all participants are in countries outside the E.U., unless there is a permanent establishment within the E.U.
- A Belgian corporation sells the shares of another Belgian corporation to the Belgian permanent establishment of a foreign corporation

The Directive and the Belgian Law distinguish intermediaries from participants.

- Under the Directive, an "intermediary" is anyone who designs, markets, organizes, or makes available or implements a reportable arrangement or anyone who helps with reportable activities and knows or could reasonably be expected to know that it is doing so.[11] Belgian Law is in line with this broad definition.[12] The F.A.Q. mentions typical intermediaries, such as consultants, lawyers, auditors, accountants, notaries, in-house legal counsel, banks, and holding companies.
- Neither the Directive nor the Belgian Law define the concept of "participant." The F.A.Q. indicates the following:[13]
    - The relevant taxpayer is always a participant.
    - An intermediary becomes a participant when he plays an active role in an arrangement. For instance, the mere fact that an intermediary

[8] Directive, art. 1, (1), (b), 18; Belgian Income Tax Code, art. 326/1, 1°.

[9] Explanatory Memorandum, p. 8.

[10] F.A.Q., no. 3.2.1.

[11] Directive, art. 1, (1), (b), 21.

[12] Belgian Income Tax Code, art. 326/1, 4°.

[13] F.A.Q., no. 3.2.2.

advises a resident of an E.U. Member State to use a foreign corporation in an arrangement does not make the intermediary a participant. Conversely, if the intermediary is a director of the foreign corporation that is recommended to a participant, the intermediary has taken an active role in the arrangement and is considered to be a participant.

- Any legal entity or person – such as a corporation, limited liability company, and the like – becomes a participant when it plays an active role in the arrangement.

When a Belgian tax resident transfers real property located outside of Belgium to another Belgian tax resident, the transaction is not a cross-border arrangement because the participants are residents of Belgium. The foreign property is not a "participant."[14] Similarly, the F.A.Q. mentions that the formation of a corporation outside of Belgium by two Belgian tax residents does not have any cross-border dimension, in principle. At the time of formation, the new corporation does not qualify as a "participant" because no activity has yet been carried on by the corporation. As a result, the two founders in the example are the only participants and the arrangement does not involve cross-border activity. The conclusion would differ if the two founders were tax resident in different jurisdictions, carried on activity in different jurisdiction, or one more played active roles in the arrangement.

"Hallmarks are broad categories setting out characteristics identified as indicative of aggressive tax planning."

When is a Cross-Border Arrangement Reportable?

Cross-border arrangements are reportable when at least one of the "hallmarks" set out in the Belgian Law is met. Belgian hallmarks are identical to those listed in the Directive. Hallmarks are broad categories setting out characteristics identified as indicative of aggressive tax planning.[15] While some hallmarks automatically trigger a reporting obligation, others apply only if they meet a so-called "Main Benefit Test" ("M.B.T."). The M.B.T. is met where a tax advantage is the main or one of the main benefits of an arrangement. However, the Directive does not define the concept of "tax advantage." As a result, Member States have opted for slightly different interpretations.

Regarding the M.B.T., the F.A.Q. mentions that Belgium requires a "direct tax advantage" such as a tax deduction, an exclusion from the tax base, a deferral of tax, or the elimination of a withholding tax.[16] Conversely, the mere application of a preferential foreign (non-Belgian) tax regime does not constitute a direct tax advantage. Under the Belgian M.B.T., a direct tax advantage covers taxes within or outside the E.U.

Regarding the hallmarks, the F.A.Q. provides various examples and sheds some light on the vague terminology of Belgian law.[17] In broad terms, the following are the key elements that come out of the Belgian administrative guidance:

- Hallmark A3 – Standardized documentation and/or structure:[18] This hallmark aims at so-called "mass-marketed schemes," involving prefabricated tax products that can be sold and implemented without much professional

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[14] Explanatory Memorandum, p. 9.

[15] Belgian Income Tax Code, art. 326/1, 3°.

[16] F.A.Q., no. 5.2; Explanatory Memorandum, p. 12.

[17] See Belgian Income Tax Code, art. 326/2.

[18] F.A.Q., no. 4.1.5.

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assistance. For instance, the mere inclusion of the taxpayer's name on a readymade arrangement could lead to the application of this hallmark. In comparison, newsletters, brochures or leaflets providing general information about an arrangement are not considered to be standardized documentation. The same applies to internal working documents that merely reflect incomplete ideas or concepts.

- Hallmark B1 – Transfer of tax losses:[19] This hallmark applies only where artificial steps are taken to (i) acquire a loss-making corporation, (ii) discontinue the corporation's principal historic activity, and (iii) utilize the losses. The order of steps is irrelevant, but all three must be present.

- Hallmark B2 – Conversion to low-tax income:[20] This hallmark applies only when pre-existing income is effectively converted into a new category of income that is taxed at a lower rate or is completely exempt from tax. However, this hallmark does not apply when a Belgian corporation issues a convertible bond to a foreign shareholder.

- Hallmark C4 – Transfer of assets:[21] Transfers of assets between a Belgian corporation and its foreign permanent establishment are covered by this hallmark no matter which is the transferor or transferee. Also covered is the transfer of the shares of a subsidiary when the investment in the subsidiary constitutes a participation. The share investment in this circumstance constitutes an asset and the transfer of the asset across a border is covered by this hallmark.

- Hallmark D2 – Obscuring beneficial ownership:[22] This hallmark refers to arrangements that have the effect of undermining the rules on beneficial ownership, the Common Reporting Standards or any other equivalent agreement on the automatic exchange of financial account information. According to the F.A.Q., this hallmark does not apply when the ultimate beneficial owner identification is made in accordance with the E.U.'s anti-money laundering legislation.

- Hallmark E1 – Unilateral transfer pricing safe harbor rules:[23] A unilateral safe harbor rule, whether implemented by an E.U. Member State of another country, is a deviation from a jurisdiction's transfer pricing regulation. Belgium does not have any unilateral safe harbor rules.[24]

- Hallmark E2 – Transfer of a hard-to-value-intangible asset:[25] The term "transfer" refers more to the economic reality of beneficial enjoyment rather than to legal title of the asset. Licensing or cost contributing agreements are covered. Transfers across a border between the head office of a corporation

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[19] F.A.Q., no. 4.2.3.

[20] F.A.Q., no. 4.2.4.

[21] F.A.Q., no. 4.3.4.

[22] F.A.Q., no. 4.4.4.

[23] F.A.Q., no. 4.5.3.

[24] *Id.*

[25] F.A.Q., no. 4.5.4.

and this branch are also covered. It does not matter whether the head office is the transferor or the transferee.

- Hallmark E3 – Transfer of a business:[26] Tax neutral, cross-border mergers and liquidations are not covered by this hallmark when functions, risks and assets have not been transferred in advance of the transaction.

". . .the Belgian Ruling Commission will not take any position on the D.A.C.6 reporting obligation in an Advance Tax Ruling."

ADVANCE TAX RULING

The F.A.Q. clearly mentions that the Belgian Ruling Commission will not take any position on the D.A.C.6 reporting obligation in an Advance Tax Ruling ("A.T.R.").[27] The rationale is that the timeline for the reporting obligation is difficult to match with the timing of an A.T.R. application.[28]

LEGAL PROFESSIONAL PRIVILEGE

The Directive allows intermediaries to waive filing information on reportable cross-border arrangements where the reporting obligation would breach a legal professional privilege ("L.P.P.") under the national law of that Member State.[29] In such circumstances, each Member State must take the necessary measures to require intermediaries to notify any other intermediary without delay or, if there is no such intermediary, to promptly notify the relevant taxpayer of its reporting obligation.

In line with the Directive, the Belgian Law requires intermediaries bound by the L.P.P. to inform in writing any other intermediary or the relevant taxpayer of the fact that the reporting obligation shifts to them.[30]

The Belgian L.P.P. exemption contains two peculiar provisions.

- The exemption under the L.P.P. rule does not apply when the transaction is a "marketable arrangement."[31] This is an arrangement that is "designed, marketed, ready for implementation or made available for implementation without a need to be substantially customized."[32]
- According to the Explanatory Memorandum of the Belgian Law, the L.P.P. exemption applies only where legal counsel has been retained to defend the

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[26] F.A.Q., no. 4.5.5.

[27] F.A.Q., no. 2.6.

[28] In line with the Directive, the Belgian Law mentions that intermediaries must report within 30 days beginning: (i) on the day after the reportable cross-border arrangement is made available for implementation; (ii) on the day after the reportable cross-border arrangement is ready for implementation; or (iii) when the first step in the implementation of the reportable cross-border arrangement has been made, whichever occurs first (Belgian Income Tax Code, art. 326/3).

[29] Directive, art. 1, (2), 8ab, par. 5.

[30] Belgian Income Tax Code, art. 326/7, par. 1; The taxpayer may however waive the L.P.P., and request the intermediary to fulfil the reporting obligation on his behalf (Belgian Income Tax Code, art. 326/7, par. 2).

[31] Belgian Income Tax Code, art. 326/7, par. 3.

[32] Directive, art. 1, (1), (b), 24; Belgian Income Tax Code, art. 326/1, 6°.

taxpayer in a matter that is before judicial courts or where legal counsel is representing the taxpayer in actual or threatened litigation.[33]

The Flemish Bar Council and the Belgian Association of Tax Lawyers disagree with this restrictive interpretation of the L.P.P. On August 31, 2020, they lodged claims for the suspension and annulment of the Flemish Decree implementing the Directive before the Belgian Constitutional Court. At the time of writing, the Belgian Constitutional Court requested a preliminary ruling from the Court of Justice of the E.U.[34] The request for a preliminary ruling concerns the compatibility of the Directive with Article 7 (right to respect for private life) and Article 47 (right to a fair trial) of the Charter of Fundamental Rights of the E.U. insofar as it requires legal counsel to notify other intermediaries of a need to report under D.A.C.6.

SANCTIONS

In case of noncompliance, the Directive requires Member States to provide for "effective, proportionate and dissuasive" penalties.[35] Member States interpret this requirement differently.[36] Poland, for instance, imposes fines of up to €4.7 million (8 million Polish zloty), whereas the maximum penalty in Ireland is €4,000.

Belgium appears to be on the reasonable side, with the following fines:[37]

- Insufficient or incomplete reporting:
  - Without fraudulent intent, a fine is imposed in the range of €1,250 and €12,500.
  - With fraudulent intent, a fine is imposed in the range of €2,500 and €25,000.
- No reporting or late reporting:
  - Without fraudulent intent, a fine is imposed in the range of €5,000 and €50,000.
  - With fraudulent intent, a fine is imposed in the range of €12,500 and €100,000.

CONCLUSION

The Directive's vague wording and undefined concepts are currently leading to significant differences in the application of D.A.C.6 among E.U. Member States. Moreover, as illustrated in the case of Belgium, administrative guidance is helpful.

[33] Explanatory Memorandum, p. 19; This approach is in line with the exemption from the reporting obligations laid down in the Belgian Law of 18 September 2017 related to the prevention of money laundering.

[34] Case C-694/20, Orde van Vlaamse Balies and Others v. Vlaamse Regering, 21 December 2021.

[35] Directive, art. 1, (2), 25a.

[36] For a comparison between E.U. Member States, see K. Resenig, op. cit., pp. 530-531.

[37] Belgian Income Tax Code, art. 445, par. 4; See also Belgian Royal Decree of May 20, 2020, Belgian State Gazette, June 4, 2020.

Nonetheless, intermediaries and taxpayers must form their own views about most practical questions. As a result, the intended harmonized approach remains a distant prospect. Uniform action with the E.U. remains a goal, but not a reality.

As with many other E.U. initiatives in the direct tax area, the Directive can be seen as another attempt to achieve a harmonization of the direct tax systems of Member States, even though the founding fathers of the E.U. made such harmonization subject to the unanimous consent of Member States, as only national governments are accountable to national parliaments which are empowered to impose direct taxes. It is a reality that unanimous consent is nearly impossible to reach among the 27 Member States. Consequently, E.U. bureaucracy leaves no occasion unused to fulfill its ultimate dream of harmonization achieved through the back door.

IMPLEMENTATION OF THE MANDATORY DISCLOSURE DIRECTIVE IN THE NETHERLANDS – D.A.C.6

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INTRODUCTION[1]

The E.U., Directive 2011/16/E.U. on administrative cooperation in the field of taxation (generally abbreviated as the 'D.A.C.') provides a framework for the exchange of information between the Member States. As such, the D.A.C. also forms the legal basis for the various tax transparency initiatives aiming to provide the authorities with additional tools to counter tax planning that is considered inappropriate. Over the past decade, Directive 2011/16/E.U. has been amended several times to accommodate these new initiatives. The latest in this series of amendments concerns the 6th ("D.A.C.6") provided by Directive 2018/822/E.U., also known as the Mandatory Disclosure Directive ("M.D.R.").

Building on Action Point 12 of the O.E.C.D. B.E.P.S. project, the M.D.R. has introduced an entirely new reporting obligation for "intermediaries," and in certain cases, taxpayers in respect of cross-border tax planning structures which contain a possible risk of tax avoidance, at least within the spirit of the M.D.R. The information reported goes into a database in order to be automatically exchanged with other E.U. Member States that are relevant to the arrangement. The underlying idea behind the M.D.R. is that the information gathered should enable the tax authorities to identify undesirable planning in advance – and potentially take action against these practices.

In the Netherlands, the M.D.R. has been implemented through the Act Implementing the E.U. Directive on Reportable Cross-Border Arrangements (the "Dutch Implementation Act"). Even though the relevant legislation was enacted as of July 1, 2020, the actual duty to report was postponed until January 1, 2021, reflecting the COVID-19 global pandemic. However, such deferral did not alter the periods subject to reporting obligations.

Since the M.D.R. merely provides a minimum standard, certain other E.U. Member States may have implemented the M.D.R. more broadly. However, the Dutch Implementation Act is essentially a transposition of the provisions of the M.D.R.

It is a truism that the M.D.R. is characterized by rather broad and vague concepts, meaning that it leaves much room for interpretation – and raises many questions. Although the legislative history of the Dutch Implementation Act provides for some clarification, tax advisers in the Netherlands were anxiously waiting for the Guideline on Reportable Cross-Border Arrangements ("the Guideline"), ultimately published on June 24, 2020.

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1 Following the adoption of the E.U. Mandatory Disclosure Directive known as "D.A.C.6" in 2018, some further clarification was provided in the legislative history of the Dutch Implementation Act. Despite the fact that last summer the Dutch Tax Authorities published their Guideline on Mandatory Disclosure of Cross-Border Structures, clear and concrete guidance is often still lacking.

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Unfortunately, the general sentiment is that the Guideline does not provide the clear and concrete guidance sought. This is somewhat disappointing, particularly in light of the fact that the M.D.R. imposes an inherent reputational risk on intermediaries, not to mention the considerable financial risk – with potential fines up to € 870,000 for not reporting, not correctly reporting, and over-reporting. Even though the Dutch Tax Authorities are precluded from imposing a fine where the intermediary or taxpayer has a reporting position – or in this context, a nonreporting position, legal certainty is key here.

This article zooms in on a number of aspects and features of the M.D.R. which are addressed in the Guideline, noting that there may be differences in interpretation between the various Member States with respect to the same provisions of the M.D.R. Some of these topics are rather generic, others specifically focus on certain specific Categories of Hallmarks (B, C and E) and the main benefit test ("M.B.T.").

ARRANGEMENTS

As mentioned, the M.D.R. imposes an obligation on intermediaries and – in certain cases – relevant taxpayers to report information to the tax authorities on reportable cross-border arrangements ("R.C.B.A.'s"). In this respect, an arrangement may be reportable where it has at least one of the Hallmarks listed in the Annex to the M.D.R., while it has the required cross-border element if it involves at least one Member State and another country, which can be either another Member State or a third country.

It follows from the above that the concept of an "arrangement" plays a crucial role within the context of the M.D.R., as in each case it will need to be assessed whether an arrangement has a cross-border element and is potentially reportable. Clearly, this makes the identification and definition of an arrangement essential for purposes of the application of the Dutch implementation of the M.D.R.

In this respect, it is not helpful that the M.D.R. deliberately does not contain a clear and concrete definition of the term "arrangement" – by contrast, this term is intended to be neutral, as it may take many forms, such as an agreement or a transaction, and may consist of various elements. In line with this approach, an arrangement may consist of several steps or parts and may also comprise a series of arrangements.

The Guideline stipulates that the concept of an arrangement must be interpreted extensively and may include any kind of legal action. Also, it indicates that a series of arrangements or several related arrangements must be regarded as one larger arrangement: what matters most is that the arrangements serve the same purpose.

Furthermore, the Guideline clarifies that the point in time where an arrangement begins and ends depends on the type of arrangement as well as the applicable Hallmark, which would imply that the latter may well determine the extent of an arrangement. In turn, this would imply that elements of an arrangement that are not essential for the application of either the relevant Hallmark or the M.B.T., should not be considered part of the arrangement.

For instance, where an entity based in the E.U. finances a transfer of assets between two of its non-E.U. affiliates, that might not be relevant for the application of either the relevant Hallmark or the M.B.T. Even though the E.U. company is clearly involved with a set of transactions that must be regarded as one single cross-border

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arrangement ("C.B.A."), providing the financing is not relevant for the applicable Hallmark. As a result of this demarcation, the C.B.A. identified does not concern an E.U. Member State meaning that this should not constitute a reportable arrangement, after all.

Finally, an adjustment to an existing C.B.A. may lead to the conclusion that a "new" C.B.A. may need to be reported. This may be particularly relevant in those cases where a structure dates to a period prior to the adoption of the M.D.R. because such structure would otherwise not be reportable.

"Hallmark B2 concerns arrangements that result in the conversion of one category of income into another income category that is taxed at a lower rate or is completely exempt from tax."

Therefore, it is important to monitor adjustments to existing structures closely, in order to determine if the adjustment constitutes an R.C.B.A., and if it does, the scope of required reporting.

Even though there is little guidance as to whether an adjustment leads to a new arrangement, it seems fair to say that a minor amendment should not have that effect. In this respect, the Dutch Tax Authorities have indicated that a mere contractual adjustment of the interest rate applicable to a loan should not result in a new reportable arrangement, while this conclusion may be different if the adjustment triggers the application of another Hallmark.

Since cross-border arrangements can only pose a potential risk of tax avoidance if the arrangement meets one or more of the Hallmarks, an adjustment should not lead to a new reportable arrangement unless it triggers a new Hallmark or if other intermediaries or taxpayers come into play as a result of the adjustment.

HALLMARK B – LINKED TO THE M.B.T.

The Guideline touches upon the application of a number of Hallmarks that often occur in practice, as well as the application of the M.B.T. provided for in the M.D.R.

Hallmark B2 concerns arrangements that result in the conversion of one category of income into another income category that is taxed at a lower rate or is completely exempt from tax. Legislative history of the Dutch Implementation Act does not contain any clarifications concerning the scope of this Hallmark, other than to clarify that, for Dutch personal income tax purposes, a shift from one "box" to another "box" falls within scope of Hallmark B2.

Nonetheless, the Guideline contains a number of clarifications. For instance, lower taxation may also result from a more favorable treaty allocation or a lower treaty rate. In relation to payroll taxes, the Guideline clarifies that a choice for a service agreement over an employment contract may well constitute a conversion in the sense of Hallmark B2, while applying for a fictitious cost deduction for expats under the Dutch 30% ruling does not constitute a conversion.

In connection with this Hallmark, an example addressed a remuneration package that partially consists of an equity incentive, since this often results in favorable tax treatment. Where a specific remuneration package that is granted upon commencement of employment does not include an equity incentive, but the arrangement is redesigned at a later point in time in order to reduce the tax burden, clearly there is a conversion. However, if the remuneration package already included an equity incentive from the start, no right to any income component existed prior to entering into the initial employment contract.

This raises the question whether a conversion is present in these circumstances, particularly whether it is relevant that the equity incentive was granted upon entering into the employment contract or only at a later stage.

In view of the above, the question rises whether Hallmark B2 is limited to actual conversions involving cases where there is an existing entitlement to an income component that, as a result of an arrangement, is converted and subsequently taxed at a lower rate or whether newly established structures where no prior entitlement to any income component existed may also fall within scope of this Hallmark. Since no limitation can be read in the wording, it would seem that no pre-existing entitlement to income must be present in order for a conversion to occur.

For that matter, an example included in the Guideline where services are provided under a service agreement instead of an employment contract also seems to indicate that Hallmark B2 may be applicable to newly established structures. From the outset, the preference for a service agreement over of an employment contract may well be driven by the wish to achieve tax savings. Hence it seems that a conversion as referred to in Hallmark B2 may also occur when establishing a new structure.

Although it would go too far to compare all possible alternative income components within this context, what is probably decisive here is whether it is commercially customary for the parties involved to provide such income components and whether in the case at hand the choice has been made on the basis of business considerations.

Hallmark B3 concerns arrangements involving circular transactions, often using intermediary entities with no other primary business purpose, or transactions that compensate or nullify each other or have other similar characteristics. According to the legislative history of the Dutch Implementation Act, providing a loan that is tainted pursuant to the Dutch anti-base erosion rules may be considered as a clear example of a Hallmark B3 arrangement. Other than that fact pattern, the legislative history does not provide any further explanation of the scope of this Hallmark.

The Guidance contains three examples of Hallmark B3 arrangements that would be reportable. Two of these are obvious, but the Guidance also contains an example where the application of Hallmark B3 is not so evident. In a nutshell, this concerns an arrangement where a Dutch company that has just realized a substantial taxable capital gain is subsequently acquired by a foreign entity that provides it with loans to acquire other companies. Subsequently, the Dutch company receives dividends from its participations and uses these to service the interest on the loan from its foreign shareholder. The interest paid is considered deductible and therefore reduces the tax burden on the capital gain realized.

Clearly, this type of arrangement, which is strongly reminiscent of the recent judgment of the Dutch Supreme Court in the case of Credit Suisse, is mainly aimed at eroding the Dutch tax base and perhaps should be reportable. However, it seems doubtful whether Hallmark B3 is applicable in this case, as there would seem to be no circular element. After all, the foreign company will not receive the amount lent until the maturity date of the loan. In the meantime, the flow of funds will only comprise the fruits of the amount lent, consisting of the dividends received and the interest paid by the Dutch company.

The phrase "circular transactions resulting in the circulation of funds" presumes that there is a set of legal transactions resulting in the return of funds to the entity that

initially paid them upon completion of the arrangement. If the above example falls within scope of this Hallmark, this may lead to an undesirable extension thereof, as any loan would seem to be covered.

To clarify Hallmark B3 In the E.U. context, the example has been used of group companies transferring their capital abroad and then bringing it back in order to benefit from the favorable regime for so-called foreign direct investment ("F.D.I.") in their jurisdiction. Interestingly, in one of these examples, the capital does return to the same country, however to another group entity. This indicates that it may well be sufficient for the application of Hallmark B3 that the funds return to the same country.

In sum, Hallmark B3 concerns arrangement involving at least two legal transactions resulting in assets or their equivalent transferred by and then returning to the same taxpayer or at least the same country. Furthermore, these transactions must either take place through intermediate entities with no other primary business purpose or offset or cancel each other.

HALLMARK C – PARTIALLY LINKED TO THE MAIN BENEFIT TEST

". . . the M.B.T. is relevant only where the payment is not taxable because the recipient is resident in a jurisdiction that is not blacklisted, but simply does not tax the income by virtue of very low statutory rates or the application of an exemption or preferential tax regime."

Under the M.D.R., Category C Hallmarks consist of four types of arrangements, and of those arrangements, the M.B.T. comes into play only in relation to the first category, concerning deductible payments that, for some reason, are not materially taxed in the hands of the recipient. Even then, if the relevant item of income is not taxable by reason of the fact that the recipient is not resident anywhere or is based in a non-cooperative country, the M.B.T. is not applicable in the context of the first category. Therefore, the M.B.T. is relevant only where the payment is not taxable because the recipient is resident in a jurisdiction that is not blacklisted, but simply does not tax the income by virtue of very low statutory rates or the application of an exemption or preferential tax regime.

In the Dutch legislative history, it has been indicated that, in principle, the term "recipient" must be interpreted from a legal perspective, but that in the event of differences in tax qualification, the underlying participants of a transparent entity may be regarded as a "recipient" as well. From the example provided in the Guidance, it can be deduced that a potential C.F.C. levy imposed on a shareholder does not qualify as a pick-up of the payment.

Legislative history also shows that an imputed charge may qualify as a payment for this purpose, meaning that there need to be an actual payment in order for the Hallmark to apply.

Furthermore, it has been noted in legislative history that, within the context of Hallmark C1, the term favorable tax regime is broader than a "harmful tax regime" and that the mere fact that a regime results in a significantly lower level of taxation than normally applies in the relevant country does not by definition result in a favorable tax regime. In any case, legislative history indicates that the Dutch innovation box and the Dutch tonnage regime for shipping companies qualify as favorable tax regimes.

Where a foreign company benefits from a notional interest deduction, obviously that deduction may significantly reduce its effective tax rate from the level of the stated statutory rate. Within this context, the question may arise whether a deductible

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cross-border payment must be construed as the application of an exemption or preferential tax regime where the recipient benefits from such notional interest deduction. It would seem that in the absence of a direct link between the payment received and the notional interest deduction, it is difficult to argue that the recipient benefits from an object exemption or favorable tax regime in that regard.

The Guideline contains several examples of arrangements that might potentially be covered by Hallmark C1. One example concerns a foreign company granting an interest-free loan to a Dutch company. In the Netherlands, interest expense is imputed, but no interest income is imputed abroad. It may be assumed that the foreign company is actually tax resident in the other jurisdiction and the relevant country is not blacklisted. Since no interest income is imputed at all, no object exemption would apply. Therefore, it would seem that the fact that the jurisdiction of the recipient deliberately does not take into account imputed interest income is construed as the application of a favorable tax regime. In this respect, within the E.U., the Code of Conduct Group determines which tax regimes must be considered as 'favorable'. For example, in Ireland, previously interest income was not imputed under certain conditions, but this did not lead to classification as a favorable tax regime.

The other items within the Category C Hallmark concern (i) double depreciation of the same assets in two or more countries and double claims for relief from double taxation in the absence of double inclusion of income and (ii) significant discrepancies in the valuation of cross-border transfers of assets. As mentioned above, the M.B.T. does not apply in those circumstances because tax considerations tend to play an essential role in these structured transactions.

Significant discrepancies in the valuation of assets covered by Hallmark C4 may also apply if a cross-border asset transfer takes place only for tax purposes, notably upon a transfer to a foreign branch. Furthermore, a substantial difference in valuation also occurs if one of the two countries involved does not recognize the transfer, at all.

The application of Hallmark C4 may well affect the application of the Dutch informal capital doctrine, which departs from the notion that an asset may be transferred below its fair market value, if only because the transferor's country may have a different view on the application or interpretation of the arm's length principle than the acquirer's country.

In practice, Dutch subsidiaries of U.S. multinationals often are made transparent for U.S. tax purposes through a check-the-box election. For U.S. tax purposes, typically this entails a deemed liquidation involving a deemed liquidation distribution of an existing Dutch entity as the assets of the Dutch company are treated as owned by the U.S. shareholder, giving rise to a cross-border asset transfer for U.S. tax purposes.

However, from a Dutch tax perspective, the U.S. check-the-box selection is a non-event and therefore no transfer takes place at all, which leads to a concrete example of a situation where one jurisdiction recognizes an asset transfer while the other does not.

The mere fact that both from a legal and tax perspective no asset transfer occurs in the Netherlands should not alter the conclusion that making the relevant check-the-box election gives rise to a reportable cross-border arrangement. Since the purpose of the M.D.R. is to identify mismatches between jurisdictions that allow cross-border tax planning, Dutch legislative history indicates that Hallmark C4 is applicable in those situations.

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HALLMARK E – NOT LINKED TO THE MAIN BENEFIT TEST

Category E Hallmarks comprise three types of transfer pricing arrangements. However, since the M.B.T. does not apply to these Hallmarks, it is not relevant whether a tax benefit is obtained through the implementation of the arrangements.

Hallmark E2 pertains to transfers to affiliates of intangible assets which are difficult to value. Since shares in a company are not intangible assets for purposes of this Hallmark, it would seem that Hallmark E2 does not apply where instead of the underlying intangibles the shares in the company that owns the intangibles are transferred. Moreover, it would seem that Hallmark E2 is also not applicable to a migration of a company that owns the intangibles, simply because no transfer to an affiliate occurs.

Hallmark E3 concerns arrangements involving a cross-border, intra-group transfer of functions, risks, or assets, if the projected annual E.B.I.T. of the transferor, during the three-year period following the transfer, is less than 50% of the projected annual E.B.I.T. of that transferor were the transfer not to take place. The rationale of this feature is to detect profit shifts to other jurisdictions.

Considering this rationale, Hallmark E3 should also apply to a migration. However, it seems doubtful whether the literal wording of the relevant M.D.R. provisions would offer sufficient room for such interpretation, as these require a cross-border transfer within the group and a decrease of the E.B.I.T. of the transferor by more than 50% as a result of that transfer.

MAIN BENEFIT TEST

As mentioned above, certain Hallmarks lead to a reporting obligation only if the M.B.T. is satisfied as well. One may wonder why the M.B.T. does not apply to all Hallmarks, even though for some Hallmarks the tax benefit is typically a given.

The M.B.T. entails that the arrangement must (i) provide a tax benefit and (ii) that benefit is one of the main benefits or the sole main benefit that can reasonably be expected from the arrangement, determined by reference to all relevant facts and circumstances.

With reference to the European Commission's recommendation of December 6, 2012 on aggressive tax planning, Dutch legislative history indicates that a tax benefit is measured by comparing the amount of tax due by the taxpayer, taking into account the arrangement, with the amount that the same taxpayer would owe in the same circumstances if the arrangement had not taken place. This is often referred to as the "comparison test." If the amount of tax due in the first situation turns out to be lower or first becomes taxable in a later tax time, there is a tax advantage, and the first part of the test is satisfied.

According to the Dutch Implementation Act, the comparison test is not limited to the amount of tax due in the Netherlands, but rather concerns the worldwide amount of tax due by the taxpayer. The legislative history states that tax benefits can arise both within and outside the E.U.

Moreover, the prevention of a tax disadvantage may constitute a tax advantage within the meaning of the M.B.T. However, only an existing tax disadvantage should be taken into account, as the comparison is made with the existing situation.

If a tax benefit is identified, it will have to be determined whether this benefit can be considered as one of the most important benefits that can reasonably be expected from the arrangement or the sole benefit. This is to be determined based on the facts and circumstances of the case. In this respect, the legislative history indicates that if the tax advantage is achieved by adding artificial elements to the structure, the tax advantage must be one of the main benefits or the main benefit.

“. . . Dutch legislative history indicates that a tax benefit is measured by comparing the amount of tax due by the taxpayer, taking into account the arrangement, with the amount that the same taxpayer would owe in the same circumstances if the arrangement had not taken place.”

However, according to the Dutch Implementation Act arrangements without any artificial elements may still meet the M.B.T., which raises the question how to assess these cases. It would seem that the way to approach this is to identify any other benefits of the arrangement and value their importance, particularly by addressing the question whether the arrangement would also have been implemented absent the expected tax benefit.

Even then, it follows from legislative history that the M.B.T. is not tax avoidance if the desired tax consequences of the arrangement are fully in line with the objective and purpose of the relevant provision of the tax law. This means that arrangements which are set up in order to benefit from favorable tax regimes do not meet the M.B.T. if this set-up is fully in line with their underlying purpose of the law. This is often referred to as the “policy intent.”

In legislative history, the M.B.T. is illustrated by the example of a U.S. multinational that decides to transfer its Swiss based R&D department to the Netherlands because it intends to benefit from the Dutch innovation box regime. In this context, it is noted that where R&D activities are transferred to the Netherlands, generally the main benefit is not tax savings because transferring activities to another country typically entails that the economic situation changes.

CONCLUSION

Meanwhile the existence of the M.D.R. is a given and most practitioners understand and accept the desire to have an additional instrument as a deterrent for potentially tax-aggressive arrangements.

However, when considering the concept of a reportable arrangement, the mechanics of various Hallmarks, and the framework for assessment of the M.B.T., it seems clear that many ambiguities continue to exist, which may hinder practitioners from applying the M.D.R. correctly. The general perception is that its current design with open norms leads to undesirable uncertainty, not just for tax advisers, but also for the tax authorities themselves.

In anticipation of further clarification from the side of the Dutch tax authorities, as a first step towards addressing legal uncertainty, practitioners may seek guidance from their peers, by sharing experiences, best practices, and views.

THE IMPLEMENTATION OF THE D.A.C.6 E.U. DIRECTIVE IN GERMANY

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Tags
Arrangements
Cross-border
DAC6
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Hallmarks
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Participants
Reportable

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INTRODUCTION

The E.U. Directive 2018/822 of 25 May 2018 ("Directive")[1] introduced a new reporting obligation for potentially aggressive cross-border tax arrangements in order to provide the tax authorities with information about potentially aggressive tax arrangements.

The Directive was implemented into German law by the inclusion of several sections (sec. 138d to 138k) into the German General Tax Code (*Abgabenordnung*, or "A.O.") in 2019, effective as of July 1, 2020, with an additional retroactive obligation to include all open tax arrangements that were set up from June 24, 2018.[2] Germany did not elect optional postponement of the D.A.C.6 implementation due to the COVID-19 crisis.

In Germany, a political discussion of plans for such reporting obligations dates back to 2007. However, in those days, the plans[3] had not been pursued further because of heavy criticism in the tax community. In 2014 a similar proposal arose in the Federal Council.[4] However, it was never enacted the implementation of Directive.[5]

German tax authorities have not yet published the final version of the administrative decree on D.A.C.6. The latest official draft version is dated July 14, 2020 (the "Draft Decree").[6]

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1 Council Directive (E.U.) 2018/822 of 25 May 2018.

2 Law on the introduction of an obligation to report cross border tax arrangements ("*Gesetz zur Einführung einer Pflicht zur Mitteilung grenzüberschreitender Steuergestaltungen*"), the "D.A.C.6 Implementation Law", of 21 December 2019, Federal Law Gazette 2019 I, p. 2875 ff.

3 Draft of a Bill of law of 25 June 2007. Said bill of law has not been publicly released. It can be downloaded here.

4 Resolution of the Bundesrat on combating international tax arrangements, in the preliminary preparatory working papers of the Federal Council ("*Bundesrats-Drucksache*") of 23 May 2014, 205/14, p. 2 *et seq*. The Federal Council ("*Bundesrat*") is one of the two legislative bodies in Germany. It represents the German Federal States.

5 Details are provided by Johanna Hey, memorandum on the constitutionality of the introduction of a general reporting obligation for tax arrangements ("*Gutachten zur Verfassungsmäßigkeit der Einführung einer allgemeinen Anzeigepflicht für Steuergestaltungen*") of February 2018, p. 5 *et seq*.

6 Draft version of the administrative decree on the application of the provisions on the reporting obligation for cross border tax arrangements ("*Entwurf eines BMF-Schreibens betreffend die Anwendung der Vorschriften über die Pflicht zur Mitteilung grenzüberschreitender Steuerverwaltungen*") of 14 July 2020, IV A 3 – S 0304/19/10006: 008.

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SCOPE OF THE REPORTING REQUIREMENT

Covered Taxes

The reporting requirement is limited to tax arrangements regarding German and E.U. taxes. U.S. taxes or the taxes of non-E.U. Member States are not covered.

Not all kinds of taxes trigger a reporting obligation. However, individual and corporate income taxes[7] and trade taxes[8] can lead to cross-border arrangements that are covered. In addition, real estate transfer tax,[9] land tax,[10] and inheritance and gift tax can lead to a cross-border arrangement that is covered by the Directive.[11]

On the other hand, tax effects resulting from V.A.T.[12] or customs, E.U. harmonized excise duties or social security contributions or other fees are excluded and cannot trigger a D.A.C.6 reporting obligation.

Tax Arrangements

The definition of the term "tax arrangements" in the Draft Decree is abstract and broad. For that reason, it has limited use in practice. A tax arrangement is defined as a deliberate process of creation that changes factual and/or legal events with tax relevance through transactions, arrangements, actions, operations, agreements, commitments, obligations or similar events.[13]

At least of a certain practical use is the additional statement that a deliberate and active induction or change of a structure, process or situation is required.[14] In principle, this should prevent an intentional deferral of action until a statutory time period passes from being a tax arrangement.[15] A case in point is the deferral of dividend declaration until after the passing of the minimum holding period for applying the participation exemption for dividend income.[16]

Nonetheless, the definition of tax arrangement does not provide much help in causing a cross-border arrangement from being reportable.

Cross-Border Element

The tax arrangement must be a cross-border tax arrangement. This cross-border element requires that

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7 *Einkommensteuer or Körperschaftsteuer.*

8 *Gewerbesteuer.*

9 *Grunderwerbsteuer.*

10 *Grundsteuer.*

11 *Erbschaft- und Schenkungsteuer.*

12 *Umsatzsteuer.*

13 Draft Decree, no. 9.

14 *Id.*

15 *Id.*

16 Such as Art. 10 (3) a) of the double tax treaty between Germany and the U.S.A. of July 4, 2008.

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- either more than one E.U. member state are affected by the tax arrangement, or
- at least one E.U. member state and one or more countries in nonmember states, such as the U.S. are affected by the arrangement.

Hence, even cross-border tax arrangement without German nexus might be reportable in Germany if not reported already in another competent E.U. jurisdiction by the same or another intermediary.[17]

In addition, one of five alternative prerequisites must be met:

- The first alternative[18] is that not all of the participants in the tax arrangement are resident for tax purposes in the same jurisdiction. Hence, this alternative would not be met if all participants are tax resident in the U.S.A. The one-country exception is not limited Germany.
- The second alternative[19] is that one or more of the participants in the tax arrangement is simultaneously tax resident in more than one jurisdiction. If the U.S. consider U.S. citizens as U.S. tax residents, while Germany considers somebody as German tax resident if that person has his domicile or habitual abroad in Germany, this alternative should be met. The same should apply if, for example, a corporation is considered U.S. tax resident because it is formed under the laws of a State of the U.S. such as Delaware, while it is also considered German tax resident as its effective place of management is in Germany.
- The third alternative[20] is met if one or more participants in the tax arrangement carries on a business in another jurisdiction through a permanent establishment and the tax arrangement relates to the business of that permanent establishment. This would be the case of a U.S. corporation with German or Dutch permanent establishment, where the tax arrangement relates to German or Dutch activity. If, however, the activity of the U.S. corporation relates solely to a U.K. permanent establishment, this alternative is not met if not relevant to the Dutch or German permanent establishment. No E.U. member state is affected by the tax arrangement between the U.S. corporation and its U.K. permanent establishment.
- The fourth alternative[21] is met if one or more participants in the tax arrangement carries on an activity in another jurisdiction without being tax resident or creating a permanent establishment in that jurisdiction. A typical case is the real estate investment of a foreign investor in Germany. In order to limit the extent of that alternative, the Draft Decree requires that such activity in the other jurisdiction must be substantial as to taxes and provides a respective example.[22]

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[17] See below under 6.3 for details on the measures to exclude double reporting and under 7. For details on the interaction between several intermediaries.

[18] Sec. 138d (2) no. 2 lit. a) AO.

[19] Sec. 138d (2) no. 2 lit. b) AO.

[20] Sec. 138d (2) no. 2 lit. c) AO.

[21] Sec. 138d (2) no. 2 lit. d) AO.

[22] Draft Decree, no. 36.

In the example, a German corporation X purchases German real estate from a German corporation Y. Both are tax residents in Germany. X provides digital services to customers in Germany and Italy. The real estate purchase as potential tax arrangement has no connection with the digital services to Italian customers. Thus, the Italian activity is not substantial as to taxes under the purely German tax arrangement. Hence, there is no cross-border tax arrangement.

- The fifth alternative[23] relates to tax arrangements that have possible impact on the European automatic exchange of information (roughly this can be compared to F.A.T.C.A.) or the identification of beneficial ownership (money laundering related concept).

The Intermediary

If there is a cross-border tax arrangement on reportable taxes, the further analysis refers to the intermediary. The intermediary can be described as the master mind behind the tax arrangement and the person generally in charge of the reporting of a reportable tax arrangement. Hence, it is also the primary person, who must assess whether there is a reportable tax arrangement.

The intermediary is defined by reference to certain activities with respect to a reportable cross-border tax arrangement. It is the person who designs, markets, organizes or makes available for implementation or manages the implementation of a reportable cross-border tax arrangement. Hence, many professionals can qualify as intermediary, such as lawyers, tax advisors, banks, investment managers or insurance companies. This list is not exhaustive.

For German D.A.C.6 reporting obligations, German tax residents, E.U. tax residents or even third country tax residents, such as a U.S. tax resident, can qualify as intermediary.

The Draft Decree provides certain guidance and relief as to each of the activities that makes a person an intermediary. For example, a person does not design a tax arrangement when it merely assesses a tax arrangement planned, designed or developed by the relevant taxpayer on its own or by a third party.[24] Hence, an expert opinion on the tax consequences of a pre-designed tax arrangement should not trigger intermediary status on the expert.[25] Furthermore, the mere abstract reproduction of the wording (*i.e.* of the law and the presentation of the administrative decrees, the case law of the (tax) courts) should also not trigger the intermediary status.[26]

There are also cases that do not use an intermediary, such as a fact pattern involving a mere inhouse restructuring by the relevant taxpayer planned for and implemented by itself. In such case, the relevant taxpayer must fulfills the tasks normally assigned to the intermediary. It must analyze whether reportable cross-border tax arrangement results from the restructure and must report the arrangement to the competent tax authority.

[23] Sec. 138d (2) no. 2 lit. e) AO.

[24] Draft Decree, no. 55.

[25] *Id.*

[26] *Id.*

The Hallmarks

In accordance with the Directive, the German implementation distinguishes two types of Hallmarks which must be realized in order to give rise to a D.A.C.6 reporting requirement. On one hand, there are Hallmarks for which one of the main benefits of the arrangement is the reduction of taxes (so-called "main benefit test" ("M.B.T.")). On the other hand, there are certain Hallmarks that do not require a finding under the M.B.T.[27]

The M.B.T. is required for those Hallmarks that are not necessarily viewed as potentially aggressive tax arrangements in appropriate fact patterns. The M.B.T. of sec. 138d (2) no. 3 lit. a) A.O., thus, requires in addition that from the perspective of a prudent observer and in an overall assessment at least one of the main benefits of an arrangement is the tax advantage that results from the transaction. In this respect, the nontax advantages must outweigh the tax advantages to such an extent that the tax advantages are reduced to mere relics.[28] Hence, a tax arrangement does not escape the M.B.T. solely by providing proof of considerable nontax reasons.[29]

Hallmarks That Require a Finding Under the M.B.T.

The Hallmarks that require a finding as to the main benefit are the following:

- An arrangement where the relevant taxpayer or a participant in the arrangement undertakes to comply with a condition of confidentiality which may require them not to disclose to other intermediaries or the tax authorities how the tax arrangement could realize a tax advantage.
- An arrangement where the intermediary is entitled to receive a fee for the arrangement and that fee is fixed by reference to the amount of the tax advantage derived from the arrangement or includes an obligation on the intermediary to partially or fully refund the fees where the intended tax advantage derived from the arrangement was not partially or fully achieved.
- An arrangement that has substantially standardized documentation or structure and is available to more than one relevant taxpayer without a need to be substantially customized for implementation.
- An arrangement whereby a participant in the arrangement takes contrived steps which consist in acquiring a loss- making company, discontinuing the main activity of such company, and using its losses in order to reduce the participant's tax liability, including through a transfer of those losses to another jurisdiction or by the acceleration of the use of those losses.
- An arrangement that has the effect of converting income into capital, gifts, or other categories of revenue which are taxed at a lower level or that are exempt from tax.

"In accordance with the Directive, the German implementation distinguishes two types of Hallmarks which must be realized in order to give rise to a D.A.C.6 reporting requirement."

[27] The German legislator did not further categorize the hallmarks. Therefore, the categories set out in the annex of the D.A.C.6 Directive are not reflected and thus the distinction of various specific hallmarks into specific hallmarks, for which the main benefit test applies, and specific hallmarks, for which it does not apply, is not implemented as categorization type in Germany.

[28] Draft Decree, no. 108.

[29] *Id.*

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- An arrangement which includes circular transactions resulting in the round-tripping of funds, namely through involving interposed entities without other significant commercial function or transactions that offset or cancel each other.

- An arrangement that involves deductible cross-border payments made between two or more associated enterprises where the recipient is tax resident in a jurisdiction, that does not impose any corporate tax or imposes corporate tax at the rate of zero or almost zero.

- An arrangement that involves deductible cross-border payments made between two or more associated enterprises where the payment benefits from a full exemption from tax in the jurisdiction where the recipient is resident for tax purposes.

- An arrangement that involves deductible cross-border payments made between two or more associated enterprises where the payment benefits from a preferential tax regime in the jurisdiction where the recipient is resident for tax purposes.

Other Hallmarks for which the M.B.T. is not Relevant

The Hallmarks that do not require a finding as to the main benefit are the following:

- An arrangement that involves deductible cross-border payments made between two or more associated enterprises where the recipient is not tax resident in any tax jurisdiction.

- An arrangement that involves deductible cross-border payments made between two or more associated enterprises where the recipient is tax resident in a jurisdiction that is included in a list of third-country jurisdictions which have been assessed by Member States collectively or within the framework of the O.E.C.D. as being noncooperative.

- An arrangement that involves deductible cross-border payments made between two or more associated enterprises where depreciation deductions for the same asset are claimed in more than one jurisdiction.

- An arrangement that involves deductible cross-border payments made between two or more associated enterprises where relief from double taxation in respect of the same item of income or estate is claimed in more than one jurisdiction.

- An arrangement that includes transfers of assets with a material difference in the amount being treated as payable in consideration for the assets in those jurisdictions involved.

- An arrangement which may have the effect of undermining the reporting obligation under the laws implementing the E.U. automatic exchange of financial account information under common reporting standard.

- An arrangement involving a nontransparent legal or beneficial ownership chain with the use of persons, legal arrangements or structures that do not carry on a substantive economic activity supported by adequate staff, equipment, assets and premises and that are incorporated, managed, resident,

controlled or established in any jurisdiction other than the jurisdiction of residence of one or more of the beneficial owners of the assets held by such persons, legal arrangements or structures and where the beneficial owners of such persons, legal arrangements or structures, as defined in sec. 3 of the German Money Laundering Act, are made unidentifiable (a "nontransparent chain").

- Arrangements concerning transfer pricing arrangements involving the use of unilateral safe harbor rules.
- Arrangements concerning pricing for the transfer of intangibles or rights in intangibles for which, at the time of the transfer between associated enterprises, no reliable comparable elements exist, and at the time the transaction was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer ("hard to value intangibles").
- Arrangements concerning transfer pricing arrangements involving an intragroup cross-border transfer of functions, risks assets, or other advantages, if the projected annual earnings before interest and taxes ("E.B.I.T.") of the transferor during the three-year period after the transfer are less than 50% of the projected annual E.B.I.T. of such transferor had the transfer not been made. In this Hallmark it is assumed that the associated enterprises must act in accordance with the principles of proper and conscientious business managers. These regulations also apply to permanent establishments.

Guidelines for the Interpretation of the Hallmarks

The guidelines for the interpretation of all of the Hallmarks in the Draft Decree are not voluminous much uncertainty continues to exist. However, with respect to the Hallmarks in connection with confidentiality clauses, standardized documentation, and anti-hybrid Hallmarks concerning the deduction of business expenses that are paid to a resident of a low tax jurisdiction, several bits of guidance appear useful.

- Regarding a confidentiality clause that requires nondisclosure of the rational of a tax planning arrangement, the Draft Decree suggests an exception that allows disclosure to the tax administration and other intermediaries having comparable reporting obligations with regard to the transaction.[30] It also advises that confidentiality clauses with respect to the preparation of tax declarations, bookkeeping, annual audits, engagement letters for due diligence reports and the due diligence report itself does not fall under this Hallmark.[31]
- With respect to the use of standardized documentation and structure, the Draft Decree provides a list of standardized legal and tax advice that are not proscribed under Hallmark, if occurring in isolation That list includes standard forms *inter alia* with respect to the following tasks:

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[30] Draft Decree, no. 120.

[31] Draft Decree, no. 121.

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- ○ Setting up a company
- ○ Granting a loan or license
- ○ Settlement of payment and securities transactions
- ○ Amending continuing obligations solely to meet arm's length conditions

Nonetheless, circumstances that comprise an isolated event in this context are not explained. In addition, the exception applies in general, which means that a certain residual risk remains regarding exceptions. However, it seems that standardized documentation can be used if it is limited to setting-up of a company, issuance of loans or licenses, secondment of employees, payment services, and standardized leasing contracts.[32]

> ***"Nonetheless, circumstances that comprise an isolated event in this context are not explained. In addition, the exception applies in general, which means that a certain residual risk remains regarding exceptions."***

- In case of a tax arrangement that involves deductible cross-border payments made between two or more associated enterprises where the recipient is tax resident in a jurisdiction that does not impose any corporate tax or imposes corporate tax at the rate of zero or almost zero percent, the Draft Decree defines "almost zero" as up to 4%,[33] which is much higher than the 1% European standard threshold.[34]

The White List

The German legislator empowered the tax administration to provide a "White List." Tax arrangements or tax aspects on that list do not qualify as tax advantage arrangements if they concern solely German tax. While the idea of having a White List was well appreciated by practitioners, in the end the list is quite short and considered as the absolute minimum. It is not likely to be expanded prior to the publication of the final version of the Decree.

Procedural Aspects

Competent Authority

The competent authority for D.A.C.6 reporting is the Federal Tax Office (*Bundeszentralamt für Steuern*). It is designated to receive reports of intermediaries that are tax resident in Germany. It can also receive reports from intermediaries that are not German tax resident where the intermediary is tax resident outside the E.U. and fulfills one of the following three requirements set out in sec. 138f (7) A.O.:

- The intermediary has a permanent establishment in Germany, through which the services with respect to the tax arrangement are provided.
- The intermediary is registered in the German commercial register or another German public professional register.
- The intermediary is registered with a professional association related to legal, tax, or consultancy services in Germany.

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[32] Draft Decree, no. 130.

[33] Draft Decree, no. 150.

[34] Summary Record prepared by the E.U. Commission Services, E.U. Working Party IV -Direct Taxation of 24 September 2018, p. 5.

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Hence, a French corporation with German permanent establishment is not required to report in Germany (but probably in France). A U.S. corporation with German permanent establishment is required to report with the Federal Tax Office in Germany.

A failure to report based on gross negligence or a willful disregard of the rules result in the imposition of a fine of up to €25,000 for each failure to report. While such maximum amount may be rather low compared to other E.U. Member States, the extent of the failures add up.

Legal Professional Privilege

In principle, lawyers, tax advisors or other groups providing services that give rise to a professional privilege recognized by German law opt out of the full reporting under certain requirements if released by the taxpayer.

This does not lead to a full reporting obligation of the taxpayer, but to a reporting obligation that is split. The lawyer, tax advisor or other intermediary has an obligation to file a partial report of non-individualized information. The report may include the following:

- A summary of the content of the reportable arrangement
- The details on all applicable Hallmarks
- The date on which the first step in implementing the reportable arrangement
- The details of the relevant national provisions
- The value of the reportable arrangement.

The taxpayer is, then, obliged to report the individualized information in its partial reporting. In the end, a full report is filed, comprised of two partial reports.

The intermediary must inform the taxpayer about the taxpayer-related information it reported to the Federal Tax Office. The taxpayer must include in its partial report the registration number and the disclosure number of the intermediary's partial report. The 30-day reporting period for the taxpayer begins to run when it receives the required information from the intermediary.

Reporting in Another E.U. Member State

Several intermediaries that work on the same tax arrangement transaction are each responsible to report independently on that arrangement. However, once the Federal Tax Office receives a report on a particular tax arrangement or has been advised properly that a report was already filed with the competent authority of another E.U. Member State in accordance with the local D.A.C.6 requirements of that Member State, the obligation of a German intermediary is deemed to be satisfied.

For the foregoing rule to apply, the German intermediary must, upon request, submit proof that the tax arrangement was reported. Initially, degree of proof that was required to be submitted was not clear. However, the Draft Decree provides a practical solution – it is sufficient to provide the registration I.D. number (called the "arrangement I.D. number or reference number) and the disclosure I.D. that relates to the

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initial reporting by the other intermediary.[35] The German Tax Administration requires that the intermediary who wants to benefit from the foregoing process must have been reported by the initial intermediary in its reporting.[36]

Reporting Another Intermediary

If an intermediary knows that at least one other intermediary is involved, it must include general personal information about that other intermediary the D.A.C.6 reporting filed with the Federal Tax Office. Once an intermediary files a D.A.C.6 report with the Federal Tax Office, it receives a registration number, which must be provided to all other intermediaries. Once the registration number is obtained, other intermediaries do not receive a further registration number for that tax arrangement from the Federal Tax Office.

CONCLUSION

In Germany, the reporting requirements are continuously increasing. This triggers high costs for all participants. It is doubtful whether the aim of all such new requirements will be reached, including, the avoidance of truly abusive tax structures. If the tax authorities are inundated with excessive data, abusive structures can be missed. In addition, German tax authorities do not have enough personnel to monitor cross-border arrangements and may require initial screening through the use of artificial intelligence. Perhaps it would have been a better alternative for the German tax authorities to expand its team of tax auditors so that audits could be concluded on a more rapid basis. In Germany, the tax examination teams often focus on tax periods that ended more than five years in the past.

[35] Draft Decree, no. 98.

[36] *Id.*

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D.A.C.6 IMPLEMENTATION IN LUXEMBOURG – RISK OF MULTIPLE REPORTING OBLIGATIONS EXISTS

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Tags
Arrangements
Cross-border
D.A.C.6
Hallmarks
Intermediaries
Luxembourg
Participants
Reportable

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INTRODUCTION[1]

D.A.C.6 is the latest European Union Directive on Administrative Cooperation. It requires Intermediaries, and in some cases taxpayers, to report a wide range of "potentially aggressive tax planning arrangements" to tax authorities. The Directive became effective on July 1, 2020. It imposes obligations to report transactions entered into from June 25, 2018. It introduced the concept of "Hallmarks" into European tax law, albeit with a sense somewhat different to its more everyday usage.[2]

LEGISLATIVE BACKGROUND

European Council Directive (E.U.) 2018/822 of 25 May 2018 regarding the mandatory exchange of information in the field of taxation in relation to reportable cross-border arrangements, known as D.A.C.6, introduces mandatory reporting obligations on intermediaries who play a role in reportable cross-border arrangements ("C.B.A.'s") entered into by taxpayers. D.A.C.6 formed the basis of the Luxembourg draft Bill (*Projet de Loi*) No 7465 dated the August 8, 2019. On March 21, 2020, the Luxembourg Parliament approved the law of 25 March 2020 ("L.L.2020") and stated that the provisions would be applicable from July 1, 2020. D.A.C.6, however, foresees a retroactive effect with respect to any C.B.A. where "the first step in implementing" occurred between June 25, 2018 and July 1, 2020.

The main purpose of D.A.C.6 is to enhance transparency through the imposition of mandatory reporting obligations on "gate keepers" (*i.e.*, intermediaries) of arrangements that contain Hallmarks of potentially aggressive tax planning. This information is shared with other tax authorities in the E.U. It was inspired by the Final Report on Action 12 of the O.E.C.D. B.E.P.S. Project. However, the Mandatory Disclosure Rules ("M.D.R.") of D.A.C.6 are broader in that they impose an obligation to disclose potentially aggressive tax planning arrangements.

Due to the COVID-19 pandemic, the implementation of these rules was delayed. Any reportable C.B.A.'s where the first step was implemented between June 25, 2018 and July 1, 2020 should have been reported by February 28, 2021. Additionally, any reportable C.B.A.'s which took place between July 1, 2020 and the present must be reported within 30 days from January 1, 2021. The first exchange of information between the Member States under D.A.C.6 is scheduled to occur by April 30, 2021.

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[1] The authors acknowledge the insights obtained from Thierry Pouliquen, Andrew Knight, Simon Gorbutt, and Graham J. Wilson during the preparation of this article.

[2] While the term "hallmark" is generally a positively affected word, being a symbol of certifying the standard of purity attributed to an object/ article, the hallmarks referred to within D.A.C.6 are the contrary and have negative features.

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This article will consider the position in Luxembourg in relation to the transposition of D.A.C.6 and examine guidelines such as the Circular of the Luxembourg Tax Authority ("L.T.A.") (formally the *Administration des Contributions Directes* or "A.C.D.") as well as the commentaries on the draft law and the State Council opinion. References will be made to relevant existing law that may lead to duplicate reporting of the same facts.

TRANSPOSITION OF D.A.C.6 IN LUXEMBOURG

Almost Identical Transposition of D.A.C.6

There are three means of legislating within the European Union: by Directive, by Regulation, and by Decision. As stipulated by Article 288 of the Treaty on the Functioning of the European Union, Directives are implemented in the following way.

> A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods.

In comparison to Regulations and Decisions, Directives must be transposed into national law by each Member State. As a Directive, D.A.C.6 provides for a general legal framework that can be considered as the minimum standard for achieving its stated purposes. While transposing D.A.C.6 into national law, the E.U. Member States were required to specify certain provisions but were also free to broaden its scope. However, the reality with respect to Directives has been to move away from the "framework" style of Directive as embodied in Article 288 and towards the issuance of more detailed provisions. This shift leaves the Member States less wriggle room when transposing the Directive into national law. As such, Member States seem to be reluctant to depart from the wording of the Directives and the wording of domestic legislation frequently follows the exact wording of the Directives.

The Luxembourg legislative procedure, which is unicameral, nevertheless requires formal consultation by the Government with several nongovernmental organizations, the most important of which is the State Council (*Conseil d'Etat*). While N.G.O.s are consulted according to the subject matter of a proposed law, the State Council is consulted on all proposed laws and has the power to delay, although not amend, legislation. Commentaries by the State Council are often illuminating, as are the commentaries that accompany practically every proposed law in Luxembourg, whatever the subject matter.

The wording of L.L.2020 aligns closely with the text of D.A.C.6. The main definition of the terms such as "C.B.A.'s," "intermediary," "relevant taxpayer," "associated enterprise," "Hallmarks," and "marketable arrangement" – are identical to the definitions within the D.A.C.6, Thus, L.L.2020 adopted the five categories of Hallmarks in D.A.C.6:

- General Hallmarks linked to the main benefit test ("M.B.T.")
- Specific Hallmarks linked to the M.B.T.
- Specific Hallmarks related to cross-border transactions, with only some being subject to the M.B.T.

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- Specific Hallmarks concerning automatic exchange of information and beneficial ownership
- Specific Hallmarks concerning transfer pricing

Luxembourg decided to transpose D.A.C.6 as an autonomous law and not merely as an amendment to the law of 29 March 2013 (itself as amended) on administrative cooperation in the field of tax, which transposed Directive 2011/16/UE. Therefore, L.L.2020 needed to define the notion of "financial accounts" and "persons" and to specify that the L.L.2020 applies to all taxes except V.A.T., customs duties, excise duties, and compulsory social security contributions.

The main scope of the reporting obligation was not extended beyond the scope expressly set down in D.A.C.6. For example, no additional Hallmarks were included and no reporting in relation to purely domestic arrangements is required.

Some Specifics of L.L.2020

D.A.C.6 authorizes the Member States to provide waivers from intermediary reporting. Thus, Member States may

> * * * take the necessary measures to give intermediaries the right to a waiver from filing information on a reportable C.B.A. where the reporting obligation would breach the legal professional privilege under the national law of that Member State.

Initially limited to lawyers in the draft Bill 7465, L.L.2020 provides an exemption from reporting obligations for lawyers, chartered accountants (*experts-compatibles*) and auditors (*réviseurs d'entreprises*) reflecting the important role of accountants in providing tax advice to businesses and also reflecting the growing number of accounting firms that are associated with legal practices to a greater or lesser degree.

D.A.C.6 further requires E.U. Member States to introduce effective, proportionate, and dissuasive penalties for failure to comply with the provisions of the national laws that implement the Directive.

To this end L.L.2020 provides that intermediaries and relevant taxpayers may incur a fine that will be fixed by the Luxembourg Tax Administration up to an amount of EUR 250,000 in cases involving (i) failure to report information, (ii) late transmission of information, (iii) transmission of incomplete information, and (iv) transmission of inaccurate data.

Additionally, in cases where an intermediary is within the scope of legal professional privilege, a fine may be levied where an intermediary fails to notify other intermediaries or relevant taxpayers within the relevant ten-day notification period. The commentaries to the draft law indicate that the level of the penalty imposed will consider the circumstances of the case as well as the intentional character of the breach. Those commentaries also refer to the effective, proportionate, and dissuasive criteria of the penalties decided. The practice of enforcing tax reporting rules by means of having the tax administration impose fines occurs regularly in Luxembourg.[3]

[3] See for example the European Court of Justice case of Berlioz: C-682/15.

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INTERPRETATION OF THE RULES AND AVAILABLE GUIDANCE

Official Guidance?

The fact that D.A.C.6 itself is very broad in terms of its definitions and the Hallmarks may lead to different interpretations within the E.U. Member States. The wording of the L.L.2020 aligns closely with the text of D.A.C.6 and consequently does not provide much information on the definitions and Hallmarks. Most unfortunately the same is true of the commentaries to the draft law.

"The fact that D.A.C.6 itself is very broad in terms of its definitions and the Hallmarks may lead to different interpretations within the E.U. Member States."

The State Council noted, in its opinion dated January 14, 2020, that the Luxembourg Government commentaries do not provide sufficient clarification allowing for a better understanding and, therefore, a possibly better assessment of whether a C.B.A. must be reported. In the same opinion, the State Council suggested some clarifications that have not been followed by the Luxembourg Government. Nevertheless, the L.T.A. followed some of the suggestions made by the State Council when the L.T.A. published its circular.

The L.T.A. Circular

The L.T.A. published a circular, most recently amended on February 12, 2021 (the "Circular"), providing further details in relation to the implementation of L.L.2020. It is our understanding that several Member States produced guidelines are more fundamental and categorical than those from Luxembourg and did so much sooner than Luxembourg.

The Circular contains only a few further details and clarifications in relation to the definitions or interpretation of the Hallmarks, specifically with regard to the M.B.T., which appear to stem from the opinion of the State Council. Apart from this, it contains mainly guidelines about the practical aspects of the reporting obligations, including (i) forms and communication methods to report information, (ii) languages that should be used, and (iii) scope of information to be provided to the L.T.A. However, some very important practical issues have not been dealt with and these items are discussed below.

Some of the details provided by the Circular are as follows.

Cross-Border Arrangement

In terms of the definition of a C.B.A., the Circular specifies there is no C.B.A. within the meaning of Article 1 (1) a-d if (i) all participants concerned with the arrangement are tax resident in the same Member State (which is not Luxembourg), and (ii) the intermediary is not to be considered as a participant of an arrangement, and (iii) the intermediary is the only one to present a link with Luxembourg. At the same time, it clarifies that this reasoning does not apply when the arrangement may have consequences on the automatic exchange of information or on the identification of the beneficial owner.

Clarifications on Intermediary Definition

Regarding the term of "made available for implementation" in relation to the definition of an intermediary, the Circular clarifies the time when the reporting clock begins to run. The activity

> * * * is made available when the intermediary has provided the relevant taxpayer with the contractual documents or made them accessible to him otherwise, while specifying that an effective implementation, however, is not required.

The Circular further specifies that an intermediary who exercises, in relation to a C.B.A., exclusively activities such as the design, marketing, organization of a C.B.A., or the provision of such an arrangement for implementation, is not to be qualified as a participant in the arrangement unless this intermediary is also active in the arrangement that he himself has imagined, proposed, set up, made available for implementation or has managed the implementation for the benefit of the relevant taxpayer.

Participant of an Arrangement

Participants include not only the relevant taxpayer but also their commercial and contractual partners regarding the arrangement in question, such as buyer and seller of a property or lenders and borrowers.

Marketable Arrangement

Interesting to see is that the Circular expressly states that Hallmark A3, involving, an arrangement that has substantially standardized documentation and/or structure and is available to more than one relevant taxpayer without a need to be substantially customized for implementation, is not automatically considered as a marketable arrangement.

Professional Secrecy- Notification Obligation

Where the exemption for professional secrecy applies, the Circular clarifies that the exempt intermediaries are required to notify other intermediaries involved, including non-Luxembourg intermediaries, meaning that those intermediaries will, if they consider the transaction as reportable, make the reporting to the tax authorities of their respective Member States of residence. It also specifies that any intermediary or relevant taxpayer may, after receiving notification of a reporting obligation by an intermediary subject to professional secrecy, revise the initial assessment made by the notifying intermediary and may conclude that the arrangement is not reportable, based on the facts and circumstances. In the event the notified intermediaries and the taxpayer erroneously determine that no report is required, the exempt intermediary likely will not face a penalty for noncompliance on its part.

The Main Benefit Test

L.L.2020 subjects certain Hallmarks to the M.B.T. This means that even if the facts indicate that terms of the Hallmark have been met by the arrangement, reporting is required only if the following M.B.T. conclusion is reached:

> [I]t can be established that the main benefit or one of the main benefits which, having regard to all relevant facts and circumstances, a person may reasonably expect to derive from an arrangement is the obtaining of a tax advantage.

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Commentaries on draft law note that under paragraph 81 of Action 12 of the O.E.C.D. B.E.P.S. Project, the analysis calls for a comparison of the value of the expected tax benefit with the value of other benefits that may arise from the transaction based on an objective assessment of the tax benefits.

The Circular clarifies that the M.B.T. is not met when the tax advantage concerned is obtained from an arrangement that is in accordance with the purpose or the aim of the applicable legislation and the legislator's intention. In that case, that arrangement or transaction need not be reported. It further clarifies that to determine whether the arrangement is in accordance with the legislator's intention, all elements of the arrangement must be taken into consideration. An example of where the M.B.T. is met involves an arrangement that takes advantages of the subtleties or nuances of a tax system, or inconsistencies between two or several tax systems, to reduce the tax due. In these circumstances, the arrangement or transaction would be reported.

The Circular further confirms the view of the legislator within the draft bill that the M.B.T. must be met with respect to direct and certain indirect taxes, such as inheritance tax. It would not apply where the tax advantage is linked to V.A.T., customs duties, excise duties and compulsory social security contributions. Whether the tax advantage was obtained in an E.U. or a non-E.U. country does not affect the application of this exception.

The concept of the M.B.T. is not a new phenomenon. It has already been seen within the General Anti-Abuse Rule ("G.A.A.R.") provided under the Anti-Tax Avoidance Directive 2016/1164, however under different criteria. Directive 2016/1164 has been transposed by Luxembourg in the law of 21 December 2018. Under the G.A.A.R., nongenuine arrangements or a series of arrangements that are put in place for the main purpose, or one of the main purposes, of obtaining a tax advantage that defeats the object or purpose of the applicable tax law should be ignored for the purposes of determining the tax liability. An arrangement under the G.A.A.R. is regarded as nongenuine to the extent that it is not put into place for valid commercial reasons which reflect economic reality. Because the M.B.T. under D.A.C.6 does not have the same objective requirements, the scope of its application under D.A.C.6 is much broader.

Point 14 of the preamble of D.A.C.6 states the following:

> [I]t is appropriate to recall that aggressive cross-border tax-planning arrangements, the main purpose or one of the main purposes of which is to obtain a tax advantage that defeats the object or purpose of the applicable tax law, are subject to the general- anti-abuse rule as set out in Article 6 of Council Directive (E.U.) 2016/1164.

Examples of Hallmarks

For each Hallmark, an intermediary must analyze arrangements on a case-by-case basis and consider all Hallmarks under D.A.C.6 and existing laws to ensure compliance. The discussion that follows addresses several Hallmarks, but not all.

B2: Conversion of Income in Context of Classes of Shares

Classes of shares with different economic rights such as preferred shares or tracking shares, are commonly used by Luxembourg companies and held both by investment funds and others.

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The redemption of a class of shares by a Luxembourg company might be viewed as an arrangement falling within Hallmark B2, which relates to the conversion of income into capital or low or zero taxed income. In particular, this is because the shareholder in such case may be considered to be receiving a return in the form of a capital gain that is free of withholding tax rather than receiving a dividend that might be subject to withholding tax.

The conversion of the income should be assessed, in principle, at the level of the shareholder. Moreover, Hallmark B2 is subject to the M.B.T. This being said, the reporting of any repurchase of the classes of shares must be analyzed on a case-by-case basis.

For instance, in the case of a Luxembourg company held by a Luxembourg investment fund in the form of a tax-exempt opaque company, the redemption of an entire class of shares should not be considered as falling under the Hallmark B2 since any income received by such an investment fund is tax-exempt. Nevertheless, the repurchase of the entire class of shares would have to be analyzed in light of the M.B.T. to complete and support the absence of reporting of the C.B.A..

A3: Standardized Documentation and B2: Income Conversion in the Context of Life Insurance

As a preliminary remark, in many European countries, life insurance is seen as a good thing, whether it contains a greater or lesser element of savings or investment. This may also be linked to pension considerations. This means that in many countries one or more of the three principal components of life/pension insurance are the following:

- The payment of the premium by the policy holder
- The investment by the insurer/pension fund
- The eventual payment to the beneficiary

Each provides tax benefits, which may or may not be limited by ceilings or other standards. These advantages may include (i) the tax deductibility of premiums by the policy holder, (ii) the exemption or low taxation of investment income and gains in the hands of the insurer/pension fund, and (iii) the exemption or lower taxation of payments to a beneficiary or withdrawals by a beneficiary. This is a huge business and is heavily based upon standardized contracts. In 2017 life insurance premiums in the E.U. totaled €710 billion.

Hallmark A3 (Standardized documentation) and Hallmark B2 (Income conversion) might have an impact on Luxembourg life insurance contracts. Both Hallmarks are subject to the M.B.T. A life insurance contract is not automatically reportable under those Hallmarks and therefore needs to be analyzed on a case-by-case basis.

Regarding Hallmark A3, the commentaries of the draft law specify, by referring to paragraph 104 of Action 12, the following:

> [This Hallmark] covers "prefabricated" tax products that can be used as they are, or after limited modifications. In order to set up such an arrangement, the customer does not need significant support in the form of professional advisory services.

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On December 12, 2020, the Luxembourg Insurance and Reinsurance Association (*Association des Compagnies d'Assurance et Réassurance* or "A.C.A.") published on its website a post called "Frequently Asked Questions" on D.A.C.6 (F.A.Q.) constituting a nonbinding common interpretation of A.C.A. members presented and discussed with the Ministry of Finance and the L.T.A.

According to these F.A.Q., the A.C.A. suggests that Hallmark A3 should not apply to life insurance contracts, to the extent that those contracts are in compliance with the Luxembourg law, regulations, other binding measures or best practices, are in principle personalized to the client (*e.g.*, determination of the beneficiary, choice between different types of investments and vehicles), and a certain degree of advice is provided.

Moreover, through life insurance contracts, the policyholder has the possibility to

> [* * * invest] in a wide variety of instruments in order to constitute, using the income derived by these investments, a capital sum that can be repaid or bequeathed to one or more beneficiaries, generally with some preferential tax treatment, if certain specific conditions are met.

In this respect, life insurance contracts might be viewed as an arrangement falling within Hallmark B2 ,which relates to the conversion of income into capital or low or zero taxed income.

Based upon a particularly narrow view of the nature of an insurance contract, in the F.A.Q., the A.C.A. considers that, to the extent that the insurance company is the legal and beneficial owner of the invested assets, the policyholder does not benefit from any conversion of its income throughout the duration of the life insurance contract, and therefore Hallmark B2 is not automatically satisfied. In addition, if Hallmark B2 were to be considered as satisfied, the application of the M.B.T. to the policy would need to be analyzed.

E3 - E.U. Cross-Border Merger

Hallmark E3 refers to the following fact pattern:

> [A]n arrangement involving an intragroup cross-border transfer of functions and/or risks and/or assets, if the projected annual earnings before interest and taxes (E.B.I.T.) during the three-year period after the transfer, of the transferor or transferors, are less than 50 % of the projected annual E.B.I.T. of such transferor or transferors if the transfer had not been made.

This Hallmark is not subject to the M.B.T. As a result, many transactions commonly used in Europe to effect corporate reorganizations can be caught by Hallmark E3. This despite the fact that there is specific European legislation which is intended to facilitate such transactions, including mergers, demergers, migrations, and liquidations, where tax deferral and/or reduction is a natural consequence alongside the other usual advantages sought in such reorganizations.

Whether Hallmark E3 is applicable to all sorts of mergers will likely depend on the activities, functions, risks, and assets carried on and held by the companies involved, keeping in mind that the Hallmark E3 is part of specific Hallmarks concerning transfer pricing.

Where an absorbed target company carries out shareholding and financing activities, transfer pricing issues generally should not be relevant. Therefore, profit that might be generated by those activities should not correspond to the E.B.I.T. notion referred to under Hallmark E3, rendering the cross-border merger potentially not reportable.

Conversely, if the absorbed target company carries on a commercial activity generating profitable operating revenues, besides its shareholding and financing activity, such profit should correspond to the E.B.I.T. notion referred to under Hallmark E3. As, a merger will inevitably reduce the E.B.I.T. of the absorbed company to nil, the cross-border merger could potentially qualify as a reportable C.B.A.

DOUBLE COUNTING OR THE INTERACTION OF REPORTING MECHANISMS

"Where an absorbed target company carries out shareholding and financing activities, transfer pricing issues generally should not be relevant."

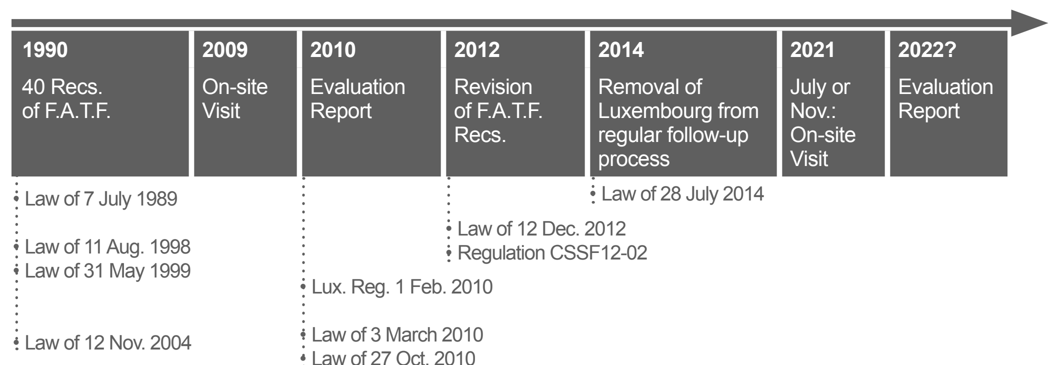
Law of 12 November 2004 on the fight Against Money Laundering and Against the Financing of Terrorism, as Amended (A.M.L. Law) and All Hallmarks of D.A.C.6

Figure 1 shows that the journey of the A.M.L. Law goes back to 1990 when the 40 recommendations published by the Financial Action Task Force ("F.A.T.F.") were implemented in Luxembourg in the law of 7 July 1989. A few years later, the recommendation were transposed into the Luxembourg criminal code and finally into the law of 12 November 2004.

In 2009/10, F.A.T.F. undertook an on-site visit to Luxembourg as part of its general plan to verify the implementation of the F.A.T.F. recommendations by the E.U. Member States. A mutual evaluation report was issued in 2010 indicating recommendations as to how strengthen certain aspects of the Luxembourg system in relation to its actions to counter money laundering and terrorist financing ("A.M.L./T.F."). Luxembourg consequently enacted several additional laws strengthening its A.M.L./T.F. system. Finally, in February 2014, the F.A.T.F. recognized that Luxembourg made significant progress in addressing deficiencies identified in the February 2010 mutual evaluation report so that it should be removed from the regular follow-up process.

The next ten-year evaluation process was scheduled for the spring of 2020. Due to COVID-19, it was first delayed until the autumn of 2020 and is now due to take place in July or November 2021, with the report to potentially follow in 2022. Luxembourg is extremely concerned about ensuring that it will receives a favorable evaluation report from the F.A.T.F. To be fair, this is, entirely justified given the rigorous procedures that have been put in place and which are well policed.

Figure 1: F.A.T.F. and Luxembourg



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The first and only anti-money laundering Directive ("A.M.L.D.") on the fight against money laundering that existed in 1991 was transposed into Luxembourg Law in 1993. In 2001, a second directive was transposed into the current A.M.L. Law. In 2005 the 3rd A.M.L. was adopted and covered not only anti money laundering but also terrorist financing. Over the years additional A.M.L. Directives have been issued. To date, the A.M.L. Law has been amended as a result of the growing problem of tax fraud and money laundering six times, the last one being by the law of February 25, 2021.

The evolution of the Directives on Administrative Cooperation (D.A.C.) in the field of taxation in the European Union is enormous. So far, the original Directive 2011/16/E.U. ("D.A.C.1") has been amended five times by the following Directives with the object and purpose of strengthening the administrative cooperation between the E.U. Member States. As can be seen by the dates, the main, or one of the main, motivations was the fall-out from the 2008/9/10 financial crisis and the perceived need to raise tax revenues without raising taxes.

- **Directive 2014/107/E.U.**: This Directive introduced an automatic exchange of information on financial accounts and the related account holders ("D.A.C.2"), implemented in Luxembourg by the law of 18 December 2015 on the common reporting standard (C.R.S.).
- **Directive 2015/2376/E.U.**: This Directive addressed the automatic exchange of tax rulings and advance pricing agreements ("D.A.C.3"), implemented into Luxembourg law by the law of 23 July 2016.
- **Directive 2016/881/E.U.**: This Directive introduced the automatic exchange of country-by-country reports ("D.A.C.4"), implemented in Luxembourg by law of 23 December 2016.
- **Directive 2016/2258/E.U.**: This Directive ensures that tax authorities have access to beneficial ownership information collected pursuant to 4th E.U. A.M.L. Directive ("D.A.C.5"), implemented into Luxembourg legislation by the law of 1 August 2018.
- **Directive 2018/822/E.U.**: This Directive addressed automatic exchange of reportable C.B.A.'s ("D.A.C.6").

D.A.C.7 was issued earlier this month (March 2021) and addresses tax transparency on digital platforms. D.A.C.8 has been proposed on reporting of crypto assets.

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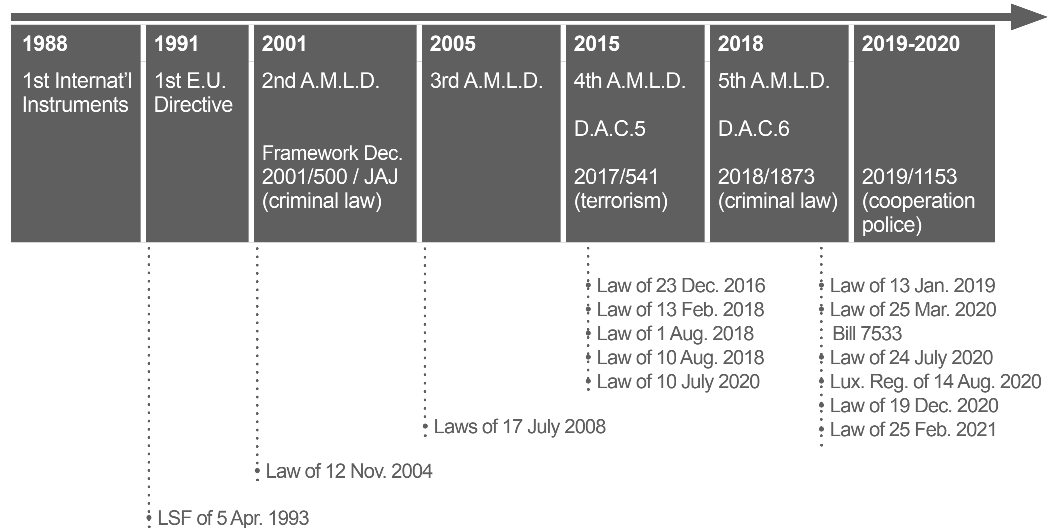
Figure 2: Development of the Legislative and Regulatory Framework Over the Past Three Decades on A.M.L.

Historical Overview of Anti-Money Laundering Law (E.U.)



Luxembourg Law of 18 December 2015 Transposing E.U. Directive 2014/107, Known as "D.A.C.2," Relating to the Mandatory Automatic Exchange of Information in Tax Matters (C.R.S. Law) and Hallmark D1 (Automatic Exchange of Information)

The C.R.S. Law requires financial institutions to report financial accounts held by account holders that are tax residents in a C.R.S. jurisdiction. At the same time, separate reporting obligations under L.L.2020 may be triggered if the specific Hallmarks concerning automatic exchange of information (Hallmark D1) are considered to be satisfied. This Hallmark is not subject to the M.B.T.

In comparison to the C.R.S. Law, the reporting obligation under Hallmark D1 is not addressed only to financial institutions but extends to include intermediaries or if there is no intermediary to the "relevant taxpayer." The scope of Hallmark D1 is extremely broad and reporting under Hallmark D1 covers arrangements that may have the effect of undermining the reporting obligations under the C.R.S.

As a result, an intermediary is left with considering two sets of rules when an arrangement falls within the scope of Hallmark D1. The preamble to D.A.C.6 however points to the M.D.R. developed by the O.E.C.D. and related commentary as a source of illustration and interpretation which might be useful in analyzing whether the reporting arrangement is consistent with the C.R.S. law. Nevertheless, in the circumstances where Hallmark D1 applies, the intermediary or the taxpayer should consider whether C.R.S. Law have been complied with, too.

Luxembourg Law of 13 January 2019 Creating a Register of Beneficial Owners Transposing the 4th E.U. A.M.L. Directive, as Amended by the 5th E.U. A.M.L. Directive (R.B.E. Law) and Hallmark D2 (Concealment of Beneficial Owner)

Hallmark D2 is not linked the M.B.T. and looks at arrangements where the intermediary or taxpayer intends to conceal the beneficial owner by using offshore entities

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and structures with no real substance. O.E.C.D. examples look to fact patters in which undisclosed nominee shareholders are used or where control is exercised indirectly rather than by means of formal ownership. Beneficial ownership may also be obscured where arrangements are based in jurisdictions where there is no requirement to maintain information on beneficial ownership. This Hallmark should not be triggered in the first place if A.M.L. obligations and R.B.E. Law have been complied with during the identification process and the beneficial owner is recorded on the Luxembourg beneficial owner register.

"Hallmark D2 is not linked the M.B.T. and looks at arrangements where the intermediary or taxpayer intends to conceal the beneficial owner by using offshore entities and structures with no real substance."

Law of 10 February 2021 introducing Defensive Measures Towards Blacklisted Countries and Hallmark C1 b (ii) (Blacklisted Countries)

This law denies, under certain circumstances, the deduction of interest and royalties owed by Luxembourg corporate taxpayers to associated enterprises and individuals established or based in noncooperative tax jurisdictions (E.U. "blacklisted countries"). As of February 22, 2021, those jurisdictions include American Samoa, Anguilla, Dominica, Fiji, Guam, Palau, Panama, Samoa, Seychelles, Trinidad and Tobago, the U.S. Virgin Islands, and Vanuatu. Hallmark C1.b(ii) is not subject to the M.B.T. and target situations where arrangements involve tax-deductible payments to a resident in blacklisted countries. The fact that those arrangements are now reportable to the tax authorities under the Hallmark C1.b(ii) may permit the L.T.A. to apply the law of 10 February 2021 and sanction those arrangements.

Law of 23 July 2016 Transposing Directive 2015/2376/E.U. on Automatic Exchange of Tax Rulings, known as "D.A.C.3" and Hallmarks, Particularly Hallmark E (Concerning Transfer Pricing)

As of January 1, 2017, all cross-border advance tax rulings and advance pricing agreements issued, modified, or renewed by the L.T.A. are subject to automatic exchange of information with all other E.U. Member States. In this respect, if an arrangement falls within one of the Hallmarks or in particular Hallmark E, it must be reported. Moreover, if the arrangement is considered to be exchanged under the law of 23 July 2016, this will lead to unnecessary double exchange between the E.U. tax authorities and ultimately to an increase of workload for the tax authorities.

CONCLUSION

As we have seen from the above, it has taken eight years to move from D.A.C.1 to D.A.C.6 and the process is ongoing with D.A.C.7. Perhaps the E.U. will soon get it right.

- D.A.C.6 itself is very broad in terms of its definitions and Hallmarks. This may lead to different interpretations across the different E.U. Member States. Luxembourg followed the wording of D.A.C.6 rather closely. Thus, there is a serious need for further guidance in Luxembourg concerning L.L.2020, in particular the definitions and the interpretation of the Hallmarks.

- The limited clarification within the commentaries to the draft law and the State Council opinion, which as indicated, have not been followed by the Luxembourg Government, as well as the rather practical guidance from the L.T.A., are not sufficient.

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- L.L.2020 concerns C.B.A.'s, which indicates that more than one intermediary will almost certainly be involved in a particular arrangement. Thus, different intermediaries may have different views as to whether a particular arrangement is considered as reportable or not.
- Depending on the decision taken by the intermediaries involved, this may result in unnecessary multiple and even overlapping filings in relation to the same arrangement, increasing the workload of not only of the intermediaries but also the tax authorities (all of course paid for by the taxpayer directly or indirectly).
- According to L.L.2020, an intermediary for which the exemption applies under the professional legal privilege must notify "any other intermediary" involved, and in the absence of an intermediary not subject to the legal professional privilege, the relevant taxpayer.
- The State Council notes, in its opinion dated March 10, 2020 on the draft law, that given the definition of the term intermediary, "any other intermediary" means the other intermediary regardless of whether it benefits from an exemption from the reporting obligation for a C.B.A.. This leads to an unnecessary and inconsistent multiplication of notifications to the various intermediaries.
- The Circular states that "the intermediary subject to professional secrecy is required to notify the reporting obligations to the persons to whom they fall and of which he is aware, whether he is an intermediary or a relevant taxpayer." But it is still not clear whether "to whom they fall" excludes intermediaries benefiting from an exemption from the reporting obligation, which does not put an end to the concerns.
- The fact that the intermediaries and tax authorities must also consider above mentioned existing laws while analyzing a C.B.A. leads to an increase of work and expenses. Thus, specific guidelines from the Luxembourg Government are long overdue to avoid such unnecessary reporting and increase of workload.

This being said, and to the extent that Member States tend to replicate the text of Directives as mentioned above, it may be time for the E.U. Commission to go beyond providing more and more precise Directives by providing detailed rules as to how expedient and efficient implementation, including simple reporting, should be made.

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D.A.C.6 – THE ITALIAN WAY

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Tags
Arrangements
Cross-border
DAC6
Hallmarks
Intermediaries
Italy
Participants
Reportable

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INTRODUCTION

In the context of the various initiatives in the field of tax transparency, the European Union ("E.U.") issued E.U. Council Directive 2018/822 of 25 May 2018 ("D.A.C.6" or "Directive"), which introduced a broad mandatory reporting obligation for intermediaries and taxpayers involved in cross-border arrangements that meet certain features, commonly referred to as "Hallmarks."

The Italian Government implemented D.A.C.6 with Legislative Decree no. 100/2019 (the "Legislative Decree"). The Legislative Decree follows the wording of the Directive, Annex I to the Legislative Decree includes the list of Hallmarks to be considered for identifying reportable cross-border transactions, which matches Annex IV of the Directive.

On November 17, 2020, the Italian Ministry of Finance published a decree containing specific clarifications for certain key aspects, including definitions of terms used in connection with the Hallmarks (the "Decree").

On November 26, 2020, the Director of the Italian Tax Authority (the "I.T.A.") issued Regulation no. 364425/2020 providing for technical rules and procedures.

On February 10, 2021, after the first reporting deadline of January 31, 2021, the I.T.A. issued Circular no. 2/E (the "Circular") which provides certain clarifications regarding who must report, the scope of the report, and several interesting examples of cross-border arrangements that are reportable. Because the Circular was published after the first reporting deadline passed, no penalties are applied where complete reports have been filed by February 28, 2021.

Both the Legislative Decree and the Circular specify that the absence of any action by the I.T.A. in response to a report of an intermediary or taxpayer does not mean that the underlying transaction has been accepted as compliant with substantive provisions of Italian tax law. That determination can be made only after the completion of an I.T.A. examination. Similarly, the filing of a report under D.A.C.6 by an intermediary or taxpayer should not be viewed as an admission that an abusive arrangement has taken place.

This article provides a brief overview of the Italian implementing regulations and focuses on recent clarifications contained in the Circular with respect to Hallmarks contained in Categories A, B, C and E.

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WHO IS REQUIRED TO REPORT?

In principle, the new mandatory reporting obligation lies with both intermediaries and taxpayers. Intermediaries have the primary obligation to report. The reporting obligation lies with the taxpayer only when the intermediary is exempt or does not have access to all information.

Intermediaries

According to the Legislative Decree, the intermediary is the person who

- designs, markets, organizes, or makes available for implementation or manages the implementation of a reportable cross-border arrangement (the "Promoter"); or
- provides, directly or indirectly, assistance or advice in relation to the reportable cross-border arrangement (the "Service Provider").

The Circular clarifies that the term of "intermediary" encompasses (i) financial entities subject to reporting obligations under the Common Reporting Standard, such as banks, insurance companies, and fund asset managers and (ii) advisors already subject to anti-money laundering regulations, such as lawyers, accountants, and notaries. Based on the clarifications contained in the Circular, the reporting obligation is fundamentally the same for the Promoter and the Service Provider, but the latter is required to report a cross-border arrangement to the extent that it appears to be "reportable" on the basis of its experience and the available information, without an obligation to collect further information. This is commonly referred to as the "standard of knowledge."

To be subject to the reporting obligations under D.A.C.6, the intermediary must meet at least one of the following territorial requirements:

- It is resident in Italy for tax purposes.
- It has a permanent establishment in Italy through which it provides services in respect of the reportable cross-border arrangement.
- It is incorporated in Italy or is regulated by Italian laws.
- It is registered with an Italian professional providing legal, tax or consultancy services.

Where more than one intermediary meets the above-mentioned territorial requirements, the obligation to file the report on the cross-border arrangement lies with all intermediaries involved in the same reportable cross-border arrangement.

As to the Service Provider that advises or assists a client in relation to a reportable cross-border arrangement that is already in place prior to the effective date of D.A.C.6, the Circular specifies that no reporting obligation exists to the extent that it does not participate in an update or an improvement of the existing arrangement.

Should the intermediary be an organization, the individual who must comply with the reporting obligation depends on the nature of the intermediary. Where the intermediary is a company or an entity with legal personality, the legal representative of the organization is obligated to file the report. Where the intermediary is an entity

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without legal personality, the person who is in charge of the professional engagement relating to the reportable cross-border arrangement is obligated to file the report.

Intermediaries are exempt from the reporting obligation in several circumstances:

- The first is that they receive from clients or others relevant information on reportable cross-border arrangements while examining the client's legal position or providing legal assistance in connection with a proceeding before a judicial authority.
- The second is that they have evidence that a reportable cross-border arrangement has been reported by another intermediary and the report contains the same information that they would otherwise be required to file.
- The third is that filing it could trigger exposure to their own criminal liability (self-incrimination).

"According to the Legislative Decree, the definition of the term 'taxpayer' encompasses any person that implements a reportable cross-border arrangement or to which a relevant arrangement is made available."

Taxpayers

Taxpayers are required to report cross-border arrangements where (i) there is no intermediary, (ii) the intermediary is exempt from reporting and there are no other intermediaries, or (iii) the intermediary does not provide the taxpayer with the evidence that the same information has already been reported.

According to the Legislative Decree, the definition of the term "taxpayer" encompasses any person that implements a reportable cross-border arrangement or to which a relevant arrangement is made available. The Circular clarifies that, to qualify as a taxpayer, a person must know the key features of the arrangement.

To be subject to the reporting obligations under the D.A.C.6 regulations, a taxpayer must meet at least one of the following territorial requirements (the "Italian Taxpayer"):

- It is resident in Italy for tax purposes.
- It has a permanent establishment in Italy through which benefits are available from the reportable cross-border arrangement.
- It receives income or generates profits within the Italian territory, although it does not meet the foregoing requirements.
- It carries on its business in the Italian territory even if it does not meet the foregoing requirements.

Regarding the reporting obligation on a taxpayer that receives income or generates profits within the Italian territory, the Circular clarifies that the criteria for identifying income that is deemed to be originated or derived within the Italian territory are those set forth under Article 23 of the Italian Income Tax Code,[1] without taking into account the effect of any applicable Double Tax Treaty. Regarding the reporting obligation on a taxpayer that carries on its business in the Italian territory, the Circular specifies that a reporting obligation exists even where a nonresident person carries on its business in Italy without creating a permanent establishment in Italy.

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[1] Presidential Decree no. 917 of 22 December 1986.

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Where a reportable cross-border arrangement involves more than one taxpayer meeting the territorial requirement, the Circular specifies that the reporting obligation lies with the taxpayer that agreed to the arrangement with the intermediary or, absent the intermediary, with the taxpayer who managed its implementation. Should the Italian Taxpayer not be an individual, the reporting obligation is imposed on the legal representative, even if the taxpayer does not have legal personality.

As pointed out in the Circular, the distinction between an intermediary and a taxpayer may be blurred. In particular, the Circular clarified that a taxpayer may fall under the definition of "intermediary" if an entity belonging to a multinational group designs, organizes or makes available to another group entity a reportable cross-border arrangement for implementation by a sister company, in which case the entity designing the arrangement is a Promoter. Additionally, a taxpayer may be an intermediary if it provides assistance or advice to another group entity in relation to an arrangement, in which case the advising entity is a Service Provider.

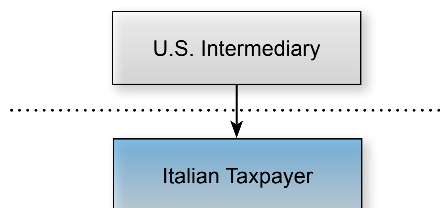
Taxpayers are exempt from the reporting obligation in two circumstances. The first is when they have evidence that the same information regarding a reportable cross-border arrangement has been reported by the intermediary. The second is where it could trigger their own criminal liability (self-incrimination).

WHAT ARE REPORTABLE CROSS-BORDER ARRANGEMENTS?

Identifying the arrangements that are subject to the reporting obligation requires an understanding of various provisions contained in both the Legislative Decree and the Decree.

First, the arrangement must relate to cross-border situations in order to be reportable. Consequently, it must be "a scheme, agreement or project concerning Italy[2] and one or more foreign jurisdictions," meaning that at least one of the participants (either an intermediary or the taxpayer) has a connection with the Italian territory.[3] At the same time, another participant or the same participant has a connection with another jurisdiction. This could happen in various ways, as illustrated under the following fact patterns.

- Not all the participants in the arrangement are resident in Italy for tax purposes. This is illustrated in the following diagram:[4]



[2] See Article 2, para. 1, letter a) of the Legislative Decree.

[3] See the territorial requirements illustrated in the previous section.

[4] It is based on the Example 2 contained in the Circular (page 29).

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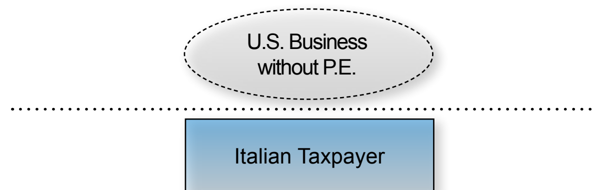
- One or more of the participants in the arrangement are simultaneously resident for tax purposes both in Italy and in another jurisdiction. This is illustrated in the following diagram:[5]

- One or more of the participants in the arrangement carry on a business in another jurisdiction through a permanent establishment situated in that jurisdiction and the arrangement forms a part or the whole of the business of that permanent establishment. This is illustrated in the following diagram:[6]

- One or more of the participants in the arrangement carry on an activity in another jurisdiction without being a tax resident of that jurisdiction or creating a permanent establishment situated in that jurisdiction. This is illustrated in the following diagram:



- The arrangement has a possible impact on the automatic exchange of information or the identification of beneficial ownership.

Second, for a cross-border arrangement to be reportable, it must include at least one of the tax avoidance risk indicators ("Hallmarks") contained in the five categories (Categories A through E) listed in the Annex 1 to the Legislative Decree which exactly mirrors the content of the Annex IV to the Directive. As illustrated below, the presence of certain Hallmarks is not always sufficient by itself to trigger reporting, but become so if a specific test is met.

As provided for by the Decree, Hallmarks under Categories A, B, C, and E trigger the reporting obligation only in cases where the transaction can result in a reduction in taxes[7] due by a taxpayer in one of the E.U. Member States or in another jurisdiction that signed an *ad hoc* agreement with Italy for the exchange of information for D.A.C.6 purposes.[8] In line with the scope of the Directive, the tax reduction feature covers all taxes, except for V.A.T., customs duties, and excise duties.

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[5] It is based on the Example 4 contained in the Circular (page 30).

[6] It is based on the Example 9 contained in the Circular (page 32).

[7] See Article 6 of the Decree.

[8] Please note that, at the time of this document, no specific agreements for the exchange of information for D.A.C.6 purposes has been signed by Italy yet.

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"According to the Circular, the tax reduction is the tax advantage that it is expected to be derived from the cross-border arrangement."

Regarding Italian taxes, the Circular refers to

- Italian corporate income tax (I.R.E.S.),
- Italian individual income tax (I.R.P.E.F.),
- regional tax on productive activities (I.R.A.P.),
- final withholding taxes and substitute taxes,
- local taxes,
- indirect taxes (such as the registration tax, stamp duty, mortgage, and cadastral taxes), and
- wealth taxes on financial assets held abroad (I.V.A.F.E.) and on immovable properties held abroad (I.V.I.E.).

According to the Circular, the tax reduction is the tax advantage that it is expected to be derived from the cross-border arrangement. It must be calculated as the difference between taxes payable as a result of the cross-border arrangement and taxes that would have been paid without such arrangement (the "Tax Reduction Test"). The Circular specifies that the tax reduction may result in (i) a reduction in the taxable income or resulting taxes, (ii) a relief from double taxation or an increase in that relief, (iii) a tax refund or an increase in the amount refunded, (iv) the deferral of a tax payment and (v) the elimination or a reduction of withholding taxes.

The Circular states that the existence of a tax reduction must be made without taking into account that the reduction may be offset by specific Italian tax provisions (such as C.F.C. rules and anti-hybrid rules). It is not clear that the mandate to ignore corrective provisions is valid. This was pointed out in a submission by the Association of Italian Joint Stock Companies,[9] which explained that entering into a transaction that results in the imposition of Italian tax under C.F.C. legislation or anti-hybrid rules does not appear to be potentially agressive within the meaning of D.A.C.6.

For Hallmarks listed under Categories A and B and several under C, transactions are reportable only if the tax reduction meets the "main benefit" test ("M.B.T."). Under the M.B.T., no reporting is required if nontax advantages that are obtained from a transaction are viewed to be greater than the identified tax advantages. In that set of circumstances, it cannot be said that the main benefit of entering the transaction is the resulting tax benefit. Both the Decree and the Circular clarify that the M.B.T. takes into account only the tax advantage of an Italian Taxpayer, meaning that tax advantages that will be derived by a taxpayer resident outside Italy are not considered. Finally, the benchmark that is applied under the M.B.T. is that the tax advantage must exceed 50% of all the benefits to be derived by an Italian Taxpayer, including both tax and nontax advantages.[10] The M.B.T. does not require an analysis of the taxpayer's intentions. Hence, it is an objective test rather than a subjective test.

To identify the nontax advantages deriving from the cross-border arrangement, the Circular clarifies that it is necessary to take into account reduction in costs or any

[9] Assonime, Consultation document no. 9/2018.

[10] See Article 7, para. 2 of the Decree.

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increase in revenues. These advantages must be objectively quantifiable based on accounting and nonaccounting documentation, such as provisional budgets. In addition, the Circular clarifies that if a cross-border arrangement includes both a Hallmark for which the M.B.T. is required and a Hallmark for which the M.B.T. is not required, the arrangement must be reported under the last-mentioned Hallmark. Hence, the M.B.T. becomes irrelevant to the reporting obligation.

HALLMARKS

Category A - Generic Hallmarks Linked to the M.B.T.

Hallmark A1 applies to arrangements where at least one of the participants undertakes to comply with a condition of confidentiality that prohibits disclose of how the arrangement secures a tax advantage. For this Hallmark to apply, the Circular clarifies that it is sufficient that the confidentiality is required with regard either to an intermediary or the Tax Authority. In addition, this Hallmark applies even if the confidentiality is required of any person that is not involved in the arrangement.

Hallmark A2 applies to an arrangement where the intermediary is entitled to receive a fee or, remuneration for the arrangement, and that fee is fixed by reference to the amount of the tax advantage derived from the arrangement, even if no tax advantage is actually derived by the Italian Taxpayer. The Circular points out that this Hallmark applies only if an intermediary is involved in the cross-border arrangement.

Hallmark A3 applies to an arrangement that has substantially standardized documentation and/or structure and is available to more than one taxpayer without a need to be substantially customized for implementation. Regarding this Hallmark, the Decree clarifies that it does not cover standardized arrangements to obtain a specific tax incentive provided by Italian tax law. In this regard, the Circular specifies that this Hallmark does not cover the drafting of documentation to be used for requesting the refund of tax credits or withholding taxes or the application of any tax incentive.

Category B - Specific Hallmarks Linked to the M.B.T.

Hallmark B1 applies to an arrangement whereby a participant undertakes contrived steps which consist of (i) acquiring a loss-making company, (ii) discontinuing the main activity of that company and (iii) using the losses to reduce the acquiring company's tax liability in Italy or elsewhere. The Circular clarifies that

- acquisition of a company is determined by reference to the acquisition of the control of a company in accordance with Article 2359 of the Italian Civil Code,[11]
- the discontinuation of the main activity of the acquired company must be real, and
- Hallmark B1 covers cases where, *inter alia*, the losses are used in a jurisdiction other than the one where the losses have been originated.

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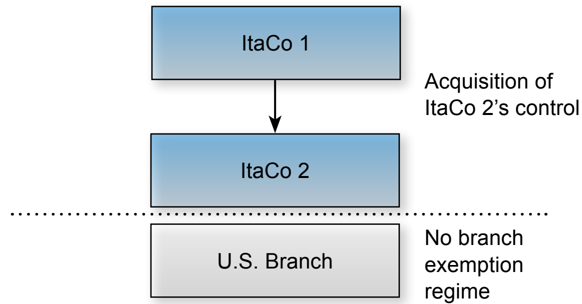
[11] Pursuant to Article 2359 of Italian Civil Code, "controlled companies" means: 1) companies in which another company has got the majority of votes exercisable in ordinary shareholders meetings; 2) companies in which another company has got sufficient votes to exercise dominant influence in the ordinary shareholders meetings; 3) companies that are under the dominant influence of another company by virtue of particular contractual arrangements.

In broad terms, Hallmark B1 is intended to cover the following fact pattern:

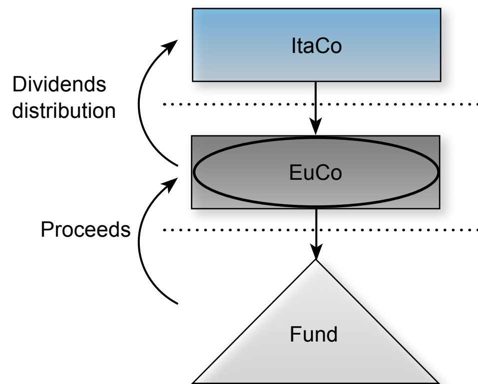
> ItaCo 1 is a company resident in Italy for tax purposes. It carries on its business in the U.S. through a loss-making permanent establishment. ItaCo 1 did not opt for the branch exemption permitted under Italian law. ItaCo 2, a company resident in Italy for tax purposes, acquires the control of ItaCo 1 in accordance with Article 2359 of Italian Civil Code. ItaCo 1 is merged into ItaCo 2, ItaCo 1's main activity is interrupted, and its losses are used to reduce ItaCo 2's tax liability.[12]



Hallmark B2 applies to an arrangement that has the effect of converting income into capital, gifts, or other categories of revenue that are taxed at a lower level or are completely exempt from tax.

In broad terms, Hallmark B1 is intended to cover the following fact pattern.

> ItaCo, a company resident in Italy for tax purposes, sets up EuCo, a fiscally transparent entity located in an E.U. Member State. ItaCo makes a capital injection into EuCo to allow the latter to invest in the Fund, a foreign collective investment fund. Since EuCo is treated as an opaque entity for Italian tax purposes, the proceeds distributed by the Fund flows through EuCo and arrive in the hands of ItaCo as dividends. In principle, 95% of the dividends are exempt from Italian taxation. If Fund's profits were distributed directly to ItaCo, the distribution would be fully subject to tax in Italy.



12 It is based on the Example 9 contained in the Circular (page 77).

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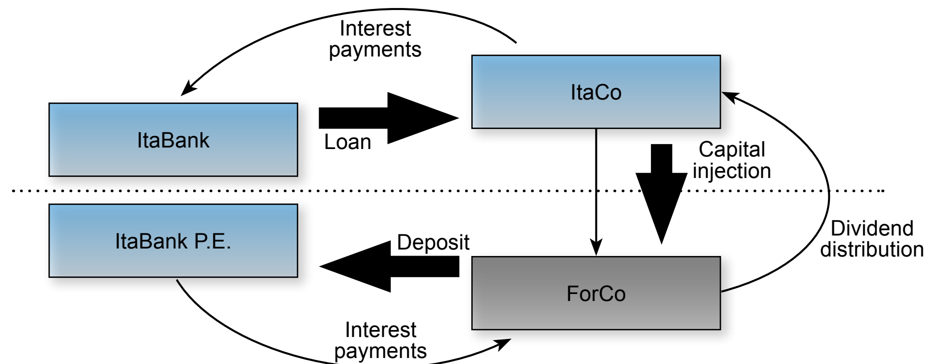
Hallmark B3 applies to an arrangement which includes circular transactions resulting in the round-tripping of funds, namely through (i) involving interposed entities without other primary commercial function or (ii) transactions that offset or cancel each other or that have other similar features.

In broad terms, Hallmark B1 is intended to cover the following fact pattern:[13]

> ItaBank, a bank resident in Italy for tax purposes, makes a loan available to ItaCo. ItaCo uses the borrowed funds to inject capital in ForCo, a loss-making foreign company. ForCo deposits the funds with ItaBank PE, a foreign branch of ItaBank, which pays interest to ForCo as remuneration. Interest income is offset with losses at the level of ForCo. The interposition of ForCo results for ItaCo in (i) the deduction of interest payments made to ItaBank under the loan and (ii) the 95% exemption from Italian corporate income tax of dividends received from ForCo.



Category C - Specific Hallmarks Related to Cross-Border Transactions

Hallmark C1 applies to an arrangement that involves deductible cross-border payments made between two or more associated enterprises where at least one identified condition occurs.

- The recipient is not resident for tax purposes in any tax jurisdiction.
- The recipient is resident for tax purposes in a jurisdiction, but that jurisdiction
  - does not impose any corporate income tax or imposes corporate income tax at the rate of zero or almost zero, meaning an effective corporate income tax rate that is less than 1%; in addition, the M.B.T. must be met in order for the arrangement to be reportable; or
  - is included in a list of jurisdictions that are noncooperative for E.U. purposes (the "E.U. List") or are noncooperative within the framework of the O.E.C.D. (the "O.E.C.D. List"). Since both lists are updated periodically, the Circular specified that the taxpayer/intermediary must refer to the list in effect when the reporting obligation arises, as discussed below.

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[13] It is based on the Example 15 contained in the Circular (page 84).

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- The payment benefits from a full exemption from tax in the jurisdiction where the recipient is resident for tax purposes. In this regard, the Circular specifies that that the Hallmark applies when the payment received by the payee is not subject to tax in the payee's jurisdiction as a result of (i) a tax exemption, (ii) a set-off, or (iii) a tax credit. According to I.T.A., this Hallmark should not apply if the tax relief applies as a result of the tax exempt status of the payee under the laws of its jurisdiction; in addition, the M.B.T. test must be met regarding the arrangement in order for it to be reportable.

- The payment benefits from a preferential tax regime in the jurisdiction where the recipient is resident for tax purposes. The Circular clarifies that the term "preferential tax regime" refers to those harmful tax regimes illustrated in the O.E.C.D. B.E.P.S. Action 5 "Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance." The assessments of preferential tax regimes carried on by the Forum on Harmful Tax Practices ("F.H.T.P.") periodically identify those tax regimes that, although they are "preferential," do not qualify as "harmful;" in addition, the M.B.T. test must be met in order for the arrangement to be reportable.

"The test used to judge the existence of associated enterprise for purposes of Hallmark C1 and E is the same as in the Directive. This test appears to be broader than the test that is relevant for Italian transfer pricing purposes."

For an arrangement to come within the scope of Hallmark C1, all the covered arrangements must take place between "associated enterprises." The test used to judge the existence of associated enterprise for purposes of Hallmark C1 and E is the same as in the Directive. This test appears to be broader than the test that is relevant for Italian transfer pricing purposes. Since Hallmarks apply also to transactions that are not subject to transfer pricing regulations, taxpayers will need to adopt different standards of identifying intra-group transactions, one for transfer pricing purposes and one for Hallmarks C1 and E.

For the application of the Hallmark C1, the Circular clarifies the definitions of the terms "payment" and "recipient" of the payment. According to the I.T.A., the concept of payment refers to any item that is deductible for tax purposes. In this regard, the definition also includes hypothetical or notional payments occurring between a permanent establishment and its head-office or between two permanent establishments of the same company. As to the definition of a recipient, a set of rules is adopted by the Circular.

- Where a conduit company is interposed between two associated companies, the interposed company is to be disregarded, even though it is the formal recipient of the payments and is not an associated company.

- Where the recipient is an entity that is treated as fiscally transparent under the laws of its jurisdiction, such as limited liability partnerships in U.K., or a C.V. in the Netherlands,

  - the recipient is its partner to the extent that the partner's jurisdiction qualifies the entity as fiscally transparent, or

  - the recipient is the entity itself to the extent that the partner's jurisdiction qualifies the entity as opaque for tax purposes. Should the entity's partners not be subject to tax in the entity's jurisdiction, the entity should not qualify as a resident for tax purposes in any tax jurisdiction. This case would fall under the first category of Hallmark C1 for which only M.B.T. is not applicable.

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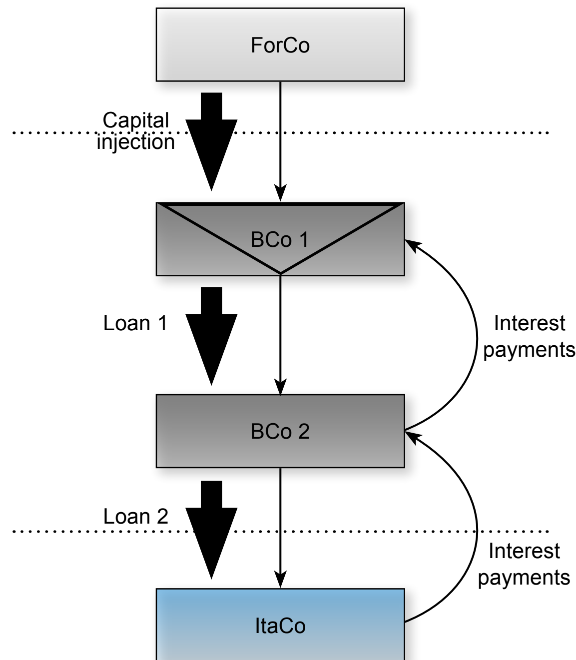
- In cases where a notional payment is made by the head-office to a permanent establishment for which the branch exemption regime has been opted, the recipient is the head-office to the extent that the jurisdiction where the permanent establishment is located does not recognize the separate existence of the permanent establishment. This case would fall under the third category of Hallmark C1, for which the M.B.T. must be met, also.

In broad terms, the first category under Hallmark C1 is intended to cover the following fact pattern.

> ForCo, a company resident outside the E.U. for tax purposes, wholly owns BCo1, a company resident in the Netherlands for tax purposes. BCo 1 is treated as tax transparent in the Netherlands while it is treated as opaque for tax purposes in the ForCo's jurisdiction (so-called "reverse hybrid"). ForCo injects capital into BCo1 which uses these funds to make available a loan in favor of BCo2, its subsidiary which is also resident in the Netherlands for tax purposes (the "Loan 1"). BCo 2 enters into a loan agreement with ItaCo, an associated enterprise being resident in Italy for tax purposes (the "Loan 2"). The Loan 2 mirrors the terms and conditions of the Loan 1. As a result, BCo 2 offsets the interest income received by ItaCo against the interest payments made to BCo 1. The overall structure produces a deduction of interest payments at the level of ItaCo without the inclusion of the related income in any jurisdictions.



Hallmark C2 applies when depreciation deductions are claimed for the same asset in more than one jurisdiction. According to the I.T.A., this Hallmark applies where differences in ownership concepts[14] exist for accounting purposes in two or more countries and those differences lead to the claiming of depreciation deductions more than once for the same asset. This Hallmark is not affected by the M.B.T.

[14] Legal vs. economic ownership.

Hallmark C3 applies when relief from double taxation in respect of the same item of income or capital is claimed in more than one jurisdiction. The Circular provides the following example of an arrangement that is covered by Hallmark C3.[15]

> TaxCo is an intermediary that is resident in Italy for tax purposes. It advises on a structure applicable to ACo, which is a tax resident of State A, and BCo, which is tax resident of State B, ACo, enters into a securities lending agreement with BCo regarding the shares of CCo, which is a tax resident of State C. ACo is the lender and BCo is the borrower. The loan covers a period during which CCo pays a dividend. BCo collects the dividend net of the withholding tax that has been levied in State C and remits the amount to Company A without the imposition of withholding tax in Country B. Each of ACo and BCo claim a foreign tax credit for the withholding tax levied in State C.

Hallmark C4 applies when an arrangement provides for the transfer of assets between companies in two jurisdictions and a material difference exists in those jurisdictions between the transaction price payable for the assets and market value. The Circular clarifies the following requirements for application of Hallmark C4:

- The transaction price must be at least 10% lower than the arm's length market value.
- The arm's length market value is determined under concepts of transfer pricing regulations applicable to controlled transactions.
- The asset is not an operating asset, with examples being immovable assets (real property) and financial assets.

Category E - Specific Hallmarks Concerning Transfer Pricing

Category E encompasses certain Hallmarks applicable to cross-border, intra-group transactions which may be evaluated in ways that that are not consistent with arm's length transfer pricing principles due to complexity of the transaction or the nature of the assets involved. The Hallmarks contained in this category are not linked to the M.B.T. Consequently, the transactions falling under this category must be reported even if tax reduction is not the main benefit of the transaction.

Two grey areas exist for this category.

- The term "associated enterprise" is mentioned only for Hallmark E2. As a result, it is not clear whether transactions covered by the other Hallmarks under Category E apply when parties are not associated.
- As with Hallmark C1, the definition of "associated enterprise" appears to be broader than the definition that is relevant for Italian transfer pricing purposes, meaning that, since the Hallmark applies to transactions that may not be subject to transfer pricing regulations, taxpayers will need to adopt different standards of tracing of intra-group transactions.

Hallmark E1 applies to an arrangement which involves the use of unilateral safe harbor rules.

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[15] It is based on the Example 21 contained in the Circular (page 97).

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The Circular clarifies that “safe harbor” rules are a set of rules that operate as automatic presumptions of appropriateness for transfer pricing purposes and, if followed by a taxpayer, exempts the taxpayer from certain compliance obligations normally imposed by applicable transfer pricing regulations. These rules are unilateral when they depart from the O.E.C.D. Transfer Pricing Guidelines. According to the I.T.A., safe harbors rules may provide taxpayers with tax planning opportunities. For instance, if safe harbor rules apply to simple or small transactions, taxpayers may be tempted to divide larger transactions into a series of smaller transactions to come within the safe harbor rules.

“The Circular clarifies that ‘safe harbor’ rules are a set of rules that operate as automatic presumptions of appropriateness for transfer pricing purposes and, if followed by a taxpayer, exempts the taxpayer from certain compliance obligations normally imposed by applicable transfer pricing regulations.”

According to the I.T.A., the Hallmark also covers practices that result in a series of agreements systematically entered between Tax Authorities and taxpayers, having effects substantially similar to those of safe harbor rules. Examples include cost-plus mark-up percentages for distribution activities without any analysis of the actual activities performed and regardless of the actual profits generated by the taxpayer. The Circular does not address whether certain unilateral measures can be removed from coverage of the general rule for tainted safe harbors.

Hallmark E2 applies to an arrangement involving the transfer of hard-to-value intangibles. The term “hard-to-value intangibles” covers intangibles or rights in intangibles for which, at the time of transfer between associated enterprises (i) no reliable comparable exists and (ii) the projections of future cash flows or income expected to be derived from the transferred intangible or the assumptions used in valuing the intangible are highly uncertain. As a result, it is difficult to predict the level of ultimate success of the intangible at the time of the transfer.

Hallmark E2 encompasses all those transactions involving the transfer of ownership in intangible assets or rights to use intangible assets. This Hallmark applies to assets such as patents, trademarks, know-how, copyrights, and similar items, which by their nature are hard-to-value. The Circular uses as guidance the definition of the hard-to-value intangibles provided by the O.E.C.D. Transfer Pricing Guidelines.[16]

The Circular provides the following example of an arrangement that is covered by Hallmark E2.

> USCo, a company formed in the U.S., and for that reason a tax resident of the U.S. It is the sole owner of ItaCo, a company that is tax resident in Italy. USCo and ItaCo enter into an agreement of sale under which ItaCo transfers a hard-to-value patent to USCo. Immediately thereafter, USCo grants the right to use the patent to ItaCo through a license agreement.

Hallmark E3 applies to an arrangement involving an intragroup, cross-border “transfer of functions and/or risks and/or assets” (referred to as “Eligible Transfers”), where the projected annual earnings before interest and taxes (E.B.I.T.) of the transferor during the three-year period following the transfer are less than 50% of the projected annual E.B.I.T. of such transferor if the transfer had not been made. The Circular refers to Chapter IX of the O.E.C.D. Transfer Pricing Guidelines on business restructuring for guidance under this Hallmark. As a result, Hallmark E3 should cover business restructurings (such as mergers, demergers, etc.) that result in the actual relocation of functions and/or risks and/or assets.

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[16] See paragraph 6.190 of the O.E.C.D. Transfer Pricing Guidelines.

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The Circular provides that the computation of E.B.I.T. begins with gross margins for operating companies and the spread between interest income and cost of funds for financial institutions. Interest costs of financial institutions that are unrelated to lending activity are ignored. For both operating companies and financial institutions, general and administrative costs are deducted, exclusive of interest and taxes. Financial statement information is to be used in making calculations.

Where the average E.B.I.T. of the seller during the three-year period following the transfer is negative whereas a positive average E.B.I.T. would have existed in the absence of the transfer, the Circular indicates that the Hallmark applies. On the other hand, if the seller projected a negative average E.B.I.T. in the absence of the transfer, but as a result of the transfer the average E.B.I.T. is positive or less negative than originally projected, the Circular indicates that the Hallmark will not be applicable.

Finally, the Circular does not address the relationship between the Hallmarks under category E. As a result, no guidance is given whether Hallmark E2 or Hallmark E3 applies where an Eligible Transfer involves a hard-to-value intangible.

WHEN MUST THE CROSS-BORDER ARRANGEMENT BE REPORTED?

Should an arrangement qualify as a reportable cross-border arrangement, the following rules apply regarding the deadline for filing a report with the I.T.A.

- For the Promoters, filing is required within 30 days from the day after the earlier of (i) the date on which the reportable cross-border arrangement is made available for implementation and (ii) the date on which implementation begins.
- For the Service Provider, filing is required within 30 days after the date on which assistance or advice is directly or indirectly provided regarding the implementation of the reportable cross-border arrangement.
- For the Italian Taxpayer, filing is required within 30 after the date on which the Promoter or Service Provider that is exempted from the reporting obligation informs the Italian Taxpayer that the reporting obligation lies with the taxpayer. The Circular clarifies that, in any case, the Promoter or Service Provider is required to advise the Italian Taxpayer of the duty to report within the applicable guidelines of the preceding bullets.
- Regarding marketable reportable cross-border arrangements, an intermediary is subject to follow-up reporting every three months after the first reporting takes place.

PENALTIES

Penalties for non-compliance with the D.A.C.6 mandatory reporting regime vary depending on the nature and the severity of the infringement. In the case of a failure to report within the abovementioned deadlines, penalties range from €3,000 to €31,500. If the reporting is filed within 15 days from the relevant deadline, penalties are reduced by 50%. In the case of an incorrect or incomplete reporting, penalties

range from €1,000 to €10,500. Again, if the correct reporting is filed within 15 days from the relevant deadline, penalties are reduced by 50%.

The Circular clarifies that, where the intermediary is a company or entity with legal personality, the penalties are imposed on the legal entity, itself. On the other hand, if the infringement is made by an entity without legal personality, the penalties are imposed on the individual who is required to report. That person is the individual who is in charge of the professional engagement relating to the reportable cross-border arrangement.

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FRENCH ADMINISTRATIVE PRONOUNCEMENTS ON D.A.C.6

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Tags
Arrangements
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France
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Intermediaries
Participants
Reportable

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INTRODUCTION

Before the European Directive was enacted and then transposed into domestic law, France adopted rules to tackle tax fraud, starting with measures aimed at residents holding undisclosed funds through foreign bank accounts.

In December 2012, the Cahuzacgate[1] was the trigger for the law of 6 December 2013.[2] M. Cahuzac was a former Minister of Economy and Finance. While in charge of leading his government's fight against tax fraud, he was found to have concealed bank accounts abroad for two decades. Hidden funds in Switzerland and Singapore amounted to at least €3.5 million.

Since 2013, France enacted a variety of measures to tackle tax fraud. A dedicated regularization unit was set up to allow French taxpayers to voluntarily disclose foreign bank accounts, income, and assets with the promise of lower penalties. Once the automatic exchange of information became effective among many countries by the end of 2017, the regularization unit was closed. By 2019, information on foreign bank accounts was gathered by this automatic exchange.

The law of October 23, 2018, authorized the Government to legislate by way of Ordinance the transposition into French law of the European Directive of 25 May 2018,[3] called D.A.C.6. The Ordinance[4] finally entered into force on July 1, 2020 and is codified under articles 1649 AD et seq. of the French Tax Code ("F.T.C."). And since, the French tax authorities have issued detailed guidelines.[5]

The French regularization unit and the automatic exchange of information were directly inspired by the Actions of the B.E.P.S. project. Similarly, D.A.C.6 is the European translation of the set of recommendations for the design of mandatory disclosure rules when aggressive tax planning arrangements appear (B.E.P.S. Action 12).

D.A.C.6 goes further than the B.E.P.S. recommendations since it fits into a more global framework of transparency to combat fraud and tax evasion. All Member States of the European Union ("E.U.") were required to transpose the Directive into their own legislation by December 31, 2019.

1 French Minister of Economy and Finance for 2012 and 2013.

2 Law related to the combat tax fraud and serious economic and financial crime.

3 E.U. directive 2018/822.

4 Ordinance no. 2019-1068, related to automatic and mandatory exchange of information in tax area in relation to reportable cross border arrangements dated October 21st, 2019.

5 B.O.F.I.P. dated November 25th, 2020.

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After a delay in recognition of Covid, intermediaries and taxpayers have a 30-days following the triggering event to report cross border arrangements within the scope of D.A.C.6. This article describes the French legislation in the light of administrative guidelines and highlights areas of divergences between the French rules under D.A.C.6 and those adopted by other Member States.

WHO SHOULD REPORT AND WHEN?

Who Should Report?

According to D.A.C.6, intermediaries have a primary obligation to disclose cross border arrangements ("C.B.A.'s"). French regulations implement that obligation.[6] The reporting obligation switches to the taxpayer when reporting by intermediaries cannot be achieved. This situation occurs when

- there is no intermediary,
- the intermediary is outside of the jurisdiction of the E.U. Member State, and
- when the reporting obligation would breach the legal professional privilege of the intermediary under the law of France.

One should not underestimate the possible reach of these reporting obligations for taxpayers established or active in France. Taxpayers, such as French subsidiaries or permanent establishments ("P.E.'s") of multinational groups should be aware and attentive to the transactions having a tax impact in France. The French subsidiary or P.E. may be subject to the reporting obligations because no intermediary was involved in a reportable transaction or because an in-house department designed the transaction and qualifies as an intermediary, itself.

Under French law, the taxpayer means "any person to whom a reportable cross-border arrangement ("R.C.B.A.") is made available for implementation, or who is ready to establish an R.C.B.A. or has implemented any step or part of such an arrangement." The definition is broader in scope than the one provided by the Directive as it can apply to a taxpayer even when no first step has been taken.

The French guidelines add useful guidance regarding pass-through entities. For such entities, the partners or members who are liable to tax in France are "taxpayers" and not the pass-through entity itself, except if an election has been made by a pass-through entity to become subject to corporate income taxes ("C.I.T.") in its own right.

For example, one can easily imagine a US headquarter company designing a cross border arrangement ("C.B.A.") that is used by a French subsidiary. The French subsidiary is the taxpayer having the reporting obligation, unless an intermediary[7] has a nexus with France or a Member State without being exempt from reporting by reason of attorney-client privilege.

The concept of an intermediary is broadly interpreted and includes a natural person or a legal person whether acting in its professional capacity or otherwise.

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[6] F.T.C. Art 1649 AE.

[7] A Promoter or a Service Provider that knows enough about the arrangement to assess its reportable nature.

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Intermediaries are divided in two categories, "Promoters" and "Service Providers." The time when Promoters and Service Providers must file a report differs from that of a taxpayer.

Promoters are any person that designs, markets, organizes, or makes available for implementation or manages the implementation of an R.C.B.A. Service Providers include persons who know or could reasonably be expected to know that they have undertaken to provide aid, assistance, or advice, directly or indirectly, in relation to the and R.C.B.A., based on available information and relevant expertise and understanding.

This is exactly the definition of the Directive and therefore, the definition of intermediary is very large and is not limited to certain professional categories. Promoters could be lawyers, tax advisors, bankers, and accountants. The term also includes an in-house department of a company that otherwise fulfills the definition of Promoter, such as an in-house tax team that designs a C.B.A. Accountants, auditors, insurance companies, wealth managers, asset managers of investment funds, lawyers specializing in company law or financial law, bankers, notaries, family offices, etc. might fall in the category of Service Providers if they participate in implementation rather than design of an R.C.B.A.

The French regulations however provide detailed definitions of the terms "design," "market," and "implementation" of such arrangements. Under the French legislation, the obligation to report is a simple presumption and Service Providers are entitled to demonstrate by all ways of proof that they did not know and could not reasonably have known that they provided aid, assistance, or advice in relation to an R.C.B.A.

Unlike some Member States, France did not expressly indicate that the Service Providers have no duty of investigation with respect to the facts and circumstances of any given transaction. Instead, the law states that the assessment to report must be made based on available information. This might imply an absence of additional due diligence obligation for the Service Provider.

The mere fact that the presumption can be countered by any elements of proof is a relief. Indeed, some Member State require the written proof in this respect. Unlike some other Member State, the French legislation and guidelines do not limit in any other ways the definition of Service Providers based on a sufficient involvement or an active involvement.

When a French lawyer provides advice containing general tax considerations, or if a taxpayer asks his accountant to prepare a general tax memorandum – for example, a comparison between the holding regimes in the Netherlands and in France – whether or not in a view to implementing a C.B.A., the lawyer or the accountant can be viewed as an intermediary at this early stage, without any further involvement.

The French guidelines provide an express exemption to reporting obligations for financial institutions in relation to ancillary banking services (*i.e.*, the granting of a loan, the opening of an account, the transfer of funds) – excluding exceptional banking operations. Indeed, financial institutions are rarely "actively" involved.

The only relief the French guidelines provide applies to Service Providers that are first involved in an R.C.B.A. after the arrangement has been implemented or after the advice has been provided. In that fact pattern, a Service Provider has no reporting obligation. To illustrate, a statutory auditor who first learns about an R.C.B.A.

during an audit that occurs at or after yearend or a tax advisor who merely provides a second opinion about an R.C.B.A. without suggesting any amendments to the existing arrangement is not a Service Provider.

An Intermediary with Nexus in France

An intermediary must fulfill its reporting obligations in France where there is a territorial nexus between the intermediary and France. A territorial nexus is defined as (i) having a tax residence in France, (ii) having a P.E. in France through which the services with respect to the R.C.B.A. are provided, (iii) being incorporated in France, (iv) governed by the laws of France, or (v) being registered with or authorized by a professional association in France in relation with the legal, taxation or consultancy services. The last item of nexus likely draws U.S. law firms having an office in France into the D.A.C.6 rules in France when advising on a C.B.A. involving France.

For intermediaries that are liable to reporting obligations in more than one Member State regarding an R.C.B.A., reporting should be made with the competent authorities of only one Member State. Here, a priority rule applies. The foregoing list of contacts that comprise territorial nexus is applied to both Member States. The first time that nexus exists to only one Member State determines the Member State that receives the report. For example, if an intermediary has its head office in France and a P.E. that provided services in the Netherlands must file the reportable information in France as tax residence trumps the location of a P.E.

"To be exempt, the French intermediary must prove that reporting has been made in another Member State."

When the reporting has been filed by another intermediary in another Member State, French nexus fades away and the French intermediary is exempt from reporting obligation.

To be exempt, the French intermediary must prove that reporting has been made in another Member State. In France, the proof demonstrating that the R.C.B.A. has been filed in another Member State encompasses all means available. This is less burdensome than the rule in certain other Member States, which require written proof of reporting or even the "unique reference number" under which the R.C.B.A. was reported. Some countries even require a summary of the R.C.B.A.

This can be quite a challenge when within the E.U., multiple filing obligations arise. One intermediary should report the transaction unless the intermediary or the taxpayer is able to provide the proof the transactions has been filed with the tax authorities.

Because of the 30-day time period for reporting, an intermediary must promptly identify the transaction, other intermediaries, coordinate who will report, obtain the proof of reporting, and if necessary communicate its proof to the other intermediaries. No need to say that strong internal processes and procedures will be useful.

In addition, uncertainty remains where one Member State considers a C.B.A. to be reportable while the other does not require the arrangement to be reported. For example, an intermediary located in a foreign Member State through a P.E. in France, designs an arrangement that affects the tax base in France and the C.B.A. qualifies as reportable from a French perspective, but not from the other Member State's perspective. The priority rule for nexus requires the intermediary to report in the foreign Member State, so one should question if the R.C.B.A. will be reported.

The Exemption of Intermediary Bound by the Legal Professional Privilege

When the intermediary is bound by legal professional privilege, reporting the R.C.B.A. is prevented. This exemption has raised many questions and critics from tax practitioners both in and outside the E.U.

In this situation, the intermediary must notify the other intermediaries, in writing, of the reason why he or she cannot perform the reporting obligation based on the professional-client privilege, which leads to a shift of the reporting duty to the other intermediaries. In the absence of other intermediaries, the intermediary should notify the taxpayer in writing, of the reason why reporting cannot be performed. This leads to a shift of the reporting obligation to the taxpayer. Of course, the taxpayer may waive its rights under the privilege, thereby allowing the intermediary to fulfill the reporting obligation. From the viewpoint of the attorney, the waiver must be in writing and must be unequivocal.

In France, this exemption applies only to members of the legal profession, as they can be sanctioned by the criminal code if in breach. For others, a confidentiality obligation based on contractual obligations[8] will not be sufficient to trigger an exemption.

The French concept of legal privilege is broad and is not limited to (i) litigators who represent a taxpayer before judicial courts or (ii) an intermediary that determines the legal position of the taxpayer.[9] Accordingly, lawyers, notaries, and certified public accountants ("*Experts-comptables*") are within the scope of the legal professional privilege.

The French guidelines provide a detailed procedure in order to inform other intermediaries or the taxpayer and the steps for an efficient and legal waiver of the professional privilege. The notification to the taxpayer should include all information the intermediary is aware of, or that is under its control or possession, in order for the taxpayer to be in a position to report the C.B.A.

The French legislation also allows a notified intermediary or the taxpayer to revise the initial assessment regarding the facts and circumstances of the reportable nature of the arrangement. Should either conclude that there is no obligation to report, the initial intermediary that is bound by the professional privilege cannot be held responsible if the C.B.A. is ultimately deemed reportable by the tax authorities.

Timing and Information for Filing

Intermediaries generally must file information that is within their knowledge, possession, or control on an R.C.B.A. within 30 days, beginning at the earliest of the following times:

- On the day after the R.C.B.A. is made available for implementation
- On the day after the R.C.B.A. is ready for implementation
- When the first step in the implementation of the R.C.B.A. been made

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[8] This is true for example in Portugal.

[9] This approach, in line with the exemption from the reporting obligations laid down in the Anti-Money Laundering Directive (2015/849), has been chosen by Belgium.

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For an intermediary that is a Service Provider, the 30-day window begins on the day the intermediary first provides aid, assistance, or advice in relation to designing, marketing, or making available the C.B.A.. When a French lawyer provides a detailed tax memorandum to a client with respect to a reportable C.B.A., the 30-day period likely begins at the moment the lawyer/advisor sends the tax advice to the client, even if the client fails to implement the arrangement. However, as of the date of this article, no final decision on point has been reached.

In computing the 30-day period, calendar days are used, not business days as used by the O.E.C.D. or other countries.

In practice, it is difficult to identify the date on which an intermediary makes an arrangement available to a taxpayer. Indeed, there are as many starting points and delays as there are situations. Much depends on whether the intermediary's obligation derives from its qualification as Promoter, Service Provider, taxpayer, Service Provider who receives notification from another intermediary bound by the legal privilege, or service provider receiving notice from a person resident in another E.U. Member State.

Regarding the content of a report, a wide range of data relating to the arrangement, the tax benefit, and the taxpayer concerned must be reported to the French tax administration. The report may be made in French or English. I should contain the following information:

- A summary note describing the arrangement and the Hallmarks, if possible, in English language, on which the scheme rests
- Legal information on the intermediaries and taxpayers
- An estimate of the valuation of the arrangement

The method of valuing the arrangement is an open question. When some countries have taken a more conservative approach and define the valuation as the estimation of the tax advantage, the French legislation indicates that the valuation of the arrangement relates to the amounts at stake in the transaction – reported at nominal value which depending on the facts of the transaction, might differ from the Fair Market Value ("F.M.V.").

The information to be reported is the same no matter which Hallmark triggers the reporting obligation. The mention of the Hallmark present in the transaction is the only specific information.

Filing should be done electronically on the French tax authorities' portal. According to French law,[10] insufficient or incomplete reporting of information or lack of notification to intermediaries or taxpayers is subject to a fine up to €10,000 (or €5,000 for a first offence every three years). The amount of the fine applied to a single intermediary or taxpayer may not exceed €100,000 per calendar year.

REPORTABLE CROSS-BORDER ARRANGEMENT

Once it is understood who should be attentive to the reporting obligation, the challenge is to identify R.C.B.A.

[10] C.G.I. art. 1649 AD and following.

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Identification of Cross-border Arrangements

As the D.A.C.6 directive does not provide a definition, the French legislation[11] refers to the O.E.C.D. to provide a broad definition. Hence, the definition of the term "C.B.A." mirrors the definition of the term "arrangement or transaction" in article 29 of the O.E.C.D. Model Convention on Income and on Capital ("O.E.C.D. Model Treaty"). The guidelines provide a nonexhaustive but longer list of operations that could qualify as an arrangement, such as an agreement, understanding, scheme, transaction or a series of transactions whether or not legally enforceable.

Arrangements include the creation, assignment, acquisition or transfer of income itself, or the property or right in respect of which such the income accrues. These terms also encompass arrangements concerning the establishment, acquisition or the dissolution of a legal entity or the subscription to financial instruments.

The definition is so broad that, in the view of many commentators, an arrangement may include many subparts such that it is difficult to know if one should declare one arrangement or several arrangements, in particular when different Hallmarks are present.

The French guidelines provide examples from the O.E.C.D. Model Treaty. Included is an arrangement where steps are taken to ensure that meetings of the board of directors are held in a different country in order to claim that the company has changed its residence.

"By itself, waiting cannot be considered to be an arrangement. This covers situations in which a taxpayer merely waits for a certain deadline to expire or a certain time period to end before it carries out a transaction in order to benefit from a tax exemption. . ."

By itself, waiting cannot be considered to be an arrangement. This covers situations in which a taxpayer merely waits for a certain deadline to expire or a certain time period to end before it carries out a transaction in order to benefit from a tax exemption, such as waiting for the dividend distribution in order to dividend to benefit from the participation exemption.

Under the French legislation, to be an R.C.B.A., (i) the arrangement should concern France and another State, whether or not in the E.U. and (ii) one or more of the participants in the arrangement should be resident or have activities in more than one State.

The group of participants in an arrangement refers to the taxpayer, associated enterprises being active in the arrangement, and any other person active in the arrangement. The final version of the French guidelines exclude intermediaries from the definition of participants.[12] This is in accordance with the Directive, which does not count intermediaries as participants.

A participant may be defined as any entity participating in the arrangement that is affected or affects the legal or economic position of other entities (also participants) whose role leads to a potential tax avoidance outcome or meets a Hallmark requirement. Such a definition of participant involves the taxpayer and third parties.

As regards the notion of "cross-border" of C.B.A., French law is not perfectly aligned with the definition of D.A.C.6 and is narrower insofar as it only covers arrangements

[11] F.T.C. art. 1649 AD.

[12] Unlike some M.S. that would include intermediaries when they directly and materially interfere with the arrangement or when their intervention gives rise to the application of a hallmark.

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that concern France. As a result, for arrangements in which an intermediary, a taxpayer, or an associated enterprise is located in France but is involved with an arrangement that only relates to countries other than France, no report is required in France. In comparison, once an arrangement implicates France, the arrangement falls within the scope of R.C.B.A. even though none of the participants have a residence or an activity in France. A potentially significant number of situations might be concerned.

To be reportable, a C.B.A. should be aggressive. In order to determine if a C.B.A. is "aggressive", the key issue is now to identify whether it contains at least one of the "Hallmarks."

Identification of the Hallmarks of a Cross-Border Arrangement

A Hallmark is a characteristic of an arrangement that could indicate a potential risk of tax avoidance. The mere existence of a Hallmark is enough to be an indication of a potential risk of tax avoidance. The goal of the reporting mechanism is to identify the tax planning arrangements that the tax authorities may wish to review.

In general terms, French Hallmarks are the same as those set out in D.A.C.6 and are drafted in the same terms. There are generic and specific Hallmarks linked to the Main Benefit Test ("M.B.T.") and specific Hallmarks related to cross-border transactions .

Generic and Specific Hallmarks Linked to the M.B.T.

Generic Hallmarks and some specific Hallmarks trigger a reportable obligation only when the M.B.T. is met, such as Hallmarks A, B and C1b(i), c, and d. The M.B.T. is met if the main benefit or one of the main benefits that can reasonably be expected from an arrangement is obtaining a tax advantage considering all the relevant facts and circumstances.

In France, this M.B.T. definition is similar to the French general anti-abuse rule ("G.A.A.R."),[13] which has been enriched with a new concept allowing the French tax authorities to challenge a transaction, namely the mini abuse of law concept ("*mini abus de droit*"). This new legal ground enables the French tax authorities to disregard acts implemented to obtain, as the main purpose or one of the main purposes, a tax benefit which is contrary to the aim or the purpose of the tax legislation. As a result, intermediaries and taxpayers could be torn between a willingness to comply with the reporting obligations under D.A.C.6 and a fear of pleading guilty to a mini abuse of law.

French case law decided many years ago holds that the choice of the most favorable tax solution does not, in itself, constitute an abuse of law.[14] Indeed, between two paths, the taxpayer is never forced to choose the one that is less advantageous from a tax point of view. One should wonder how this definition will be articulated with the case law that is bound to develop as compliance with D.A.C.6 will increase or be sanctioned.

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[13] F.T.C. art. L64 A.

[14] *Conseil d'Etat*, March 21, 1986, *Société Auriège*.

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Generic Hallmarks

The Hallmarks in Categories A will only give rise to a reporting obligation if the M.B.T. has been met.

Hallmark A1 – Confidentiality Clause

This first Hallmark is an arrangement where the relevant taxpayer or a participant in the arrangement undertakes to comply with a condition of confidentiality which may require them not to disclose how the arrangement could secure a tax advantage *vis-à-vis* other intermediaries or the tax authorities.

French tax authorities indicate that agreements with a nondisclosure clause regarding information on estate planning arrangements to other intermediaries or to the French tax authorities are within the scope of Hallmark A1. Consequently, a simple confidentiality clause to any third party in an agreement related to estate planning arrangements will meet Hallmark A1, even where there is no express mention to other intermediaries or to French tax authorities – if the M.B.T. is met.

France makes an exact transposition of the Directive, in comparison with other Member States whereby the confidentiality could be induced by circumstantial factual elements even when there was no confidentiality clause in the arrangements.

Hallmark A2 – Success Fees in Relation to a Tax Benefit

The French legislation follows the Directive and adds the need for a direct link between the tax benefit achieved and the fees received by the intermediary.

"The Hallmarks in Categories A will only give rise to a reporting obligation if the M.B.T. has been met."

Hallmark A3 – Use of Substantially Standardized Documentation and/or Structures

The last general Hallmark concerns any arrangement that has substantially standardized documentation and/or structure and is available to more than one taxpayer without a need to be substantially customized for implementation.

Following D.A.C.6, the French guidelines provides examples to illustrate its application:

- The French Equity Savings Plan (*Plan d'Epargne en Actions* or P.E.A.), for which documentation is standardized is outside the scope of Hallmark A3 as these saving plans and their tax benefits result from a national law rather than arrangements designed by intermediaries.
- On the contrary, employees' share-ownership arrangements which aim to convert salaries into capital gains will meet the definition of Hallmark A3 as soon as the capital gain is taxable at a lower rate than salaries, even if no standard model of employee's equity plan is used and each plan is different. Consequently, French guidelines consider that a cross-border management package available to some managers only will be in the scope of Hallmark A3.

French guidelines do not define "substantially standardized documentation and or/structure" in relation to groups of companies. Hence, this term can have broad scope. To illustrate, it seems to cover internal standard intercompany loan agreements or support services agreements within a group and standardized agreements for transactions with clients or suppliers To limit an overbroad interpretation of this Hallmark, some Member States provide a detailed definition and expressly excluded intercompany services agreements, license agreements, loans agreement, and secondment agreements.

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Specific Hallmarks

The Hallmarks of Category B (specific Hallmarks linked to the M.B.T.) only focus on income taxation. They mention three techniques developed to obtain tax benefits and include the acquisition of a loss making company (Hallmark B1), the conversion of income (Hallmark B2) and the round-tripping of funds (Hallmark B3).

As under Category B, the link with the M.B.T. applies, but functions in this context as evidence that the applied techniques are expected to obtain a tax benefit. However, if the tax benefit is not one of the main benefits, the arrangement does not need to be reported.

Hallmark B1- Exploiting Tax-Deductible Losses

An arrangement meets Hallmark B1 if a participant[15] in the arrangement takes artificial steps in order to acquire a loss-making company, discontinue its main activity, and use its tax losses in order to reduce tax liability. The transfer of losses may be to another jurisdiction or to accompany that can accelerate the use of those losses.

The guidelines note that the acquisition of companies whose operations have already ceased at the time of acquisition or that are generating profits at the time of acquisition is also not covered by the Hallmark. However, this Hallmark is not clear as to whether a company with loss carry-forwards must generate profits for a minimum period of time to be excluded from Hallmark B1.

French guidelines implement the exact wording of the Directive and emphasize the fact that the three criteria are cumulative, which means that the intention when acquiring a loss-making company and implementing the arrangement is necessary for the arrangement to be within the scope of Hallmark B1.

Hallmark B2 – Conversion of Income to Reduce Taxes Due

An arrangement meets Hallmark B2 if it has the effect of converting income into capital or gifts or other categories of revenue that are taxed at a lower effective rate or that are exempt from tax or not subject to taxation. Here again, the French guidelines follow the wording of the Directive.

The definition of a conversion and the determination of when it occurs are unresolved questions. Is the lower tax rate sufficient for Hallmark B2 to apply or must a real change in the nature income occur?

The French guidelines illustrate the application of the Hallmark with two examples. One involves a conversion of service remuneration into dividends and the other involves income derived from a life insurance contract.

Another unanswered question is whether a stream of income must exist at the time of the change in its character or whether Hallmark B2 is applicable merely when one makes a decision prior to the recognition of any income? In comparison to guidelines of other Member States, the French guidelines do not provide any indication that the absence of a pre-existing situation does not prevent the application of Hallmark B2.

[15] See definition §16.

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Hallmark B3 – Circular Transactions Resulting in the Round-Tripping of Funds

Hallmark B3 applies to arrangements that include circular transactions resulting in the round-tripping of funds, namely through interposed entities without another primary commercial function. It also applies to transactions that offset or cancel each other.

French guidelines specify that Hallmark B3 refers to arrangements involving transactions that result in a circular movement of funds that otherwise meet one or more of the following conditions:

- Presence of interposed entities without a primary business function in the arrangement
- Presence of transactions that offset or cancel each other
- Presence of other equivalent characteristics

The guidelines indicate further that this Hallmark targets arrangements in which funds originating in a Member State pass through one or more intermediary companies established in Member State or a state outside the E.U. in order to benefit from favorable tax treatment after which the funds return to the Member State of origin.

The guidelines, however, do not address the factual and temporal connection between two offsetting transactions. For instance, it is currently not clear whether offsetting transactions that occur after a significant period of time has passed would be considered as non-reportable.

SPECIFIC HALLMARKS RELATED TO CROSS-BORDER TRANSACTIONS CONCERNING AUTOMATIC EXCHANGE OF INFORMATION AND ACTUAL BENEFICIARIES AND TRANSFER PRICING

Specific Hallmarks – Cross-Border Transactions

Hallmark C – Deductible Cross-Border Payments Between Associated Enterprises

The first list of Hallmarks under Category C refers to arrangements that involve deductible cross-border payments made between two or more associated enterprises where one or more of the following conditions occur:

- The recipient is not resident for tax purposes in any tax jurisdiction.
- Although the recipient is resident for tax purposes in a jurisdiction, that jurisdiction
    - does not impose any corporate tax or imposes corporate tax at the rate of zero or almost zero, or
    - is included in a list of jurisdictions that are noncooperative, as determined collectively by E.U. Member States or are noncooperative within the framework of the O.E.C.D.

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- The payment benefits from a full exemption from tax in the jurisdiction where the recipient is resident for tax purposes.
- The payment benefits from a preferential tax regime in the jurisdiction where the recipient is resident for tax purposes.

All four situations require deductible cross-border payments between associated enterprises, resulting in a favorable tax treatment at the level of the recipient.

Arrangements qualifying under Hallmark C1(a) and (b)(ii) are always reported. The M.B.T. is not a relevant consideration.

Under Hallmark C1(a), where the recipient not a resident in any tax jurisdiction, D.A.C.6 seems to presuppose that the payment will not be taxed. It does not address the treatment of a payment to a nonresident that has been subjected to withholding tax in the source State. It also fails to address income that is attributed to a P.E. of the nonresident recipient that is taxed in the State where the P.E. is located.

Hallmark C1(b)(ii) appears to be more logical. When a tax authority of the recipient entity is unwilling to exchange information, it becomes difficult for tax authorities of Member States to assess the main benefit.

French guidelines adopt the wording of the Directive and clarifies some elements of this Hallmark:

- The term "recipient" is defined as the person liable to pay tax on the payment. The French guidelines also provide for a specific identification of the recipient for pass-through entities.
- A corporate tax rate is considered to be "almost zero" when its effective tax rate is not more than 2%. France's choice of a 2% rate is within the average of Member States; some have chosen a lower rate, 1%, and some have chosen a higher rate, 4% or 5%.
- France's choice to take into account the effective tax rate, and not the statutory rate, has been made by very few countries.
- In connection with the term "payment," it is assumed that Hallmark C1 is intended to apply to deductible payments such as interest, royalties, or rents. Other Member States have clarified that the notion of payment encompasses all types of payments, whether or not income is ultimately realized.
- In connection the list of noncooperative jurisdictions, the definition used by the French guidelines are not identical to those of D.A.C.6, since it refers to the O.E.C.D. list. As this list is regularly updated, the applicable list is the one in force on the date of the triggering event for the reporting obligation.

Hallmark C2 – Deductions for the Same Depreciation of an Asset That are Claimed in More Than One Jurisdiction

Here again, French law and guidelines have used the same wording as the Directive. Hallmark C2 concerns only cases where the tax deduction for depreciation of the same asset is claimed in more than one jurisdiction without an accompanying double inclusion of income recognized for accounting and tax purposes.

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Hallmark C3 – Relief from Double Taxation in Respect of the Same Item of Income or Capital Claimed in More Than One Jurisdiction

In such cases, the arrangement that gives rise to the tax relief must be reported, unless double relief is in accordance with the intention of the French or European legislator. Arrangements based on treaty shopping should be reported, which in principle, is consistent with Action 6 of B.E.P.S.

Here again, French law and guidelines have used the same wording as the Directive. The French tax authorities were careful to clarify that this Hallmark does not apply to provisions designed to eliminate double taxation under an existing bilateral tax treaty, provided that the use of the provision is not contrary to the legislator's intention.

Taxpayers located in countries with anti-hybrid rules, implemented under A.T.A.D. 2 and Action 2 of B.E.P.S., must report hybrid arrangements.

Hallmark C4 – Transfers of Assets Where There is a Material Difference in the Amount Being Treated as Payable in Consideration for the Assets in the Jurisdictions Involved

The definition used in the French Tax Code is similar to the one in the Directive. This Hallmark covers transfers of assets where the valuation methodology significantly differs by jurisdiction. As an example, one jurisdiction uses net book value in measuring the transaction and the second jurisdiction uses market value.

The French guidelines specify that merger and similar transactions realized in accordance with the E.U. Mergers Directive are excluded from the scope of this Hallmark.

This Hallmark makes no distinction between intra-group transfers, internal transfers between a legal entity and a P.E. in another country, and transfers to third parties.

Finally, questions exist as to which valuation differences are significant or material. For example, assume one Member State excludes from the scope of this Hallmark differences that are consistent with legislative intent. At the same time, a second Member State indicates that a difference in values used of up to 25% is not characterized as material difference.

Specific Hallmarks – Automatic Exchange of Information on Ownership

Category D refers to the rules defined by the O.E.C.D. in 2018 in the *Model Mandatory Disclosure Rules for Common Reporting Standards ("C.R.S.") Avoidance Arrangements and Opaque Offshore Structures*. C.R.S. was developed by the O.E.C.D. in 2014. It calls on jurisdictions to obtain information from their financial institutions which will be exchanged automatically with other jurisdictions on an annual basis. C.R.S. has rules that set out the financial account information to be exchanged, the financial institutions required to report, the different types of accounts and taxpayers covered, and common due diligence procedures to be followed by financial institutions.

The C.R.S. rules were transcribed in D.A.C. 2. Hallmarks D1 and D2 reflect the new 2018 model established by the O.E.C.D. and reinforce the application of the C.R.S. in the E.U.

For the application of Category D, an arrangement is not considered to have the effect of avoiding C.R.S. merely because the reporting obligation has not been met, provided that the failure to report does not undermine the purposes of the legislation. D.A.C.6 and the French legislation and guidelines transcribe these rules without adding any comments or information.

<u>Specific Hallmarks – Transfer Pricing</u>

The specific transfer pricing related Hallmarks under Category E cover safe harbor rules (Hallmark E1), hard-to-value intangibles (Hallmark E2), and intra-group transfers that result in profit shifting (Hallmark E3).

The transfer pricing Hallmarks have a very broad reach and apply without regard to the M.B.T. A purely business driven transaction cannot be reportable under these Hallmarks. That results from the divergence in the definition of associated enterprises for Category E and for transfer pricing purposes. For transfer pricing purposes, a 25% interest in an entity generally is not sufficient to constitute control over the transfer prices between related parties. But for D.A.C.6 purposes, a 25% ownership interest is sufficient to trigger the reporting obligation under Category E. Consequently, taxpayers must adopt a new set of transaction tracking rules to ensure compliance with Category E.

<u>Hallmark E1 – Arrangement Which Involves the Use of Unilateral Safe Harbor Rules</u>

Hallmark E1 is met in respect of an arrangement that involves the use of unilateral safe harbor rules. However, neither the Directive nor the French legislation provide a definition of a “safe harbor rule.” The O.E.C.D. recommendations provide for a definition that could be of used. They provide that a safe harbor rule is a provision applicable to a category of taxpayers or transactions that provides relief from certain obligations normally imposed under by the general transfer pricing rules of a State.

The French guidelines limit the unilateral safe harbors that are reportable to safe harbors in the transfer pricing area, and not to other possible safe harbor tax rules. One such safe harbor that should not be reportable when used is a thin-capitalization safe harbor.

Further, the French guidelines state that safe harbor rules that are accepted by the O.E.C.D. are not considered unilateral safe harbor rules within the meaning of this Hallmark. One example of an O.E.C.D. safe harbor is an administrative simplification measures that does not directly concern the determination of the arm’s length price. Here, the tax authority and a taxpayer may agree in advance on the determination of transfer prices applicable to transactions with associated enterprises as part of an advance pricing arrangement. A second example is a 5% markup of costs for low value-added services.[16]

<u>Hallmark E2 – Arrangement Involving the Transfer of Hard-to-Value Intangibles</u>

An arrangement involving a transfer of hard-to-value intangibles will meet the Hallmark E2 requirements. Again, the definition used in the French legislation and guidelines is similar to that of the D.A.C.6.

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[16] O.E.C.D. 2017 Guidelines, Ch. VII.

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The guidelines define the term "hard-to-value intangibles" in line with the definition from D.A.C.6 and O.E.C.D. transfer pricing guidelines. This Hallmark covers situations where (i) the intangible is only partially developed at the time of the transfer, (ii) there will be a delay in achieving commercial exploitation, or (iii) there has never been commercial exploitation of the intangible prior to the transfer. In contrast, where market prices have already been established for patents or trademarks, no hard-to-value intangibles should be deemed to exist for purposes of Hallmark E2.

"The Directive also does not specify what it means by reliable comparable transactions. The guidelines suggest that the comparability criteria set out by the O.E.C.D. for intangible assets should be used wherever possible."

Where multiple intangible assets are transferred under a uniform economic process, the transfer is reported only once. The report must include all intangible assets concerned. The purpose of this treatment is administrative simplicity.

Neither the Directive, nor French law, nor the tax authorities have yet addressed whether Hallmark E2 applies to transfers between a headquarters in one Member State and branch located outside that State. In addition, neither the Directive nor French law addresses whether Hallmark E2 applies only to sales of intangible property or whether it applies also to transactions involving the transfer of use of intangible assets, such as licenses involving trademarks or patents.

To be considered hard-to-value, reliable comparable transactions of assumptions must not exist at the time the transaction is concluded so that projections of future cash flows and expected income from the transferred intangible are highly uncertain. The Directive also does not specify what it means by reliable comparable transactions. The guidelines suggest that the comparability criteria set out by the O.E.C.D. for intangible assets should be used wherever possible.

To understand the reach of this Hallmark, consider the transfer of intellectual property from Mexico to the U.S. for purely business reasons. This leads to new royalty arrangements or cost arrangements with entities resident in a Member State of the E.U. (not simply an assignment of existing arrangement). Query. Is this a transfer of use of a hard-to-value intangible? Because of its consequences in the E.U. for taxpayers, would the transfer trigger a reporting obligation and if so, by whom?

Hallmark E3 – Transfer Halving the Transferor's E.B.I.T. During the Next Three Years

An arrangement will meet Hallmark E3 if it involves an intra-group cross-border transfer of functions, risks, or assets, provided that the projected annual earnings before interest and taxes ("E.B.I.T.") of the transferor during the three-year period following the transfer are less than 50% of the projected annual E.B.I.T. of the transferor were the transfer not made. Even if realized at fair market conditions, a transfer of assets, a risk or a function may lead to reportable transaction because Hallmark E3 is not linked to the M.B.T.

The definitions used in France again similar to the one in the Directive. However, the following clarifications have been made by the French tax authorities:

- E.B.I.T. is defined by the French General Chart of Accounts – French G.A.A.P.
- The decline in earnings is assessed on the basis of the information available at the time of the transfer, and the decline must be inherent to the functions and/or risks and/or assets transferred.
- Mergers and similar transactions are excluded from this Hallmark.

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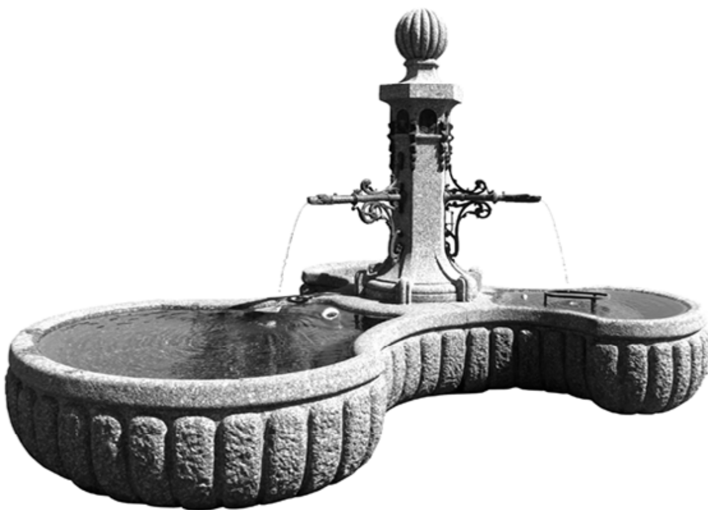
The concept of E.B.I.T. does not include interest, dividends, and capital gains. Thus, the use of E.B.I.T. does not seem to be relevant for holding companies. This raises the question of whether holding companies are indirectly excluded from Hallmark E3. or whether a criterion other than E.B.I.T. should be substituted. Other Member State have chosen to use another aggregate for holding companies, since interest and dividends are not included in the operating result.

Here again, one can think of a very insignificant transaction like the transfer of a small sale function from a Dutch subsidiary to a French subsidiary that could come within the scope of Hallmark E3. Such a transfer of an intra-group function might result in the requirement to report R.C.B.A., although tax is not a driver in the transaction.

CONCLUSION

As shown, the French legislation attempts to meet the basic requirements set by D.A.C.6. Nonetheless, several aspects of the law remain uncertain and require clarification.

In addition, Member States publish their local implementation legislation, it is becoming obvious that national implementation of D.A.C.6 could ultimately differ considerably across the E.U. For this reason, it is to be expected that compliance with the reporting obligations will be problematic in the absence of a detailed knowledge of the domestic legislation of each Member State. This need for actual knowledge affects intermediaries as well as taxpayers.



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UPDATE ON SPANISH MANDATORY DISCLOSURE REGIME – D.A.C.6

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Tags
Arrangements
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INTRODUCTION

After the implementation of European Union Council Directive n. 2018/822 ("the Directive"), enacting the sixth amendment of the Directive of Administrative Cooperation, known as D.A.C.6, all Member States of the European Union were obliged to transpose the contents of the Directive into national law. This means that each Member State was required to establish a regime of mandatory disclosure of cross-border arrangements, establish a procedure for the automatic exchange of information among Member States by December 31, 2019, and make the transposition enforceable by July 1, 2020. This established a transitory regime for reportable arrangements where the first step was taken between June 25, 2018, and July 1, 2020.

BACKGROUND

The contents of the Directive include the mandatory disclosure by intermediaries or taxpayers of certain cross-border arrangements ("C.B.A.'s") and structures that (i) could be used for aggressive tax planning and (ii) have the potential to be used as tax avoidance or evasion techniques. Mandatory automatic exchanges of C.B.A.. information among E.U. Member States would then occur.

In Spain, the exchanges of information are authorized by Law number 10/2020 ("the Spanish Law"), which modifies the Spanish General Taxation Act and was approved on December 29, 2020. The regulations that further develop the procedures have been issued in draft form ("the Draft Spanish Regulation"). In addition, a draft order issued by the Spanish Tax Authorities still must approve different forms to report the C.B.A.'s affected by the mandatory disclosure regime (the so-called, Forms 234, 235 and 236). However, this draft order has not been approved as of the date of publication of this article.

The transposition of the Directive into Spanish Law followed a bare approach, using the wording of the Directive without elaboration. This approach has raised questions surrounding interpretation of both the Spanish Law and the Draft Spanish Regulation, which will be explored in this article, following a brief comparison of the wording of the Directive and the Spanish legislation implementing the D.A.C.6.

The Spanish Law establishes general references to the Directive for many definitions and terms. In addition, it provides even more references to the Draft Spanish Regulation that is meant to develop the Spanish Law. Consequently, the Draft Spanish Regulation establishes the terms of the disclosure, the determination of the way to calculate the value of the "tax effect" of the C.B.A., and the terms of the obligation to communicate the disclosure or waiver by one intermediary to other intermediaries or to the taxpayer.

[1] CHR Legal was incorporated into Andersen Global in November 2021.

As previously mentioned, the Draft Spanish Regulation has not yet been approved. This creates uncertainty regarding the specific terms of the obligations contained in the Spanish Law. The Draft Spanish Regulation published in 2019 helps shed some light on these matters, but also raises questions on the interpretation of certain aspects of the reporting regime. Indeed, the delay in publication and approval of both the Spanish Regulation and the Order issued by the Spanish Tax Authorities establishing the forms to be used, means that, currently, neither intermediaries nor taxpayers have final guidance on the required way to comply with reporting obligations. Beyond the internal complications that this may present, failing to establish a proper procedure for the disclosure in due time puts Spain at risk of an infringement proceeding by the European Commission.

Given the lack of definitions in the Spanish Law and the provisional status of the Spanish Regulation, there is neither administrative doctrine nor jurisprudence that may shed light on the correct interpretation of the D.A.C.6 as implemented by Spain.

This article addresses the opinion of Spanish scholars in relation to the foreseeable issues that may derive from the implementation of the D.A.C.6 in Spain, considering the current wording of the Spanish Law and the Draft Spanish Regulation.

MAIN ISSUES SURROUNDING THE IMPLEMENTATION OF THE D.A.C.6 IN SPAIN

Lack of Definition of Certain Terms

Significant definitional problems have arisen in Spain because terms used in the E.U. Directive are not further explained in the Spanish Law. A similar issue arises in the Draft Spanish Regulation.

The main issues relate to scope of the Directive, which is the disclosure of C.B.A.'s. Different language versions of the Directive may have introduced differences in interpretation and transposition to domestic law. Such is the case of the translation of "cross-border arrangement" into Spanish. In Spanish, the word used is "mechanism" (*mecanismo*), which is not defined in the Directive nor the Spanish Law. The Draft Spanish Regulation defines a tax planning mechanism as an "agreement, legal transaction, scheme or operation," but some of these concepts have no recognized technical definition in Spanish tax law.

Comparing the use of the terms mechanism and arrangement, and noting the definition provided for in the Draft Spanish Regulation, questions arise regarding whether the definition of an "arrangement" (mechanism in Spanish) for purposes of the Directive and the Spanish Law implies the participation of more than one party. The uncertainty stems from the fact that unilateral decisions seem to be excluded from the definition and thus of the disclosure obligation. For example, it is unclear whether a change in tax residence, while complying with exit tax obligations, would comprise an arrangement under the terms of the Directive, considering there is only one party involved.

Regarding the cross-border characteristic of the arrangements, it is defined by the Directive as an arrangement that concerns (the Spanish word for "affects" is used in the Spanish Law) more than one Member State. While this characteristic is essential for determining the scope of the reporting obligation on an intermediary, there is no

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clarification in the Draft Spanish Regulation or the Spanish Law as to what exactly the term comprises. This may prove to be problematic when the intermediary's knowledge of the scope and reach of the arrangement is limited. It is not unlikely in this type of pattern for the intermediary to have no knowledge of the client's involvement with another Member State. Moreover, if there is only one intermediary or the client has separate dealings with all intermediaries, there may be no notification by one intermediary to a second intermediary where neither has knowledge of the other.

The Draft Spanish Regulation contemplates that the Tax Authorities will publish lists of relevant cross-border arrangements that have been disclosed, including the relevant legal regime, qualification, and classification in tax terms. If and when published, the list will assist intermediaries to better understand the scope of the reporting obligation. It may be somewhat less helpful if the list is not updated on a regular basis when and as new arrangements are encountered.

The Directive's recitals and the Spanish Law's preamble give importance to the goal of D.A.C.6 in relation to clamping down on aggressive tax planning designed to achieve tax avoidance or evasion. The use of the term "tax planning" raises the question of whether commercial arrangements that are not carried out for tax reasons are automatically excluded from the scope of the obligations.

In principle, a balance exists between pure cross-border business transactions and transactions containing identified Hallmarks. The balance may fall one way or the other depending upon whether the main benefit test ("M.B.T.") applies to the Hallmark. Currently, it is unclear whether an intermediary must consider the effects of the arrangement (as provided in the Spanish Law) and if they result in tax savings (as provided in the Draft Spanish Regulation) without considering the main purpose or aim of the arrangement. Another question left unanswered is whether a transaction is reportable if it reflects a tax incentive enacted under Spanish law, where without the incentive, the operation would not have been carried out. An example is the formation and use of an E.T.V.E. formed under Spanish law for purposes of holding shares of companies often based in South America. Some tax advisors have suggested that a test based on valid business motives should be applied for special tax regimes formed under Spanish law, provided the rules are followed by the taxpayer as contemplated in the legislation. Other commentators have suggested the opposite.

The approach of the Spanish Government to simply refer to the Directive can create many gaps in legislation, even if the approach is a valid legislative exercise that saves both time and resources at the time of transposition into law. These gaps could be addressed when the Draft Spanish Regulation is adopted in final form, but only if the Spanish Tax Authorities put in the time and effort to apply D.A.C.6 rationally.

Concept of "Intermediaries" and Its Scope

The Directive defines an intermediary as any person that designs, markets, organizes, or makes available for implementation or manages the implementation of a reportable cross-border arrangement. It also states that an intermediary will be any person that, having regard to the relevant facts and circumstances and based on available information and the relevant expertise and understanding required to provide such services, knows, or could be reasonably expected to know, that they have

undertaken obligations to provide, directly or by means of other persons, aid, assistance or advice with respect to designing, marketing, organizing, making available for implementation or managing the implementation of a reportable C.B.A. After defining who could potentially be an intermediary, the Directive follows with a clarification that in order to be considered an intermediary, one must perform at least one of the identified acts within a Member State. Neither the Spanish Law nor the Draft Regulation clarify this 151 word sentence and many questions remain unanswered.

The first is whether in-house advisors fit into this description. It is common for larger companies to have an internal department that provides internal tax advice to the company or to companies falling within a single group. In this sense, a question arises as to whether these in-house advisors are considered to be intermediaries for the purpose of the Directive or are merely representatives of the taxpayers. This may affect whether a C.B.A. is reportable by the internal group of advisors.

The second question surrounds the fact that the Directive's definition establishes two kinds of intermediaries. The first is a primary intermediary that creates a plan leading to the C.B.A. or implements the C.B.A. The second is an auxiliary intermediary, who knows or could be expected to know that they have participated in the creation or implementation of an C.B.A.

Regarding primary intermediaries, some degree of uncertainty exists in Spain as to the degree of participation required in order to have a primary obligation to report a C.B.A. when many different advisors are involved. Phrased differently, when an arrangement is tailored for a specific taxpayer by many advisors, it is not clear which advisor should be considered the intermediary with the primary or the initial obligation to file a report. Is the advisor that aids in the creation of the plan but is unaware of its implementation, the intermediary with the primary obligation? In connection with a bespoke arrangement that proposes variations to an ordinary business transaction, is the entire transaction a reportable C.B.A. and is the party that proposes the variation the intermediary with the primary obligation to report? If there is no report, are all advisors exposed to penalties for nonfiling?

". . . when an arrangement is tailored for a specific taxpayer by many advisors, it is not clear which advisor should be considered the intermediary with the primary or the initial obligation to file a report."

As for secondary intermediaries, their determination can be excluded by way of the "did not know" test, but the scope of the definition can be interpreted as either wide or restricted depending on the facts and the view taken. Some commentators argue that a wide interpretation can give rise to many involuntary violations of the obligation to disclose. It is not uncommon for several advisors to cooperate in the implementation of a plan. In those circumstances, it is common for most not to know the full set of steps of an arrangement and its tax implications. Do those secondary persons face liability for filing an incomplete disclosure under Spanish Law if they report all they know but less than the entire transaction? Further clarity is required when the Draft Spanish Regulation is adopted in final form.

Where a client uses several advisors with each focusing on a particular aspect of a plan based on its area of expertise, no single intermediary has knowledge of the full picture of the C.B.A. In this context, should an advisor on corporate law be able to claim it was unaware that the transaction turned out to be a reportable C.B.A.? Is the answer different if the advisor is a law firm with a tax department and a corporate law department, but only the latter is retained to provide services? No answer is given to this in the Spanish Law or the Draft Spanish Regulation.

Finally, regarding relations between primary and secondary intermediaries, clashes may occur in their respective obligations to disclose. If the secondary intermediary's services regarding tailored arrangements end before the first step of implementation begins, when does it face a reporting obligation? Does the secondary intermediary have an obligation to report a C.B.A. within 30 days after rendering its service but prior to the period for the primary intermediary's obligation to disclose begins to run? What is included in the report if its assignment is theoretical, without values assigned to the transaction?

While the Spanish Law establishes the obligation of the intermediaries to communicate to other intermediaries and the taxpayer that they have disclosed the relevant information, thus exempting the others from disclosure obligations, the exemption may not be operative if the first reporter does not disclose all of the required information.

These issues were identified by the Spanish Association of Tax Advisors ("A.E.D.A.F.") in a request for a tax ruling filed with the Spanish General Directorate for Taxes. However, as of the date of publication of this article, no response has been received, leaving intermediaries with uncertainty.

Legal Professional Privilege, Waiver of Report, and Conditions of the Waiver

The Directive allows Member States to provide intermediaries with a waiver of the reporting obligation for C.B.A.'s where reporting comprises a breach of legal professional privilege under the national law of that Member State.

The Spanish Government decided to include this waiver in the transposition of the Directive, but it did so "regardless of the economic activity" carried out by the intermediary and provided that it acted as a passive advisor. The Spanish Law also goes a step further than the Directive and provides that the taxpayer may expressly authorize its legal advisor to report on the arrangement. This must be done by means of a written communication to the intermediary.

While professional privilege is provided for under the Spanish Constitution, there is no substantive legal regulation developing the scope and terms of this privilege. This means that while most professional sectors have developed a privilege concept in their codes of conduct, professional privilege is recognized only for certain professionals, including lawyers, and the scope of the privilege is quite general.

This raises issues of inconsistency between the wording of the Directive and the wording of the Spanish transposition. The Directive allows for Member States to provide for a waiver if it is in accordance with national law, which can be interpreted to mean that only legally recognized professional privilege may be covered by the waiver. On the other hand, the Spanish Law establishes the waiver regardless of economic activity, which can be interpreted as a recognition of the waiver to all advisors and intermediaries, even if their professional privilege is not covered by the Spanish Law. This may be understood as a breach of the Directive, but the main issue it raises is of uncertainty for tax advisors that are not lawyers. Can those advisors access the reporting waiver because "tax advisory" services are given, even though that is not a recognized independent profession with a specific code of conduct in Spain?

Another inconsistency between the Spanish transposition and the Directive is the requirement under Spanish law that intermediaries wishing to access the waiver must have acted in a passive way regarding the arrangement. The exact terms of the Spanish Law for the recognition of the waiver to intermediaries include a specific condition precedent to the waiver. Translated into English, the intermediary must have

> * * * provided advice on the designing, marketing, organizing, making available for implementation or for the managing of the implementation of a reportable cross-border arrangement, with the sole objective of evaluating its compliance with the applicable legal standards and without providing or ensuring its implementation.

This provision is much clearer than the simple reference to "neutral advisory" included in the terms of the Draft Law, but the determination of its limits may prove to be difficult in practice.

"Tax savings include any reduction in the taxable base or the tax liability, including the deferral of tax. . ."

Finally, the waiver of the obligation in the Directive or in the Spanish Law does not imply an exemption from disclosure. Rather, it shifts the reporting obligation to the taxpayer or other intermediaries by requiring the professional to notify the other intermediaries or the client. Regrettably, as of the date of publication of this article, no mechanism has been devised for intermediaries benefitting from waivers to communicate with intermediaries linked to another Member State.

Main Benefit Test

The whole purpose of D.A.C.6 is to communicate information relating to C.B.A.'s that include the presence of certain tax avoidance Hallmarks. The Spanish Law makes a direct reference to the Hallmarks established in the Directive, without any sort of clarification as to their meaning. The Draft Spanish Regulation adopts the principle of the M.B.T. as explained in the O.E.C.D. provisions on reporting, but does so in an enhanced way. In any event, the mere reference in the Spanish Law to the Hallmarks of the Directive leaves many gaps in the meaning of the Spanish Law, notwithstanding the Draft Spanish Regulation.

Regarding the M.B.T., the Directive's annex establishes that the M.B.T. will be satisfied if one of the main benefits which a person may reasonably expect to derive from an arrangement is the obtaining of a tax advantage, having regard to all relevant facts and circumstances. It then establishes generic and specific Hallmarks that are linked to the M.B.T., meaning that no reporting is due if the M.B.T. is not met.

As mentioned earlier, the Draft Spanish Regulation defines the term "tax advantage" by reference to "tax savings," thus redefining when the M.B.T. will be met and broadening its scope. Tax savings include any reduction in the taxable base or the tax liability, including the deferral of tax that would otherwise be due in the absence of the arrangement. In addition, the term includes deferred tax savings that arise from liabilities, deductions, or credits that may be realized in following years.

Tax saving is not the same as tax advantage as used in the Directive. Tax advantages are defined in the directive as tax benefits derived from defeating the purpose of the applicable law. Tax savings, on the other hand, are defined so as to include cases where the applicable law's purpose is met and where the entities or persons involved in the arrangement are simply making use of tax incentives or special tax regimes that have been provided for by the legislator. It is difficult to reconcile the

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purpose of D.A.C.6, which is to combat aggressive tax planning, with entering into transactions that are consistent with applicable law and that would not be aggressive but for the implementation of D.A.C.6.

The circumstances where tax reduction is a main characteristic of a transaction are not well defined. This raises the question of whether the value of the tax benefits must be measured against the reasonably expected economic value of the operation, if conducted as planned.

The Hallmarks related to cross-border payments raise serious questions as to the expectations that an intermediary will be able to identify expected tax benefits when there is limited knowledge of the entire transaction. It is unreasonable to expect that a secondary intermediary can collect all relevant information to know of its obligation and to file a required report in a full and complete way.

No clarifications are made regarding the specific Hallmarks related to the M.B.T. Consequently, some degree of uncertainty remains as to the circumstances in which the conversion of income into capital has as a main benefit the reduction of tax. Similar uncertainty exists when considering when a circular transaction, a lower taxed form of completing a transaction, or merely entering a transaction that ends with a complete tax exemption can ever reflect a valuable business purpose that defeats the M.B.T.

The Draft Spanish Regulation provides that a transaction entered into with a jurisdiction that is noncooperative will be will be measured with Spanish list of noncooperative jurisdictions that is revised infrequently in comparison to the latest O.E.C.D. or E.U. list. This is contrary to the wording of the Directive, which determines noncooperative jurisdictions according to the O.E.C.D. or the E.U. standard, and moreover it is broadening the Hallmark's scope by determining that some third party jurisdictions included in the list according to a provision of national law are noncooperative when they are cooperative in the eyes of the E.U. or the O.E.C.D. In this regard, draft legislation has been proposed to update the tax regulations regarding noncooperative jurisdictions so that it is in line with O.E.C.D. and E.U. principles.

Useful clarifications have been made regarding Hallmarks concerning the automatic exchange of information, beneficial ownership, and transfer pricing, but it remains to be seen whether the final version of the Spanish Regulation will be identical to the Draft Spanish Regulation.

Again, the Draft Spanish Regulation has not yet been approved, which may mean that modifications should be anticipated.

Obligation to File Information

As mentioned above, the transposition of D.A.C.6 into the Spanish Law includes the obligation imposed on intermediaries to file reports disclosing certain C.B.A.'s and the obligation to communicate among themselves and with taxpayers. It also includes the imposition of penalties for the violations of those obligations.

The Draft Spanish Regulation generally is based on the Directive when proposing the conditions triggering the obligation to report and the person who must report. However, the actual content of the report is somewhat broader than the Directive. For example, the Draft Spanish Regulation requires information on both national and international activities. The data that is gathered may prove useful to the

Spanish Tax Authorities when communicating with other Member States, but may also impose undue obligations on intermediaries and taxpayers. For example, an intermediary that is a tax law expert in Spain will need to understand provisions contained in the law of other Member States, even if that intermediary is not an expert in that law. This begs the following question – how does a Spanish tax advisor measure the value of the tax effects of the arrangement in another member state? Is it acceptable to provide that the value is unknown? Even if acceptable, is it prudent to provide that the value is unknown? Is a guess at value acceptable? Whichever path is taken, the risk is that none of these responses is comprehensive enough for Spanish Tax Authorities.

Regarding which intermediary has the primary obligation to file a report and the scope of the relevant information in the report, no clarification is provided by the Draft Spanish Regulation. Past experience suggests that it is not uncommon for one advisor to design an arrangement for a taxpayer without ever knowing whether the taxpayer implements the arrangement. It may also be possible that one advisor has an initial obligation as an intermediary, but due to the limited scope of its role, another person would be considered the reporting intermediary because of substantially greater assistance in bringing the arrangement into fruition. Between the two intermediaries, there seems to be no answer in the Draft Spanish Regulation as to which intermediary is actually obligated to file what information.

Another question exists regarding proportionality. When balancing the value of reporting to the Spanish Tax Authorities with the burden to intermediaries, is it fair to impose burdens at the time of implementation when the Spanish Tax Authorities already have knowledge of the arrangement from a prior filing of a tax ruling request? For example, when a party submits a request for a tax ruling with the Spanish Directorate for Taxes, the Public Administration is usually provided with all relevant information on the transaction. If we follow the interpretation that information must be filed no matter what, the reporting obligation does not appear to be proportional as both Spain and the other Member State are aware of the particulars of the transaction.

The issues raised above could be addressed in a comprehensive and complete final version of the Spanish Regulation that develops rules for the disclosure of certain cross-border arrangements, but limits the obligations of intermediaries when tax rulings covering cross-border arrangements involving Spain and a Member State have been obtained from Spanish Tax Authorities by a Spanish taxpayer and those authorities have communicated the ruling to affected Member States.

Violations and Penalty Regime

As mentioned above, the transposition of the Directive into the Spanish Law includes a penalties regime to deal with violations of six separate duties related to the two main obligations of filing information and of communication among intermediaries and the taxpayer. The duties include (i) timely filing, (ii) containing complete, exact and true information, (iii) made through the proper means. Where an intermediary is exempt from reporting, an obligation is imposed on that intermediary to share information with other intermediaries or the taxpayer.

Violations of the foregoing obligations are punishable by fines. The Spanish Law establishes minimum and maximum fines, and the amount of the maximum fine may depend on the fee charged by the recalcitrant intermediary or the value of the tax saving derived from the C.B.A. It is up to the intermediary or taxpayer to prove the value that sets the maximum limits.

The determination of these values presents certain difficulties. The first difficulty is that an intermediary may have provided advice over a period of time without knowing initially that the transaction is a C.B.A. How does that intermediary apportion its fee between (i) advice in general and (ii) advice as to a C.B.A.?

Another difficulty relates to the fact that there is no provision that applies to the information that should be disclosed for a C.B.A. in which the first step is taken between the date of entry into force of the Directive (June 15, 2018) and its entry into application (July 1, 2020). Imposing a penalty that is determined retroactively to an act during that period violates several cardinal principles of Spanish law, *viz.*, the rule of law, legal certainty, and non-retroactivity of unfavorable provisions. Regrettably, any action to limit penalties is not likely to be accepted by Spanish Tax Authorities and may be viewed by the European Commission to be an infringement by Spain.

"While the transposition of the Directive should have been fully completed by July 2020, the Spanish Law was not approved until the end of December 2020. In addition, no final version of the Draft Spanish Regulation has been adopted as of the date of publication of this article."

While the transposition of the Directive should have been fully completed by July 2020, the Spanish Law was not approved until the end of December 2020. In addition, no final version of the Draft Spanish Regulation has been adopted as of the date of publication of this article. This delay affects the implementation of D.A.C.6, because while the obligation to disclose exists in Spain from late 2020, the means of filing reports are nonexistent as of the date of publication of this article as the draft order mandating the use of certain forms has not been finalized, forcing taxpayers and intermediaries into a situation of involuntary violation. While it is anticipated that the Spanish Tax Authorities will not punish intermediaries for noncompliance with reporting obligations resulting from the failure of the Spanish Government to implement the reporting regime on a timely basis, the lack of answers in this area remains worrisome.

CONCLUSION

The current situation in Spain in connection with D.A.C.6 is that of an orphaned obligation: while the D.A.C.6 has been transposed into the Spanish Law and reporting obligations now exist, there are no means to comply with the reporting obligations, as the Spanish Regulation has not yet been approved. Much uncertainty exists as to the scope of the reporting obligations and the consequences of noncompliance.

It is imperative for the Spanish Government to approve the Spanish Regulation developing D.A.C.6 obligations under Spanish law in way that is more comprehensive than the draft that has been proposed.

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D.A.C.6 IN IRELAND – KEY FEATURES OF THE ADMINISTRATIVE GUIDANCE

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Tags
Arrangements
Cross-border
DAC6
Hallmarks
Intermediaries
Ireland
Participants
Reportable

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INTRODUCTION[1]

Following the introduction of Council Directive (E.U.) 2018/822 ("the Directive"), which entered into force on June 25, 2018, certain "intermediaries," including lawyers, banks, accountants, and fund managers, and certain taxpayers are required to disclose "potentially aggressive tax planning schemes with a cross-border element" to the tax authorities in the jurisdictions where they are located. This disclosure is known as "D.A.C.6" reporting. The aim of the regime is to tackle aggressive tax planning by increasing scrutiny of the previously unseen activities of tax planners and advisers.

Despite the focus on "aggressive" arrangements, the reporting obligations can in principle catch a wider range of transactions and matters. The disclosure regime is intended to apply to cross-border transactions that could potentially be used for aggressive tax planning. As such, it is likely that cross-border arrangements that are not used for aggressive tax planning will be reportable because they bear a Hallmark that is listed in one or more of the categories discussed below.

The rules apply to "cross-border arrangements" that will be reportable if one or more relevant "Hallmarks" are applicable. The meaning of both terms is addressed below.

WHAT IS A "CROSS-BORDER ARRANGEMENT"?

The Directive provides that a "cross-border arrangement" ("C.B.A.") is an arrangement concerning (i) more than one E.U. Member State or the U.K. or (ii) an E.U. member state or the U.K. and a third country, where in either case at least one of the following conditions is met:

- Not all the participants in the arrangement are resident for tax purposes in the same jurisdiction.
- One or more of the participants is simultaneously resident for tax purposes in more than one jurisdiction.
- One or more of the participants carries on a business in another jurisdiction through a permanent establishment situated in that jurisdiction and the arrangement forms a part or the whole of the business of that permanent establishment.

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[1] Views expressed on the Irish Revenue's opinions regarding D.A.C.6 are taken from its published briefing, which can be found at www.revenue.ie under tax & Duty Manual 33-03-03 (updated to March 2021). .

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- One or more of the participants carries on an activity in another jurisdiction without being resident for tax purposes or creating a permanent establishment situated in that jurisdiction.
- The arrangement has a possible impact on the automatic exchange of information or the identification of beneficial ownership.

"Arrangement" is not fully defined in the Directive, but it includes a series of arrangements and may comprise more than one step or part of a broader arrangement.

A C.B.A. is reportable if it contains at least one "Hallmark."

WHAT IS A RELEVANT "HALLMARK"?

The Hallmarks are grouped under five broad categories (A – E) and are features or characteristics which are commonly seen in aggressive tax planning arrangements, although as noted above, several of the Hallmarks are more broadly defined and can apply to normal commercial transactions. A high level summary of each of the Hallmarks is set out below.

Certain Hallmarks require the "main benefit or one of the main benefits" of the arrangements to be the obtaining of a tax advantage. This is known as the "main benefit test" ("M.B.T.").

CATEGORIES	HALLMARKS	M.B.T.?
Category A *Commercial characteristics seen in marketed tax avoidance schemes*	The taxpayer or participant is under a confidentiality condition in respect of how the arrangements secure a tax advantage.	Yes
	The "intermediary" is paid by reference to the amount of tax saved or whether the scheme is effective.	Yes
	The transaction uses substantially standardized documentation and/or structures which are not substantially customized for implementation.	Yes
Category B *Tax structured arrangements seen in avoidance planning*	The transaction involves the acquisition of a loss-making company.	Yes
	Income is converted into capital which is taxed at a lower level or exempt from tax.	Yes
	Circular transactions result in the round-tripping of funds with no other primary commercial function.	Yes

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CATEGORIES	HALLMARKS	M.B.T.?
Category C *Cross-border payments, transfers broadly drafted to capture innovative planning but which may pick up many ordinary commercial transactions where there is no main tax benefit*	Deductible cross-border payments are made between "associated enterprises" defined in Lines (i) to (iv) **and** one of payments described in Line 1 to Line 5 below apply. Enterprises are "associated" if one enterprise (i) holds > 25% of the voting rights in another enterprise, (ii) owns > 25% of the share capital of another enterprise (directly or indirectly), (iii) is entitled to > 25% of the profits of another enterprise, or (iv) exercises significant influence over the management of another enterprise.	
	1. Payment to a recipient not resident for tax purposes in any jurisdiction.	No
	2. Payment to a recipient resident in a jurisdiction which levies a 0% or near 0% corporate tax rate.	Yes
	3. Payment to a recipient resident in E.U. or O.E.C.D. blacklisted countries.	No
	4. Payment which is tax exempt in the recipient's jurisdiction.	Yes
	5. Payment which benefits from a preferential tax regime in the recipient jurisdiction.	Yes
	Deductions for depreciation are claimed in more than one jurisdiction.	No
	Double tax relief is claimed in more than one jurisdiction in respect of the same income.	No
	An asset transfer takes place where the amount treated as payable is materially different between jurisdictions.	No
Category D *Arrangements which undermine tax reporting and transparency under the Common Reporting Standard*	Arrangements which have the effect of undermining reporting requirements under agreements for the automatic exchange of information.	No
	Arrangements which obscure beneficial ownership and involve the use of offshore entities and structures with no real substance.	No
Category E *Unilateral safe harbors* *Transfers of hard-to-value intangibles* *Transfers of items + >50% reduction in E.B.I.T. of transferor*	Arrangements involving the use of unilateral transfer pricing safe harbor rules.	No
	The transaction involves transfers of hard to value intangibles for which no reliable comparable exist and where financial projections or assumptions used in the valuation are highly uncertain.	No
	A cross-border transfer of functions/risks/assets is projected to result in a more than a 50% decrease in E.B.I.T. during the next three years.	No

WHEN DOES THE REPORTING APPLY?

The disclosure regime became effective in all Member States on July 1, 2020. However, Ireland, along with many other Member States, exercised an option given in Council Directive (E.U.) 2020/8765 to defer the first disclosures of information to January 31, 2021, and February 28, 2021, to cover the legacy periods. The Directive was transposed into Irish law by the European Union (Administrative Cooperation in the Field of Taxation) (Amendment) Regulations 2020. Thereafter, reports are due within 30 days from the first step of the transaction implementation.

WHAT DO THE IRISH AUTHORITIES CONSIDER TO BE A TAX ADVANTAGE?

According to the Revenue, the term "tax advantage" is defined broadly to include the avoidance or reduction of a charge to tax, a relief from tax, repayment of tax and the deferral of tax or the avoidance of an obligation to deduct withholding tax.

A tax advantage may be obtained or intended to be obtained in respect of any tax levied by, or on behalf of, an E.U. Member State, except for value-added tax, customs duties, excise duties and compulsory social security contributions.

Fees for documents issued by public authorities and consideration due under a contract are excluded from the scope of taxes covered by the disclosure regime.

". . . what is not important, in the context of this test, is the particular facts or circumstances of the participants as that would be a subjective test."

WHAT DOES THE M.B.T. MEAN TO THE IRISH TAX AUTHORITIES?

The Revenue have stated in the published guidance notes that the M.B.T. applies a reasonable awareness test. The specific language used in the Directive refers to scenarios where the main benefit or one of the main benefits that a person (having regard to all facts and circumstances) "may reasonably expect to derive from an arrangement is the obtaining of a tax advantage."

Accordingly, in the context of a C.B.A., what is important is whether it would be (i) reasonable for a person (ii) to expect to derive a tax advantage as a main benefit from such arrangement. In this regard, the word "reasonable" is based on the common law "reasonable man test." The reasonable man test asks what a "reasonable person of ordinary prudence" would do in a given situation. It is an objective test. The word expect, as used in this context, is a verb which means to regard something as likely to happen.

Therefore, what is not important, in the context of this test, is the particular facts or circumstances of the participants as that would be a subjective test. Rather, what is important, in the context of this test, is whether a hypothetical reasonable person could expect to obtain tax benefits from the arrangement and that such benefits would be a main benefit of that arrangement. As the reporting is generally performed by intermediaries, this approach is logical.

The test involves asking a hypothetical question of what a reasonable person would reasonably expect, given the facts of a particular arrangement.

The main benefit test requires an objective comparison of the value or significance of an expected tax advantage *vis-à-vis* any other benefit likely to be obtained from an arrangement. Such a comparison is to be carried out in the context of the arrangement itself and the range of benefits expected to arise from entering the arrangement.

If, having carried out such a comparison, it is determined that a tax advantage is the main benefit or one of the main benefits that is likely to be obtained from the arrangement, then the test will be satisfied. If, on the other hand, it is the case that a tax advantage is one of a number of benefits that are likely to be obtained from an arrangement, but not a main benefit, then the tax advantage will simply be the "icing on the cake" and the test will not be satisfied.[2]

WHAT IS THE VIEW OF THE IRISH AUTHORITIES ABOUT CONFIDENTIALITY?

According to Revenue, arrangements involving the use of confidentiality conditions will be reportable in any of three circumstances:

- The confidentiality condition has the effect of limiting disclosure of the expected tax advantage *vis-à-vis* other intermediaries and/or the tax authorities.
- It is reasonable to conclude, from an objective standpoint, that the confidentiality condition is intended to secure a tax advantage vis-à-vis other intermediaries or the tax authorities.
- A tax advantage is the main benefit or one of the main benefits which, having regard to all the relevant facts and circumstances, a person may reasonably expect to obtain from the arrangement.

For an arrangement to bear this Hallmark, it is not necessary that the confidentiality condition refer explicitly to the limitation on disclosure. It is only necessary that the confidentiality condition has the effect of limiting disclosure of the expected tax advantage vis-à-vis other intermediaries or the tax authorities.

Examples of confidentiality conditions include

- nondisclosure agreements,
- steps that discourage potential users from taking external advice,
- use of promotional material referring to nondisclosure,
- steps that discourage users from keeping promotional material or other details of how the arrangement operates, and
- discouraging users from communicating directly with the Revenue or another tax authority.

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[2] *Commissioners of Inland Revenue v. Sema Group Pension Scheme Trustees*, 74 TC 593 at 637.

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WILL CONFIDENTIALITY PROVISIONS ALWAYS TRIGGER DISCLOSURE?

No. According to the Revenue, the use of such agreements will not trigger reporting unless it is reasonable to conclude, from an objective standpoint, that the confidentiality condition is intended to secure a tax advantage vis-à-vis other intermediary or the tax authorities and the tax advantage is the main benefit or one of the main benefits which, having regard to all the relevant facts and circumstances, a person may reasonably expect to obtain from the arrangement.

"A strict application of the standardized documents Hallmark is likely to result in a significant volume of transactions being reported to the Revenue that are not used for tax avoidance purposes."

WHEN DOES THE USE OF STANDARDIZED DOCUMENTS NOT RESULT IN MEETING THE HALLMARK?

A strict application of the standardized documents Hallmark is likely to result in a significant volume of transactions being reported to the Revenue that are not used for tax avoidance purposes. To alleviate the administrative burden this may place on intermediaries and taxpayers, Finance Act 2020 introduced section 817RI. The section provides that the use of certain tax reliefs and exemptions will not trigger reporting under this Hallmark where the relief or exemption in question falls into any of the following categories:

- It benefits from equivalent reporting exclusions under Ireland's domestic mandatory disclosure regime.
- It is provided for in legislation.
- It involves some degree of Revenue oversight, certification, or approval.
- It is used in a routine fashion for *bona fide* purposes.

Examples of such reliefs and exemptions include documents that are used in regard to (i) approved profit-sharing plans, (ii) approved salary reduction arrangements, and (iii) approved retirement benefit arrangements.

WHAT ARE THE UNILATERAL SAFE HAROR RULES OF HALLMARK E1?

This hallmark applies to arrangements that involve the use of unilateral safe harbor within the meaning of the O.E.C.D. Transfer Pricing Guidelines, which provides as follows:

> A safe harbour in a transfer pricing regime is a provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a country's general transfer pricing rules. A safe harbour substitutes simpler obligations for those under the general transfer pricing regime. Such a provision could, for example, allow taxpayers to establish transfer prices in a specific way, *e.g.* by applying a simplified transfer pricing approach provided by the tax administration.[3]

[3] Paragraph 4.102 of the O.E.C.D. Transfer Pricing Guidelines.

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DO BILATERAL APA'S NEGOTIATED WITH TAX AUTHORITIES OF MORE THAN ONE STATE COME WITHIN THE SCOPE OF THE CATEGORY E HALLMARK REGARDING UNILATERAL SAFE HARBORS?

No. Only arrangements involving the use of unilateral safe harbors come within the scope of The Category E Hallmark. Examples include standard mark-ups for trading companies. Therefore, bilateral advance pricing agreements concluded between tax authorities do not fall within the scope of Category E Hallmarks.

Consequently, the following types of arrangements will not be considered to involve the use of unilateral safe harbor rules:

- Arrangements involving the use of administrative simplification measures that do not directly involve the determination of arm's length prices, for example, simplified documentation requirements in the absence of a pricing determination.
- Arrangements that adopt the simplified approach to low value intra-group services. The Revenue has issued guidance regarding its simplified approach to low value intra-group services. Revenue's practice of accepting a mark-up of 5% of the cost-base without requiring a taxpayer to provide a benchmarking analysis is consistent with international guidance in this area.
- Arrangements involving the use of provisions that exclude certain categories of taxpayers or transactions from the scope of transfer pricing rules. For instance, Small and Medium Enterprises are currently outside the scope of Ireland's transfer pricing rules.
- Where a particular category of taxpayer or transaction falls within the scope of a unilateral safe harbor rule, but the arrangement does not rely on or involve the use of that rule.

WHEN DO INTRA-GROUP TRANSFERS OF FUNCTIONS, RISKS, AND ASSETS FALL WITHIN THE SCOPE OF CATEGORY E HALLMARK?

Category E contains a Hallmark involving the transfer of functions, risks, and assets when the transfer could be part of a plan to move profits to another jurisdictions. Here, the key to the application of the Hallmark is an intragroup cross-border transfer of functions, risks, or assets combined with a substantial reduction of operating profits by the transferor.

The second leg for application of the Hallmark is that the projected annual earnings computed without taking into account interest and taxes – typically revered to as earnings before interest and taxes ("E.B.I.T.") of the transferor for the three-year period following the transfer are less than 50% of the projected annual E.B.I.T. of the transferor(s) if the transfer had not been made. E.B.I.T. is defined and computed according to applicable accounting standards. In essence, the tainted transaction

keeps the business within a corporate group, but moves the income generating activity to a low-tax country as a means of substantially transferring E.B.I.T. to the new location.

This Hallmark generally does not apply where the following two conditions are present:

- The transferor is projected to make a loss were the transfer not to proceed.
- The projected post-transfer operations of the transferor project reduced losses, zero earnings, or a positive E.B.I.T.

As the projected E.B.I.T. was negative before the transfer, this Hallmark should not apply as each of the three outcomes cannot be said to represent a 50% reduction in E.B.I.T.

WHAT COMPUTATIONS ARE REQUIRED IN DETERMINING WHETHER THE CATEGORY E HALLMARK IS APPLICABLE TO A MOVE OF FUNCTIONS, RISKS, AND ASSETS?

The Revenue advises that, to establish whether this hallmark is met, it will be necessary for a taxpayer to produce two sets of projections for the three-year period following the transfer. The first is based on the projected position of the transferor without the transfer taking place. The second is based on the projected position of transferor with the transfer taking place. Each set projections should take into account all relevant facts and circumstances at the time the reporting obligation arises under the disclosure regime.

IF A REPORT MUST BE FILED, WHO FILES THE REPORT?

In general, an intermediary files the report. However, if the intermediary is bound by professional privilege that would be violated by making the report, the intermediary is obligated to advise the taxpayer to file its own report. Full information must be transferred to the taxpayer by the intermediary.

Note that a person required to file a report to the Revenue in respect of a reportable C.B.A. is not required to include in the return information that is not within its knowledge, possession, or control.

HOW MUCH INVESTIGATION IS REQUIRED OF THE PERSON MAKING THE REPORT?

A person required to file a report regarding a C.B.A. must take all reasonable steps necessary to obtain the required information. Reasonable steps are the steps a person in this situation would ordinarily be expected to take in the course of ordinary commercial due diligence on a transaction of that nature. However, there is no specific obligation to actively seek out information that the intermediary and/or the relevant taxpayer does not hold in the first place.

WHO ARE THE INTERMEDIARIES?

There are two categories of intermediary for D.A.C.6 purposes.

The first category of intermediary is any person that designs, markets, organizes, makes available for implementation, or manages the implementation of a reportable cross-border arrangement.

This category of intermediary will comprise those that actively design and advise on tax planning schemes for their clients, such as lawyers specializing in tax law and professional tax advisors. It will also include companies in corporate groups that design and advise on such schemes using in-house experts for implementation by other group members.

The second category of intermediary is any person that, having regard to the relevant facts and circumstances and based on available information and the relevant expertise and understanding required to provide such services, knows or could be reasonably expected to know that such person has undertaken to provide, directly or by means of other persons, aid, assistance or advice with respect to designing, marketing, organizing, making available for implementation or managing the implementation of a reportable cross-border arrangement.

This category of intermediary is likely to encompass a much broader range of persons than the first category. It may include accountants, auditors, wealth managers, lawyers, insurance companies, asset managers of investment funds and bankers. As with the first category of intermediary, it will also include companies in corporate groups that design and advise on such schemes using in-house experts for implementation by other group members.

HOW DO THE IRISH AUTHORITIES VIEW THE LEGAL PRIVILEGE EXCEPTION?

An intermediary is exempt from the obligation to file a report of the specified information with the Revenue if a claim to legal professional privilege in respect of that information could be maintained in legal proceedings. Where only part of the specified information is subject to professional privilege, the exemption will apply only in respect of that part of the specified information.

For the purpose of this exemption, the term “legal professional privilege” will be interpreted in accordance with Irish law. Therefore, except for those cases where litigation is in actual contemplation, legal privilege will generally apply only to confidential legal advice given to a client by a lawyer and will not extend to documentation prepared in the ordinary course of a transaction or to the identity of the parties involved. Furthermore, as the privilege is that of the client, not the legal professional, the client may elect to waive its right to legal privilege to the extent necessary to allow the legal professional to disclose the information to Revenue.

Intermediaries should analyze whether their interactions with their clients in respect of arrangements within the meaning of section 817RA are privileged and discuss with all clients that benefit from the legal professional privilege whether

> *"Different levels of penalties are provided for under Irish law, depending on the nature of the infringement."*

they wish to waive their rights under applicable privilege. The decision belongs to the client once properly informed of the scope of the exemption, taking into account all facts and circumstance, with regard to matters for which legal counsel has been retained.

Where an exemption from disclosure applies due to legal professional privilege, an intermediary is required to notify, without delay, the relevant taxpayer of its obligation to file a return of information with the Revenue. For the purpose of this obligation, "without delay" should be taken to mean as being as soon in time as the intermediary becomes aware that an exemption applies due to legal professional privilege.

WHAT IS THE VIEW ABOUT MAKING A MISTAKE IN A DISCLOSURE?

Where a decision is taken that an arrangement is not disclosable, but it subsequently transpires that the conclusion is not supported by applicable law implementing D.A.C.6, an intermediary has the right to establish to the satisfaction of Revenue that the decision was arrived at in an objective way, considering all relevant facts and circumstances and based on available information. Where, on the other hand, the Revenue forms the view that the failure to comply is not justified, penalties for noncompliance may be imposed.

WHAT PENALTIES ARE IMPOSED FOR NONCOMPLIANCE WITH REPORTING OBLIGATIONS?

Different levels of penalties are provided for under Irish law, depending on the nature of the infringement.

The maximum penalty is generally €4,000[4] where the compliance failure relates to the obligations of an intermediary in relation to marketable arrangements for the following compliance failures:

- The failure of an intermediary to inform another intermediary or the relevant taxpayer of their disclosure obligations where a reporting exemption applies due to legal professional privilege.
- The failure of a relevant taxpayer to provide the Arrangement identification number to any other relevant taxpayer.
- The failure to comply with reporting obligations that apply in relation to the "lookback" period.

If the failure to comply continues after imposition of the initial penalty, a further penalty of €100 may be imposed for each day on which the failure continues

Where the compliance failure does not relate to marketable arrangement, the maximum penalty is €500 for each day on which any of the following compliance failures occur:

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[4] Section 817RH(1)(a).

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- The failure of an intermediary to file a return of information with the Revenue, with the exception of the reporting obligations that apply in relation to the "lookback" period.
- The failure of an intermediary to provide any other intermediary and each relevant taxpayer with the Arrangement identification number.
- The failure of a relevant taxpayer to file a return with Revenue.

If the failure continues after daily penalties are imposed, a further penalty of €500 may be imposed for each additional day on which the failure continues.

Where the failure to comply relates to the obligation of a relevant taxpayer to include the Arrangement identification number in its annual return of income, a maximum penalty of €5,000 may apply.

While the legislation prescribes the maximum penalties that may be imposed, it will ultimately be for the courts to decide whether a person is liable to a penalty and, if the person is so liable, the amount of that penalty. Once the amount of the penalty is asserted, the Revenue procedure will be to make an application to the relevant court for a determination on the matter.

When determining the amount of a penalty that is to apply, the Court is to have regard for the following:

- If the person is an intermediary, the amount of any fees received or likely to have been received by the person in relation to the reportable cross-border arrangement.
- If the person is a relevant taxpayer, the amount of any tax advantage gained or sought to be gained by the person from the reportable cross-border arrangement.

WHAT IS THE PROCESS FOR FILING A REPORT?

Returns are filed electronically on the Revenue Online System ("R.O.S."), https://www.revenue.ie/en/online-services/index.aspx. It is possible that multiple returns of the same transaction will be made. Whenever possible it is requested that the same Arrangement identification number should be used.

Before filing a report online, a person must register, either in their own account or through an intermediary, with the R.O.S. filing system.

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D.A.C.6 IMPLEMENTATION IN CYPRUS

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Tags
Arrangements
Cross-border
Cyprus
DAC6
Hallmarks
Intermediaries
Participants
Reportable

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INTRODUCTION

As a member of the E.U., Cyprus is subject to the same obligation as all other E.U. states to implement the Directives on Administrative Cooperation ("D.A.C.") including D.A.C.6, for which the Cyprus Ministry of Finance ("M.O.F.") submitted draft legislation in 2019. The D.A.C.6 draft legislation under consideration in the Cypriot Parliament, with discussions ongoing before the appropriate Parliamentary Committee. Several amended drafts of the implementing legislation were submitted, but with the COVID-19 emergency measures, the legislative process ground to a halt in March 2020. The process started up recently and the law was passed on March 18, 2021.

Reporting deadlines have been extended twice, currently to June 30, 2021. An additional extension of the deadline for filing information on reportable cross-border arrangements ("R.C.B.A.'s") set out in the D.A.C.6 Directive has been granted. The submission deadline for D.A.C.6 has been extended up to June 30, 2021, for the following cases:

- R.C.B.A.'s carried out between June 25, 2018 and June 30, 2020, that should have been reported by February 28, 2021.
- R.C.B.A.'s carried out between July 1, 2020 and December 31, 2020, that should have been reported by January 31, 2021.
- R.C.B.A.'s carried out between January 1, 2021 and May 31, 2021 and which should have been (or should be) be reported within 30 days from the earliest of
  - the day made available for implementation,
  - the day they were ready for implementation, or
  - the day on which the first step towards implementation has been (or will be) made.
- R.C.B.A.'s for which secondary intermediaries have provided (or will provide) assistance, aid or advice between January 1, 2021 and May 31, 2021, that should have been or should be reported within 30 days following the next day where such assistance, aid or advice was provided.

However, application of D.A.C.6 is immediate due to its retroactive effect. Deadlines for the commencement of exchanges between countries have also been extended as a result of the various extensions.

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GENERAL CONSIDERATIONS AND CONCERNS

The Cypriot Government recognizes that the application of D.A.C.6 is challenging for smaller countries in the E.U. The government department that will monitor the D.A.C.6 law implementation is yet to be fully staffed in view of the COVID-19 situation. The various lockdowns have challenged the Government's capacity to provide appropriate training and briefing. The Cypriot Government is aware that many medium to small professional firms likely will experience difficulties in installing and maintaining the necessary internet systems required for reporting. This will lead to outsourcing of reports to larger firms. In addition, this will lead to sharp increases in operating and compliance costs and fees that may adversely affect Cypriot competitiveness in the international business sector.

The M.O.F. is aware that the scope of D.A.C.6 reporting obligations is broad and that it may capture arrangements that arise for commercial reasons more than for tax planning reasons. Consequently, the M.O.F.'s view on the Main Benefit Test ("M.B.T.") is to compare the value of (i) tax advantages against (ii) other benefits and considerations on a case by case basis.

The Cypriot Tax Department defines tax benefit as any of the following advantages:

- The grant of relief or an increase in previously granted relief on tax
- Avoiding tax or reduction of tax
- Deferral of tax payments
- Avoidance of an obligation to withhold tax

The cardinal element of the proposed law is that the tax advantage reported under D.A.C.6 must be seated in the E.U. This means that an arrangement resulting in a tax benefit which affects only the tax base of a non-E.U. jurisdiction does not fall within the M.B.T. Hence, Hallmarks for which the M.B.T. must be met are removed from reporting when the C.B.A. reduces tax in a country other than a Member State of the E.U.

Ultimate beneficial owners of Cypriot companies are monitored in existing compliance rules. If any individual who is a tax resident of a Member State of the E.U. secures tax treatment in Cyprus that adversely affects the tax base of that E.U. Member State, information on that cross border arrangement ("C.B.A.") will be captured by the law and will be reportable once the D.A.C.6 legislation is enacted.

The objectives of the M.O.F. are identical to those of the E.U. Consequently, the reporting obligation in Cyprus will include targeting and capturing potentially aggressive tax planning arrangements resulting in tax base erosion of one or more E.U. Member States. It will not matter whether C.B.A.'s of a Cypriot company are with an E.U. Member State or a country that is not an E.U. Member State. If the Member State's tax base is of a kind that could be adversely affected by a transaction, reporting will be required by intermediaries.

In addition to D.A.C.6, the Cypriot Government will continue to adhere to all previous directives on administrative cooperation in the field of taxation. These include the following:

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- Targeting attempts at circumventing mandatory automatic exchanges of financial information (such as C.R.S.)
- Exchanges of information on cross border tax rulings
- Country-by-country reporting
- Facilitating access to anti-money laundering information by tax authorities

Regarding reportable arrangements to be included in D.A.C.6, the M.O.F. has adopted the minimum standards under which D.A.C.6 reporting will not be required for local arrangements and for arrangements with non-E.U. states where the tax base of an E.U. Member State is not affected adversely.

The internal taxes that will be addressed by the Cypriot legislation include only the Income Tax, the Special Defense Tax, and the Capital Gains Tax. No other direct or indirect taxes are covered by the proposed law. Penalties for noncompliance with various reporting obligations may not exceed €20.000 per R.C.B.A.

BASICS TO BE ADOPTED BY CYPRUS

The D.A.C.6 basic provisions addressed by the legislation and enacted are as follows:

- **The M.B.T. and the Hallmarks falling within the M.B.T.** This includes standardized documentation that is actively promoted and sold off-the-shelf, thus potentially leading to aggressive tax planning potentially eroding the tax base in any E.U. Member State, is well defined. The net is cast widely to catch even usual commercial arrangements therefore analysis of a cross border arrangement is quite a difficult and complex task.
- **The Hallmarks not requiring a finding as to the M.B.T.** These R.C.B.A.'s are defined widely. Among other elements, R.C.B.A.'s will include the following:
  - Transactions between Cypriot companies and companies and other entities based in E.U. and O.E.C.D. blacklisted countries
  - Transactions between Cypriot companies and recipients of income who are not tax resident in any country
  - Transactions otherwise resulting in deduction of depreciation on the same asset in multiple jurisdictions
  - Transfers of assets significantly projected to reduce valuation of the transferor's income stream
- **Automatic Exchanges of Information ("A.E.O.I.").** Arrangements which circumvent A.E.O.I. by utilizing jurisdictions that are not regulated or compliant must be reported.
- **Transfer Pricing.** Transfer pricing elements such as exploiting the existence of safe harbor rules, and transfer of hard-to value intangibles in an arrangement.

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“To protect company directors, the M.O.F. strategy will require lawyers, auditors, and tax compliance firms to maintain detailed documentation in order to avoid the statutory penalties.”

DEFINITION OF INTERMEDIARIES

In general, the Cypriot Government has adopted the definition of an intermediary that is provided by D.A.C.6. Consequently, intermediaries include all persons devising, drafting, advising on, and marketing tax planning arrangements. Also included are persons that assist in implementing those arrangements.

On the other hand, exemption has been granted to those providing tax compliance and auditing services. Lawyers have also been exempted due to professional confidentiality regulations in Cyprus, as with other E.U. Member States. However, these exemptions are conditional. The exempted professional is required to review and analyze the objectives of the client's arrangements and must provide notice to clients that, because of the exemption for the accountant, tax return preparer, or lawyer, the client is required to ensure that its tax advisers and primary intermediaries have reported the R.C.B.A. and must provide the relevant report reference number. If the other intermediaries fail to report, clients must be advised that the reporting obligation shifts to them. Failure by exempted persons to carry out notification responsibilities may give rise to penalties for noncompliance.

The complication in Cyprus, is that clients typically are Cyprus registered companies with ultimate beneficial owners that are resident outside Cyprus. This poses a problem for resident directors in Cyprus, who bear the responsibility of noncompliance. To protect company directors, the M.O.F. strategy will require lawyers, auditors, and tax compliance firms to maintain detailed documentation in order to avoid the statutory penalties.

FURTHER CYPRUS CONSIDERATIONS

- Cyprus adopted the position in the draft law, that E.U. approved tax schemes implemented in Cyprus such as the I.P. Box regime, Tonnage Tax regime in the shipping industry, and the N.I.D. (Notional Interest Deduction) do not fall within the proposed D.A.C.6 law.
- Regarding Hallmarks that are applicable without reference to the M.B.T., the Cypriot position is that most of these will only be applicable provided the arrangements in question are with legal entities based in countries on the E.U. and/or O.E.C.D. Noncooperative Jurisdiction lists. Cyprus implements strictly rules attacking transactions with companies based in listed jurisdictions.
- Cyprus has adopted the common goal of E.U. tax authorities to react proactively and decisively when tax rules may facilitate aggressive and harmful tax practices.
- The M.O.F. has adopted a policy that ensures access to a level playing field for large and small taxpayers.

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PRIVATE INVESTMENT FUNDS IN ISRAEL

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Beneficial Tax Arrangement
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Israel
Private Equity Funds
Venture Capital Funds

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INTRODUCTION

The State of Israel has encouraged foreign investments in Israel for many years. One of its primary tools is the special tax regime applicable to private investment funds. Over the years, the Israeli Tax Authority ("I.T.A.") has issued substantial guidance and numerous private rulings under Section 16A of the Income Tax Ordinance [New Version], 5721-1961 (the "Ordinance") to private investment funds operating in Israel. In general, these rulings provide significant tax benefits to foreign investors and funds if certain conditions are met.

This article outlines various income tax arrangements that are applicable to private investment funds operating in Israel.[1] It is based predominantly on I.T.A. Income Tax Circulars 9/2018 and 10/2018 (the "Circulars"), which govern the taxation of venture capital funds and private equity funds operating in Israel. Note that limited partners holding more than 4% of the interests in a fund cannot control the entities managing the fund and cannot hold more than 10% of the general partner if they wish to enjoy the tax benefits described below.

At present, the special tax regime applicable to private investment funds is currently under review by the I.T.A. and the Israeli Ministry of Finance. Consequently, tax benefits that are available under the existing regime may be adjusted, and additional conditions may be added. It is generally understood that any changes to the regime likely will not affect existing tax arrangements for non-Israeli limited partners.

CONDITIONS FOR BENEFICIAL TAX ARRANGEMENT

A private equity fund or a venture capital fund must comply with the following conditions in order for a non-Israeli investor to be entitled to beneficial tax treatment:

- The fund must have at least 10 investors, each of whom is unrelated to the others, as of the closing of fund raising and throughout the lifespan of the fund.
- Investors in the fund may not hold more than 20% of the capital of the fund. However, the anchor investor may hold up to 35% of the capital of the fund.
- At least 30% of the investors in the fund must be non-Israeli investors.

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[1] This article does not address the application of value added tax to the fee charged for management services provided by the general partner.

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- Throughout the duration of the fund, the total investment commitments must be at least U.S.$10 million, of which at least U.S.$5 million comes from non-Israeli investors.

- The fund may not invest in excess of 25% of the fund's total commitments (net of management fees) in any single company.

- The fund may not invest more than 20% of its total funds raised (after deduction of management fees) in companies whose securities are publicly traded.

- The fund may not hold short-term cash deposits or publicly traded securities, except if they originate from monies which investors transferred in accordance with their investment commitments in the fund, or if they originate from the realization of profits prior to their distribution or reinvestment.

- The fund must invest in "Qualifying Investments" in Israel equal to the lesser of the following amounts:

  - U.S.$10 million in Qualifying Investments, of which at least U.S.$6 million must be invested, directly or indirectly, in Israeli resident companies owning intellectual property that was developed in-house, or the non-Israeli parents of those companies.

  - At least 50% of the fund's total commitments is in Qualifying Investments, of which at least 30% of the fund's total commitments must be invested, directly or indirectly, in Israeli resident companies owning intellectual property developed in-house, or the non-Israeli parents of those companies.

- The fund must be managed by the general partner or by a person on its behalf. The limited partners may not take any role in identifying target companies or managing the portfolio companies, or in the day-to-day management of the fund, and shall not have any voting rights in the investment committee of the fund.

- The fund may be required to provide certain financial information to the I.T.A.

- Investors in the fund may be required to provide certain information to the fund or the I.T.A. in order to establish their right to enjoy the benefits of an I.T.A. ruling issued with respect to the fund.

The terms used in the above requirements have specific meaning.

- An investment is a Qualifying Investment if it relates to shares of an Israeli resident company or in the shares of an Israel affiliated company whose principal activity is a Qualifying Activity. Qualifying investments include venture capital investments. Investments in securities traded on a stock exchange will not be considered to be a Qualifying Investment unless the fund has held the shares for at least one year.

- An activity is a Qualifying Activity when it relates to the establishment or expansion of enterprises that are engaged in designated activities in Israel, such as (i) industry, (ii) agriculture, (iii) tourism, (iv) transportation, (v) construction other than real estate, (vi) water, (vii) energy, (vii) technology, (viii) communications, (ix) computing, (x) security, (xi) medicine, (xii) biotechnology, (xiii)

nanotechnology, and (xiv) research and development related to the foregoing activities in Israel.

- A foreign company is an Israel Affiliated Company where its principal assets or activities are directly or indirectly located in Israel.
- Shares include stock options or warrants, convertible notes, and convertible bridge loans that are not secured by assets other than the technology or other assets of the target company.
- Venture capital investments are Qualifying Investments in the hi-tech sector, where at least 75% of the total investment relates to an initial issuance of shares.

THE BENEFICIAL TAX ARRANGEMENT

If all of the conditions listed above are met, the following will apply to the non-Israeli investors in the fund and in the general partner:

Tax Arrangement for Non-Israeli Limited Partners

- Any income derived from non-Israeli investments (*i.e.*, non-Israeli companies or non-Israeli Affiliated Companies) will be exempt from tax in Israel.
- Income derived from venture capital investments (*i.e.*, capital gains, dividends, and interest) will be exempt from tax in Israel.
- Income derived from Qualified Investments that are not venture capital investments will benefit from the following favorable tax-related provisions.
  - Income from the realization of Qualified Investments will be exempt.
  - Dividend income derived by individual investors directly or through an entity that is tax transparent in the home country of the individual will be subject to tax at the rate of 15%, unless a treaty applies.
  - Dividend income derived by corporate investors will be subject to tax at the corporate income tax rate (currently 23%) unless a treaty applies.
  - Dividend income derived by investors from a treaty jurisdiction are entitled to the tax rates set forth under the applicable treaty, subject to confirmation by the I.T.A. of tax residence and beneficial ownership by the investor.
  - Interest income will be subject to tax at the regular tax rates set forth in the Ordinance. Individual tax rates range between 15% and 50% depending on the nature of the interest. Corporations are taxed at a flat 23%.
  - Non-Israeli investors resident in a treaty jurisdiction are entitled to the tax rates set forth under the applicable treaty, subject to confirmation by the I.T.A. of tax residence and beneficial ownership by the investor.

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- Any other income that is not covered above, including income from management fees received from portfolio companies, will be subject to the regular tax rates set forth in the Ordinance, which have been described above.
- Foreign investors in the fund will not be considered as tax residents of Israel and will not have filing obligations in Israel as a result of their investments in the fund.

Tax Arrangement for Non-Israeli Fund Managers

Once the fund qualifies for tax benefits, the general partner and the mangers of the fund may be entitled to certain tax benefits. Again, the special tax regime applicable to private investment funds is currently under review by the I.T.A. and the Israeli Ministry of Finance. It is possible that tax benefits may be adjusted and additional conditions may be added.

"Once the fund qualifies for tax benefits, the general partner and the mangers of the fund may be entitled to certain tax benefits."

Taxation of Carried Interests Held by Fund Managers

Carried interest income attributable to Israeli Investments will be subject to tax at the rate of 15% in the hands of non-Israeli fund managers. Carried interest income attributable to investments in foreign entities will not be subject to tax in Israel.

Non-Israeli general partners and fund managers resident in a treaty jurisdiction may be eligible for tax rates set forth under the applicable treaty, subject to confirmation of the recipient's tax residence and beneficial ownership by the I.T.A.

Taxation of Management Fees

Income derived from management fees will generally be subject to the regular tax rates as set forth in the Ordinance, which have been described above.

ALTERNATIVE TAX ARRANGEMENTS IF CONDITIONS ARE NOT MET

Over the years, the I.T.A. has also issued alternative tax arrangements for funds that do not meet the conditions listed above. Included are funds that have fewer than 10 unrelated investors, funds with commitments of less than U.S.$10 million, funds in which the limited partners are involved in the management of the fund, and funds in which the general partner is a substantial investor.

Funds That Have Fewer Than 10 Investors

Here, the tax rules are as follows:

- Income from realizations of Qualifying Investments will be subject to 15% income tax in Israel.
- Income from interest and dividend payments that are derived from Qualifying Investments will be subject to tax at a rate of 15%, or a lower rate that applies under a tax treaty.

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- Other income that is not derived or accrued from Qualified Investments will be subject to the tax rates established in the Ordinance. As mentioned above, the rates for individuals range between 15% and 50%. The rate for corporations is 23%.

- Income derived from non-Israeli companies and non-Israel Affiliated Companies will be exempt.

Funds With Less Than U.S.$10 million in Commitments

- A beneficial tax arrangement will be available to funds that are focused on making venture capital investments.

- Income from the realization of venture capital investments will be exempt from tax in Israel.

- Income from interest and dividend payments will be subject to the tax at the lesser of (i) the tax rates established in the Ordinance or (ii) a lower rate that applies under a tax treaty.

Non-Israeli Fund Investing in Israel Without Representation in Israel

- Generally, such a fund will enjoy the same tax benefits as enjoyed by non-Israeli limited partners, discussed above.

- Non-Israeli managers of the fund will be entitled to exemption from Israeli tax with regard to their carried interest and management fees.

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NEW ITALIAN TRANSFER PRICING REGULATIONS AFFECT MULTINATIONAL ENTERPRISES

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BACKGROUND

Italian transfer pricing documentation rules were introduced in 2010 by Article 26 of Law Decree 31 May 2010 No. 78 and implemented with the regulations issued by the Director of the Italian Revenue Agency on September 29, 2010 ("Existing Regulations"). The system gives taxpayers the possibility to obtain penalty protection in case of transfer pricing adjustments, provided that they timely prepare and maintain qualifying transfer pricing documentation.

On November 23, 2020, the Italian Revenue Agency issued Regulation No. 360494 ("New Regulations"), which entirely replaced the Regulations, introducing important changes that may have a relevant impact on multinational enterprises ("M.N.E. groups").

REVISIONS CONCERING GENERAL ASPECTS

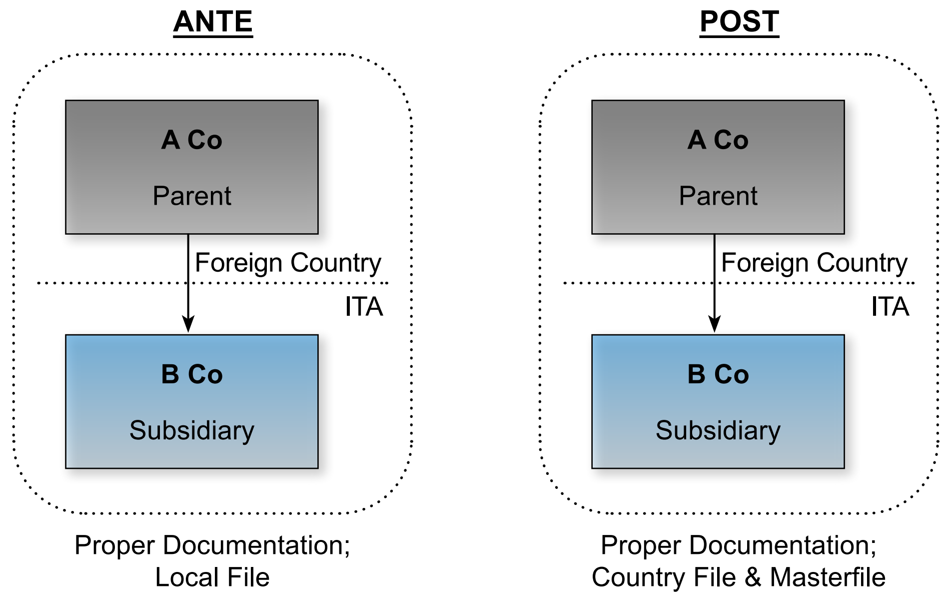
Broadening the Scope of Companies Required to Maintain a Master File

The system governing transfer pricing documentation under the New Regulations retains the same three-tiered structure of the consisting of

- a Master File containing information relevant for all M.N.E. group members,
- a Local File referring specifically to the local taxpayer, and
- a Country-by-Country Report for those M.N.E. groups having a turnover of €750 million.

However, the scope of companies required to maintain a Master File is broadened. In the previous framework of the Existing Regulations, maintenance of a Master File was required in order obtain penalty protection differed depending on whether an Italian company held foreign subsidiaries or simply was a subsidiary of a foreign M.N.E. group. In the latter case, the Italian company was not required to prepare a Master File if it did not own control shareholdings in non-Italian companies. This exception is deleted in the New Regulations. Now, all Italian subsidiaries of foreign M.N.E. groups that desire penalty protection arising from transfer pricing adjustments must maintain a Master File and a Local File, even when ownership or control stakes are not maintained in companies resident outside Italy. The new requirement applies also to permanent establishments of non-Italian companies when the permanent establishment holds shares in companies resident outside of Italy.

The difference in the requirement regarding the maintenance of a Master File is illustrated in the following diagram.



Reporting Exception for an S.M.E. Member of an M.N.E. Group

The New Regulations strengthen the requirements that must be met for a "Small and Medium Enterprise ("S.M.E.") to qualify for tri-annual reporting when it is a member of an M.N.E. Group. Tri-annual reporting is permitted for certain S.M.E.'s when (i) the comparability analysis has been performed using publicly available information sources and (ii) the five comparability factors have not changed substantially. The five factors are the following:

- The contractual terms of the transactions
- The functions performed by each of the parties involved in the operations, taking into account the capital goods used and the risks assumed, including the way in which these functions relate to the broader generation of value within the M.N.E. group to which the parties belong, the circumstances that characterize the operation, and the customs of the sector
- The characteristics of the goods sold, and the services provided
- The economic circumstances of the parties and the market conditions in which they operate
- The business strategies pursued by the parties

The Existing Regulations provide that where the foregoing conditions are satisfied, an S.M.E. qualifies for tri-annual reporting when the S.M.E. meets the following two requirements:

- It has an annual turnover not exceeding €50 million
- It does not control any company with an annual turnover exceeding €50 million.

The New Regulations introduce a third condition that must be met in order to qualify for the benefit. The S.M.E. cannot be controlled by a company with an annual turnover exceeding € 50 million. The additional condition begins with the 2021 fiscal

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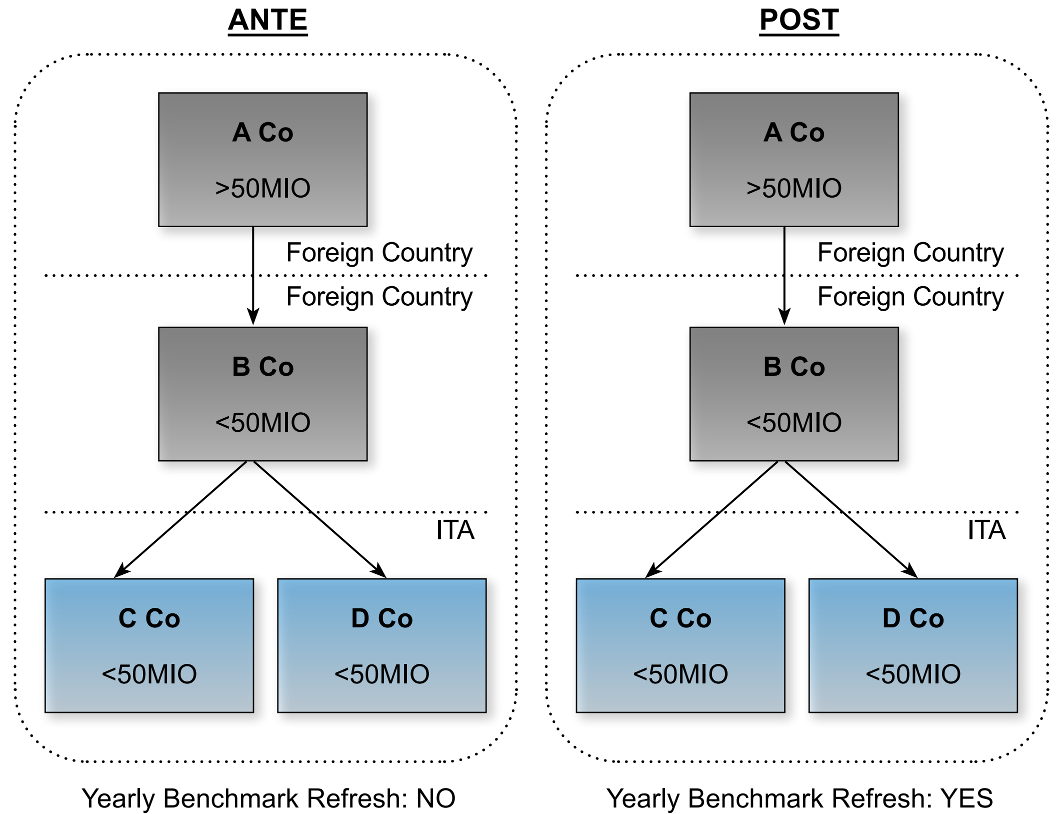
year. As a result, an S.M.E. owned by an M.N.E. likely will no longer qualify for tri-annual reporting. Benchmark analysis will need to be performed annually.

The difference in the requirement regarding annual benchmarking for an Italian S.M.E. owned by an M.N.E. is illustrated in the following diagram.



REVISIONS CONCERNING THE CONTENTS OF THE MASTER FILE AND LOCAL FILE

The New Regulations raises the level of information and data reporting in the Master File in order for an Italian company or permanent establishment to obtain penalty protection.

Master File

The Master File contains information relating to the M.N.E. group. The information must be presented in the manner provided by the New Regulations. Where the Italian company and the M.N.E. group carry on separate lines of business, with each line subject to its own specific transfer pricing rules, more than one Master File can be prepared. Where that occurs, taxpayers must submit the entire Master File for each business line in order to assure that an appropriate overview of the M.N.E. group's global business is provided. This requirement is consistent with paragraph 20 of B.E.P.S. Action 13.

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Each Master File must contain separate sections, one for each of the group's (i) value chain, (ii) intangibles, and (iii) financial transactions. It must also include specific items of additional information.

Value Chain Section

The section on value chain must include the important drivers of business profit so that the economically relevant activities that allow the group as a whole to generate value are identified. Here, it is important for the Italian company to consider carefully the information that is included. The information and data provided in this section can be used by the tax authorities to apply a profit split method to the intercompany transaction.

In this regard, paragraph 2.173. of the O.E.C.D. *Revised Guidance Profit Split* states that the M.N.E. group's Master File might be a useful source of information relevant to the determination of appropriate profit splitting factors. Indeed, the Master File should include information on the important drivers of business profit, the principal contributions to value creation by entities within the group, and key group intangibles used to generate profit. Consequently, the value chain section should describe the supply chain relating to the first five products and/or services of the group by turnover, plus any other products and/or services whose turnover exceeds 5% of the overall group turnover.

Intangibles Section

A second area of scrutiny in the Master File is that of intangibles. A general description must be included that explains the global strategy of the M.N.E. group for the development, ownership, and exploitation of intangible assets, including the location of main research and development structures and of the management of research and development activities. The description must include a list of intangibles with indication of the legal owner and of the important agreements related to those intangible assets.

Financial Transactions Section

The last section of the Master File is that of financial transactions. It should provide a general description of how the group is financed, with indication of important financing arrangements with unrelated lenders. Also to be included in this section are details on who performs centralized financial functions and the transfer pricing policy adopted for this type of transactions.

Specific Additional Information

Taxpayers must include enclose the annual consolidated financial statements of the M.N.E. group for the fiscal year concerned and a list and a short description of the advance pricing agreements ("A.P.A.'s") and advance cross-border rulings in place. The New Regulations specifically require that the latter be categorized by country and that the description must include scope, subject and validity.

Local File

The New Regulations address the Local File, and provides important changes which, in some regards, differ from the provisions of B.E.P.S. Action 13.

The New Regulations require general information about the local entity. Included are topics such as history, recent occurrences, and a general overview of the relevant markets. The taxpayer must identify the individuals within the M.N.E. group who oversee local management, specifying the location where those individuals are based. The information contains risks for the M.N.E. group because it can be used by the Italian Tax as evidence of the existence of a hidden permanent establishment of the foreign affiliate in Italy merely due to the reporting lines. The risk is that the business belongs to the foreign affiliate and the Italian company, as a dependent agent, is carrying on the business of the affiliate, thereby creating a permanent establishment in Italy for that affiliate. The ultimate conclusion is that Italian tax may be imposed on the foreign affiliate regarding its revenue from Italy.

In this regard, the Italian Revenue Agency have ruled out the possibility that the functional reporting of an Italian company to a foreign affiliate is automatically relevant in determining whether the affiliate maintains a permanent establishment in Italy where the affiliate is responsible for the production, marketing, and distribution activities of the M.N.E. group.[1]

The general section of the Local File also requires a description of the company's business and business strategy pursued including an indication as to whether the local entity has been involved in or affected by business restructurings or transfers of intangibles. A specific requirement of the Italian Local File is the request of information about the main competitors of the local entity, together with a description of the activities carried out by them.

The New Regulations request information that, in part, already is required by the Existing Regulations.[2] The taxpayer must provide the elements of the related party transactions, and the performance of the comparability analysis in order to accurately delineate the transaction. The elements of the transaction include the amount, parties, and any comparable third-party transactions. In addition, taxpayers must provide a description of the process for selecting the most appropriate method and related comparable transactions. In this regard, a multi-year analysis may be allowable. Italian practice has consistently allowed the use of multiple year data in order

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1 This is the position also taken by the Italian Tax Police in the Circular letter no. 1/2018.

> [I]t may be * * * physiological that local entities, in addition to being subject to the power of direction and control of the parent company, receive directives and are also recipients of policy indications from other subsidiaries that limit their independence also in terms of their operational management. For these reasons, the findings regarding a hidden permanent establishment (being a fixed place of business or an agency), in the presence of a legal entity resident for tax purposes in Italy and belonging to a multinational enterprise, must be carefully weighed and cannot, in any case, be based on the mere management dependency or lack of economic autonomy of the subsidiary, since these characteristics, as mentioned, can constitute aspects that are completely 'usual' in highly integrated structures.

2 A specific set of documentation is provided low value-added services. In order to use the simplified approach for the determination of arm's length charges in a controlled transaction involving low value-added services the taxpayer is required to prepare specific documentation which is consistent with that provided in the O.E.C.D. Guidance.

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to improve the process of selecting third-party comparables. However, the wording included in the New Regulations seems to allow for the use of multiple-year analysis also to obtain a complete understanding of the facts and circumstances surrounding the controlled transaction.[3]

A further change in the New Regulations allow the Italian Revenue Agency to request important assumptions made in applying the selected transfer pricing methodology and the indication of the effects deriving from their modification. The scope of this provision is not clear at this time. It may mean that the Italian Revenue Agency will seek information on any assumptions made in the context of transactions involving intangibles. Among the items of interest will be assumptions on valuation techniques, such as useful life of the intangible, projections of future revenue and future expense, and growth rate.

"A further change in the New Regulations allow the Italian Revenue Agency to request important assumptions made in applying the selected transfer pricing methodology and the indication of the effects deriving from their modification."

Finally, the New Regulations provide that the documentation should include copies of existing unilateral and bilateral/multilateral A.P.A.'s and advance cross-border rulings. In particular, A.P.A.'s and rulings must be attached even if they do not involve the local entity, but which are in any event related to the controlled transactions described in the local file. An example might involve an affiliate that licenses an intangible under the same conditions to both its Italian and Spanish subsidiaries, except that the license to the Spanish affiliate is the subject of a bilateral A.P.A. The potential downside of noncompliance with this provision is that it may result in the loss of protection from penalties added to a transfer pricing adjustment. Many advisers expect that a circular will be issued by the Italian Tax Authorities that limit the scope of the provision.

REVISIONS CONCERNING THE FORMAL REQUIREMENTS (LANGUAGE, ELECTRONIC FORMAT, AND TIME STAMP) AND DELIVERY DEADLINES

The New Regulations confirm that transfer pricing documentation must be prepared on an annual basis and in Italian except for the Master File, which may also be submitted in English. Once the Master File and the Local File have been completed, both must be signed by the taxpayer's legal representative or by a delegate by digital signature with time stamp affixed and date of submission of the tax return, which means that the documentation cannot be modified after submission. This documentation will need to be prepared by end of November. Several commentators have questioned whether subsidiaries of foreign-based M.N.E. groups will be able to acquire the necessary documentation on a timely basis prior to the date of filing income tax return.

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[3] This clarification could be relevant for the analysis of the effects of COVID-19. The Guidance on the transfer pricing implications of the COVID-19 pandemic published by the O.E.C.D. excludes the application of multiple-year data so long as

> * * * the data from independent comparables can be measured over a similar period in a consistent manner." In the remaining cases, which are certainly the most frequent, the O.E.C.D. states that "the use of combined periods (that include both years that are impacted by the pandemic and years that are not impacted) may improve reliability.

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It is unclear whether the time stamp must also be affixed to attachments, but arguments support a conclusion that attachments need not be stamped. In several places in the circular, the Italian Revenue Agency refer to the attachments as separate documents from the Master File and the Local File. This approach is consistent with a provision that prescribes a deadline of 20 days for the delivery of documents to the tax examiners. This time limit would be unnecessary as long as all the documents to be delivered are ready by the deadline for the tax return with the time stamp.[4]

All the documentation referred to in the present regulations must be submitted in electronic format.

PENATLY PROTECTION

The New Regulations specifies when the documentation is sufficient to protect a taxpayer from penalties arising from a transfer pricing adjustment. The documentation, data ,and information must be sufficient for the tax examiners to conduct a transfer pricing analysis. In contrast with the Existing Regulation, the Italian Revenue Agency place emphasis on data and information regarding the accurate delineation of transactions and the comparability analysis, including functional analysis.

Any disagreement between taxpayer and the tax examiner on the selection of the transfer pricing method adopted and on the search of comparables do not automatically affect the penalty protection. Similarly, any omissions or partial inaccuracies not material to the examination conclusions also are not relevant.

Finally, the New Regulations introduces the possibility for the taxpayer to prepare the proper transfer documentation for only a part of the transfer pricing transactions carried out. In such case, the penalty protection regime is applied exclusively to the transactions expressly described.

CONCLUSION

The New Regulations conforms Italian tax practice to B.E.P.S. Action 13 in a manner consistent with Italian tax practice in general. A significant amount of data must be provided on a timely basis in order for a taxpayer to benefit from penalty protection.

[4] Par. 5.2.1. of the New Regulations provides that the delivery of the documentation to the tax authorities must be made not later than 20 days from the relevant request.

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TAX COMPETITION BETWEEN MEMBER STATES OF THE EUROPEAN UNION – AN ACADEMIC VIEW

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Tags
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Globalization
State Aid
Tax Competition
Tax Policy

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INTRODUCTION

In May, the European Commission lost its second case in the E.U. General Court when Amazon's tax arrangement in Luxembourg was found to be onside as to rules prohibiting illegal state aid among Member States. In a companion case having a lesser amount in issue, the tax arrangement between Luxembourg and Engie, a French power company, was found to violate the illegal state aid rules in the E.U. Commissioner Vestager's record stands at two wins (Engie and Fiat) and three losses (Amazon, Apple, and Starbucks) at the E.U. General Court. Three investigations continue, involving Ikea and Nike in the Netherlands and Huhtamaki in Luxembourg. This article examines policy views that support Commissioner Vestager's position in attacking tax arrangements under illegal state aid rules.

THE ABSENCE OF A CENTRALIZED TAX POLICY LEADS TO FRAGMENTATION OF TAX SYSTEMS WITHIN THE E.U.

The rise of favorable tax rulings based solely on accepted tax concepts – without considerations of other factors – has disrupted the normal functioning of the tax systems of Member States. Historically, the role of a national tax system of a Member State was to fund government expenditures for the benefit of residents of that State. However, with globalization and the advent of unilateral advance pricing agreements ("A.P.A.'s"), the Member State's role in governing the economy has taken second seat to promoting the interests of multinational financial and business entities, with the expectation that jobs will be created as a bi-product. Because these A.P.A.'s often favor multinational groups based outside the Member State, they tend to favor nonresidents over residents and detract from the role of the state as a model of political unity within a community.

It is acknowledged that the economic strength of multinational enterprises competes with governmental power and has led to political pluralism. However, it has diminished the main function of a Member State as the sole political decision maker elected by the voters. The tax function is an example of decision-making that is no longer the exclusive province of governments of Member States or the governance structure of the E.U. Where the right to issue favorable A.P.A.'s on a selective basis solely belonged to the Member State, recent cases brought by the European Commission to address tax subsidies reflect limitations now applicable to the authority of Member States to use tax policy for the sole benefit of that State.

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THE DISCONNECT BETWEEN NATIONAL TAX POLICY AND PLURALISTIC VALUES WITHIN THE E.U.

The economic power of multinational financial and business entities has contributed to the diminished role of the national government in managing a country's economy. In the 20th Century, the tax system exclusively reflected goals of the government of each Member State. Tax policy reflected local needs. In a sense, this was true whether the government was formed by a party holding a majority in parliament or was a coalition formed by political parties have different constituencies. Granted, policies changed from time to time, reflecting the outcome of parliamentary elections. But either way, government policy was set by the elected government and its various constituencies within the Member State. In this context, the obligation to contribute to public expenses became a fundamental obligation of citizenship. Whether a resident voted for a political party in government or in opposition, the payment of taxes funded local goals.

In a liberal single-class State, legislative decisions are conceived in such a way as to reflect the homogeneous values of the ruling class. Government decision-making responsibilities are shared by political parties reflecting the view of the majority according to accepted guidelines of the national constitution. In comparison, in a modern multiclass state, a need exists to include the values of various classes and interest groups in political life.

The arrival of economically powerful multinational enterprises was accompanied by a shift of fiscal sovereignty in Europe from Member States to E.U. administrators. The issuance of Directives on Administrative Cooperation issued by the European Commission has reduced the role of Member States in making funding choices.

Nineteenth-century concepts regarding the rule of law led to the recognition of the inherent legitimacy of policy choices made by a parliamentary majority. This acceptance of majority rule, as an underlying philosophy, no longer exists. In a modern democracy that reflects a pluralistic society, legitimacy is based on shared values. The liberal state tax system was a legal instrument for achieving the objectives set by the ruling class. Inherently, the policy reflected the ideological convictions of society. The transition to a single policy center within the E.U. has undermined the connection between the tax system within a Member State and the values of the supporters of the majority party. Instead, E.U. mandated tax policy reflects a plurality of collective purposes and aims, and for that reason, often contradicts values in a particular Member State.

Stated simply, the 21st Century has witnessed the devolution of national tax systems within the E.U. into an E.U.-wide tax system that reflects its own values, often promoting a broader pluralist society designed to be homogeneous throughout the E.U.

TAX COMPETITION AMONG E.U. MEMBER STATES – IS IT HELPFUL OR HARMFUL?

The spread of globalization has had a significant impact on the mechanisms which shape the tax choices of Member States. Tax burden is an expense that directly or indirectly contributes to the pricing of a product. Corporate effective tax rates

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vary among Member States and tax burden has become an important factor when deciding the location for the next plant or value driver. Consequently, the choices made by Member States regarding effective tax rates affects a company's decision on where to locate production plants or other value drivers. While tax is only one of many factors that are considered by management, a Member State that has adopted a taxpayer-friendly tax system for companies has an advantage in attracting multinational companies to the Member State.

The illegal state aid cases brought by the European Commission serve as evidence of (i) the absence of mechanisms to regulate the behavior of companies seeking lower effective tax rates and (ii) the competition among certain Member States attempting to attract plants and value drivers by offering lower effective tax rates. The question posed is whether a Member State should be free to shape its tax system to meet its own goals related to employment and general welfare brought about through investments made by a particular multinational enterprise seeking lower effective tax rates.

At the level of the European Commission, the answer is straightforward. A Member State cannot offer an effective tax rate that is below the effective rate paid by its resident companies, whether based on reduced nominal rates or special deductions under an A.P.A. In policing this concept, the European Commission inherently attacks the independence of Member States to independently manage local tax policy, potentially creating local economic problems.

FASHIONING A COMPETITIVE TAX SYSTEM IN A MEMBER STATE

Tax competition between Member States is a decidedly recent strategy designed to attract capital and business to the territory of a Member State through use of an attractive effective rate of corporate income tax. A Member State that participates in this competition is called upon to configure a tax system capable of convincing multinational enterprises to establish production plants and value drivers within its territory. To be attractive, the effective rate must be lower than the average for all Member States in the E.U., possibly tending towards zero or close to zero.

A Member State participating in this strategy assumes that the establishment of companies and capital compensates for the low effective rate of tax through an increase in other benefits for the population. The benefits may include direct employment of employees, indirect employment of companies and self-employed individuals providing goods and services to the local branch established by a multinational enterprise, higher levels of consumption of consumer goods by residents, infrastructure development, and increases of available capital. The reduction in corporate income tax is offset by an increase in individual tax rates and collections of value added tax. It may also be offset by a reduction in the overall cost of unemployment benefits. In light of these anticipated benefits, offering a lower effective tax rate to a multinational enterprise does not damage the Member State or its residents. Rather, the opposite is achieved because of the stimulus of the national economy.

A different view is held by the European Commission. It views tax competition as a never-ending race to lower effective tax rates. Consequently, it proposes greater coordination of tax policies among Member States to prevent effective tax rates from being eroded in other Member States. The O.E.C.D. supports this approach. Both

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maintain the view that international tax competition penalizes Member States that do not participate in the competition, ultimately resulting in fiscal problems in those states.

MEMBERSHIP IN THE E.U. TRANSFERS FISCAL POLICY TO NEUTRAL E.U. ADMINISTRATORS

"The phenomenon of tax competition has long been the subject of advanced economic studies, in which the differential use of tax policy as a productive system growth lever has been analyzed."

The phenomenon of tax competition has long been the subject of advanced economic studies, in which the differential use of tax policy as a productive system growth lever has been analyzed. Studies typically focus on the economies of developing countries. By and large, the studies conclude that tax competition does not result automatically in market distortion. Rather, it is a legitimate tool of economic policy to the extent it promotes the development of certain business initiatives or investments through foreign capital that would otherwise be available in the country.

Beginning in the late 20th century, the notion of harmful tax competition among Member States developed, looking at tax competition as an inappropriate lever to distort normal market logic. Under this view, the harm results from the selective process of determining which industries will benefit from a reduction in effective tax rates. Certain activities were favored, typically the financial sector, and the beneficiaries were multinational companies, rather than companies involved in the local economy and its internal production system. In the end, benefits were given to revenue streams consisting of interest, dividends, royalties, rather than the production of goods for local consumption.

Whether due to the growth in economic power of multinational enterprises, or the rise of transnational advisory bodies such as the O.E.C.D., or the empowerment of centralized policy organs of the E.U., such as the European Commission, globalization diminished the role of Member States in setting tax policies. In a sense, pluralism overtook the central governing function of Member States as to economic policy decisions. The tax function no longer is identified with the central function of the Member State. The result is a fragmentation of the tax system into a plurality of systems, each responding to values expressed by the various legal systems. No single Member State has the power or authority to choose a path that is destructive to other Member States as determined by the governing agencies of the European Union.

In this context, the duty to contribute to public expenses is considered a responsibility connected to membership in the European Union. In terms of fiscal policy, paying taxes is a fundamental obligation of citizenship necessary for the survival of the European Union. The shift of fiscal sovereignty from the Member States to the various organs of the European Union has led to a profound transformation in the ethical concept of the tax system. The European Union is a multi-class community comprised of various cultures each with its own value system and interest groups that need to combine interests of majorities and minorities throughout the Community.

Nineteenth-century formation of the rule of law consisted of neutrality in respect to society in a single state, which led to t the validity of decision-making choices of a parliamentary majority. This has been overturned within the E.U. by the inclusion of pluralist communities in all Member States that share a common value system.

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Consistent with this transformation, all tax systems within the E.U. reflect an open structure that is not supported by the pre-eminence of values coming from a particular social class in any particular country. Instead, tax systems of member states reflect compromise solutions resulting from the political and social mediation of a plurality of demands emerging from various stakeholders throughout the E.U.

CONCLUSON

The spread of globalization and market approximation processes have limited the range of choices by Member States in regard to tax policy. Use of tax policy to make one Member State more attractive than another for the location of foreign investments is no longer acceptable. Rather, tax policy has become an instrument governing the allocation of foreign investment throughout the E.U. based on the combined needs of all Member States. The importance of greater coordination of tax policies among Member States prevents inappropriate distortions that erode the tax base of other States.

Increasingly, it can be argued that the tax system is the result of the concurrent action of a plurality of sources, located at the state, sub-state, and international levels. To the extent that divergent goals exist, the differences are addressed in the regulatory process that takes into account community-wide needs.

TAXATION IN INDIA AND THE U.S.: STAGES IN THE LIFE OF A U.S. OWNED INDIAN COMPANY

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INTRODUCTION

When a U.S. corporation expands its operations to India through formation of an Indian subsidiary, tax issues will need to be addressed at the various stages of the investment. This article discusses the Indian and U.S. tax consequences at each stage, beginning with formation and continuing through ultimate disposition.[1]

BACKGROUND

The basic facts are as follows:

- Mr. A is a U.S. citizen who runs a successful manufacturing business in the U.S. ("U.S.Co").
- He proposes expanding operations to India to take advantage of lower operating costs and a skilled workforce.
- U.S.Co forms a newly incorporated company in India ("IndiCo"). IndiCo is a private limited company which will be engaged in the business of manufacturing electric appliances in India.
- Under the U.S. default entity classification rules, IndiCo will be treated as an association taxed as a corporation for U.S. tax purposes.

STAGE 1: INVESTMENT INTO INDIA

Indian Tax Aspects When Making Investments Into India

While an investment of funds into India in return for the issuance of shares will likely not result in any income tax obligations in India, there are several factors that must be considered before entering the Indian market, such as the instrument issued to U.S.Co. in consideration for the investment and the value of investment.

Choice of Instrument

One of the key decisions for any investment is the type of instrument, or instruments, that will be issued by IndiCo, such as common shares, preference shares, convertible debt, and any other form of security. The decision is guided by various factors such as the long-term intention of the investor, the regulatory framework in India, and Indian tax rules.

[1] This article reflects rules in effect as of the date of publication. Major changes to U.S. tax law have been proposed by the Biden Administration. Those changes may have profound effect on much of the discussion contained herein.

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One option available to IndiCo is the issuance of a debt instrument. From the point of view of the company receiving the investment, the deductible nature of interest payments may make the issuance of debts attractive for tax purposes. This presumes that no limitations exist on the ability of IndiCo to claim a deduction for the entire amount paid or that IndiCo would report profits, but for the interest expense claimed as a deduction. From the investor's viewpoint, interest income will be taxable and, where the investor is a U.S. taxpayer, interest income is recognized as it accrues, even if no payment is received or the payor reports a loss without taking the interest into account.

Normally, interest expense that is reported in IndiCo's books of accounts is deductible for Indian tax purposes, provided (i) appropriate taxes have been withheld and paid over in India, (ii) the issuance of debt does not run afoul of the thin capitalization rules under the Indian Income Tax Act, 1961 ("I.T. Act"), and (iii) the decision of issue debt does not run afoul of the General Anti-Avoidance Rule ("G.A.A.R."). Under Indian thin capitalization rules, interest deductions are capped at 30% of adjusted profits. Under G.A.A.R., the tax benefit of an arrangement may be denied if it arises from an impermissible avoidance arrangement.

In comparison to the issuance of a debt instrument, IndiCo may issue equity in the form of shares of common shares or preferred shares. Dividends can be freely repatriated under the current exchange control regulations. Under the Indian law, dividends can be declared only out of current and accumulated profits, subject to certain conditions. Under the current provisions, dividend payout is not deductible for the payor and is taxable in the hands of the shareholders. The statutory tax rate is 20%, and both a surcharge and cess[2] may be imposed on a nonresident investor. The tax rate may be reduced under the applicable income tax-treaty.

Choice of Acquisition – Direct or Indirect Subsidiary

Investment in India can be made either directly or via an intermediate holding company ("I.H.C."). Investment from an I.H.C. provides the following benefits:

- It protects the parent company from liability.
- If the I.H.C. is formed in an intermediary jurisdiction and subject to tax laws in the investor's country of residence, it may allow funds to be accumulated at the I.H.C. level free of tax in the country of residence of the investor and may be used to make future investments abroad.
- It provides an asset base at I.H.C. level to facilitate the raising of external funds for future investment.
- In the past, it eased an exit from the sale of IndiCo by means of a sale of sale of shares of an I.H.C.

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[2] Surcharge is payable as a percentage of the income-tax payable. Currently, a foreign company with income in excess of INR 100 million is liable to pay surcharge at the rate of 5% on tax while foreign companies whose total income does not exceed INR 100 million (approximately $1.36 million as of September 10, 2021) but is greater than INR 10 million (approximately $136,000 as of September 10, 2021) are liable to pay surcharge at the rate of 2% on tax. Additionally, Health and Education Cess of 4% is levied on the aggregate of income-tax and surcharge.

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“Today, limitation on benefits provisions are in Indian tax treaties with the U.S., Mauritius, and Singapore.”

While the investor may have its own preference as to the location of the I.H.C., Singapore, Mauritius, and the Netherlands have been preferred jurisdictions in the past, due to the combination of attractive tax frameworks for holding companies and favorable tax treaties with India. Indian tax authorities view such sales as abusive and the Government has adopted an indirect transfer provision in the I.T. Act. Popularly known as the Vodafone tax, it provides that shares of, or interests in, a foreign entity is deemed to be situated in India where such foreign entity derives substantial benefit from India – computed in a prescribed manner. More than 50% of value must be derived from India for the tax to be imposed.[3]

Having strong commercial substance in the I.H.C.’s jurisdiction is essential in planning that is designed to reduce the exposure to the Vodaphone tax. Whether this is practical is an open question because, by definition, an I.H.C. may have been designed to be a special purpose vehicle to hold the investment in IndiCo. Building in functions for the I.H.C. may be a non-starter unless they are limited to managing only one investment, that being the investment in IndiCo.[4]

Today, limitation on benefits (“L.O.B.”) provisions are in Indian tax treaties with the U.S., Mauritius, and Singapore. India has also approved the ratification of multilateral instrument (“M.L.I.”) to implement tax treaty-related measures. Where approved by partner jurisdictions, India’s existing tax treaties could require a showing that obtaining a tax benefit was not one of the primary purposes for channeling an investment through a particular country.

Fair Value Requirement

Any investment in India is required to be tested to determine whether the value of the asset acquired – such as face amount of debt bearing specific interest or the value of shares issued – meets a fair value requirement. The Indian income-tax law lays down a computation mechanism for such fair value requirement. An investor is required to obtain a valuation report from a Chartered Accountant or Category-I Merchant Banker at the time of investment. Any investment that has a value below the value of the instrument issued is treated as taxable income for the investor. Ordinary income tax rates apply. The rules for valuation of equity shares consider the fair value of underlying assets, such as shares and securities, stamp duty value in case of immovable property, and book value for the other assets.

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3 In 2012, the Indian government enacted legislation allowing the tax authorities to impose tax retroactively on gains derived from an indirect sale of an Indian company. (The law was enacted several years after the transactions, but was made effective several years prior to enactment in response to adverse decisions in Indian courts.) The provision was challenged by Vodafone and Cairn Energy in arbitration under a bilateral investment treaty. Both companies won and the matters are currently on appeal. Recently, the Indian government has withdrawn the retroactive applicability of this law providing a relief to foreign investors.

4 An exception may exist for a Singapore corporation as the relevant income tax treaty deems a Singapore company to have substance ifs annual expenditure on operations in Singapore is at least S$200,000.

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U.S. Tax Aspects When Investing Into India

Contribution of Appreciated Property May Result in Gain Recognition to the U.S. Shareholder

Generally, the U.S. does not recognize any gain or loss if property is exchanged solely for stock of a corporation which is controlled by the transferor immediately after the exchange.[5] A person is said to control a corporation if the person owns stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation. However, the above nonrecognition provision does not apply in case of a transfer of appreciated property by a U.S. person to a foreign corporation, even if all conditions of code §351 are otherwise satisfied. The foreign corporation is denied corporate status. Consequently, nonrecognition of gain is denied because the benefit of Code §351 applies only to transfers to a corporation in return for the issuance of shares.[6] Because the transferee foreign corporation is not considered to be a corporation, the U.S. transferor must recognize gain on the appreciation in the contributed property. Certain exceptions apply to the recognition rule. The provision does not extend to losses. Such losses are not recognized if the transferee is a foreign corporation and all the conditions of Code §351 are met.

Default Entity Classification Rules

U.S. tax law contains default entity classification rules according to which a foreign entity is treated as a corporation by default, if all members have limited liability.[7] If the entity has two or more members and at least one member has unlimited liability, the default status is that of a partnership. The entity will be disregarded if it has a single owner that does not have limited liability.[8]

If an entity is an eligible entity because it is not listed in I.R.S. regulations as a *per se* corporation, an election may be made by the entity to choose a classification different from the default classification. The election is commonly referred to as a "Check-the-Box" election. It is made by filing Form 8832, *Entity Classification Election*. It may be noted that the default classification rules and check the box election are relevant only for U.S. tax purposes and it will not affect the tax treatment in the foreign country in which it is organized.

All entities making an election, must have a U.S. tax identification number. This applies to foreign entities as well as U.S. entities. Form SS-4, *Application for Employer Identification Number*, is used to obtain a U.S. tax identification number.

In the facts above, the Indian entity will be incorporated as a private company limited by liability and therefore it will default to a corporate status since its only shareholder, U.S.Co, has limited liability with respect to its debts. No check the election is made by U.S.Co.

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[5] Code §351(a).

[6] Code §367(a).

[7] Limited liability means no liability for the debts of the entity.

[8] Treas. Reg. §301.7701-3(b)(2).

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STAGE 2: TAXATION OF PROFITS OF INDICO

Indian Income Tax Consequences on the Operations of IndiCo

Under Indian tax law, the business profits earned by a domestic company is taxed on a net basis, after deduction of permissible expenses. The corporate tax rate ranges from 15% to 30%, plus applicable surcharge and cess, depending on several factors including, (i) nature of the company's business, (ii) the date of incorporation, (iii) the volume of turnover, and (iv) specified incentives and deductions claimed by the company.

In certain scenarios, IndiCo may be subject to tax on its adjusted accounting profits ("Book Profit"), if tax computed under normal profits is less than 15% of Book Profit. The term used for tax in this set of circumstances is Minimum Alternate Tax. ("M.A.T."). Such excess tax paid under M.A.T. over and above normal tax liability is allowed as a credit against IndiCo's normal tax liability for later years up to a maximum of 15 years under current law.

Income of IndiCo subject to U.S. Tax Under Two Separate Tax Regimes

U.S. tax law provides for the potential application of two anti-tax deferral regime in the context of a controlled foreign corporation ("C.F.C."). One is commonly known as Subpart F, which addresses income of a C.F.C. from intercompany transactions that are viewed to be abusive under U.S. tax law or income that is merely a passive of funds by a C.F.C. The other is Global Intangible Low-Taxed Income ("G.I.L.T.I.") that governs the operating income of the C.F.C. not otherwise subject to U.S. tax.

A C.F.C. is a foreign corporation in which "U.S. Shareholders" directly or indirectly own shares representing (i) more than 50% of the total combined voting power of all classes of stock entitled to vote or (ii) more than 50% of the total value of all issued and outstanding shares of stock.[9] A U.S. Shareholder is a U.S. person[10] who directly or indirectly owns shares representing (a) 10% or more of the total combined voting power of all classes of stock entitled to vote or (b) 10% or more of the total value of all issued and outstanding shares of stock.[11]

IndiCo is a wholly owned subsidiary of U.S.Co. Consequently, U.S.Co is a U.S. Shareholder of IndiCo and IndiCo is a C.F.C.

Transactions Viewed to be Abusive

A U.S. Shareholder of a foreign corporation generally is not subject to tax on the income of the corporation until the shareholder receives a distribution from the corporation. However, under Subpart F, certain types of income earned by a C.F.C. are currently included in the income of its U.S. Shareholders even if the C.F.C. does not distribute the income to its shareholders in that year.

One such type of income is Foreign Base Company Sales Income ("F.B.C. Sales Income"). For an item of income to be characterized as F.B.C. Sales Income, it

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[9] Code §957(a).

[10] A U.S. person includes, *inter alia*, a U.S. citizen, a lawful permanent resident of the U.S., an individual who meets the substantial presence test of determining residency, a U.S. corporation, and U.S. partnership.

[11] Code §985(b).

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must be derived by a C.F.C. from a purchase or sale of personal property involving a related party in which the goods are both manufactured and sold for use or consumption outside the C.F.C.'s country of organization. Such related party transactions are deemed to be tax motivated if the intermediary company is based in a low tax jurisdiction. If the intermediary company is subject to tax at an effective rate of 90% of the U.S. tax rate in effect for the year, the income arising from the purchase and sale of goods is not treated as F.B.C. Sales Income. Similarly, if the property is manufactured or sold for use or consumption in the C.F.C.'s country of organization, it cannot be F.B.C. Sales Income.

In determining whether an arrangement is abusive, U.S. law addresses transactions carried on through branches. The branch rule prevents a U.S. Shareholder from using a branch in lieu of a separate C.F.C. to shift sales income from a high-tax foreign country to a low-tax foreign country. Absent the branch rules, a C.F.C. and its branch would be treated as a single entity for U.S. tax purposes. However, when a C.F.C. carries on selling, purchasing or manufacturing activities by or through a branch outside its country of incorporation and the use of the branch has substantially the same tax effect as if the branch were a separate C.F.C., the branch and the remainder of the C.F.C. will be treated as separate corporations in determining whether the C.F.C. has F.B.C.S. Income from the sale of property. Generally, the branch and the remainder of the C.F.C. will be treated as separate corporations if the actual effective rate of tax of the branch is less than 90% of, and at least 5 percentage points below, the hypothetical effective rate of tax of the rest of the company.

A second type of income derived by a C.F.C. that results in immediate U.S. tax for a U.S. Shareholder is Foreign Base Company Services Income ("F.B.C. Services Income"). The rules for F.B.C. Services Income are intended to deny deferral when a U.S. Shareholder uses a C.F.C. to inappropriately shift services income from the U.S. to foreign jurisdictions or from a high-tax country to a low-tax country.

F.B.C. Services Income may take the form of compensation, commissions, fees, and other forms of payment for services. To be F.B.C. Services Income of a C.F.C., the income must be derived by a C.F.C. in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial or like services outside the C.F.C.'s country of organization for or on behalf of any related person.

Generally, services are considered to be performed where the persons doing the work are physically located when they perform the activities that generate the services income. The determination will depend on the facts and circumstances of each case. F.B.C. Services Income does not include income from services performed within the C.F.C.'s country of organization. However, in many cases, services are performed both within and outside the C.F.C.'s country of organization. In these circumstances, an apportionment is required to determine the amount of the income that is considered to be F.B.C. Services Income.

Typically, the total gross income of a C.F.C. that is derived in connection with services performed for or on behalf of a related person must be apportioned on the basis of time spent by employees of the C.F.C. performing the services within the C.F.C.'s country of organization and the time spent outside that country. In making the allocation, relative weight must be given to the value of the various functions performed by persons in fulfillment of the services contract or arrangement.

Passive Income Taxed as Subpart F Income

Items of passive income, such as interest, dividends, investment gains, royalties, and rents generated by a C.F.C. in a manner that is unrelated to the active conduct of a banking, licensing, or leasing company are considered to be items of Foreign Personal Holding Company Income. As with income from abusive transactions, Foreign Personal Holding Company Income of a C.F.C. will be subject to U.S. tax when and as generated by the C.F.C. Detailed rules have been adopted to distinguish when the above mentioned income and gains are derived in the active conduct of a trade of business by a C.F.C.

Taxation of a U.S. Shareholder

A corporate U.S. Shareholder is subject to a 21% tax on the Subpart F Income inclusion and is allowed an indirect credit for the foreign income taxes paid by the C.F.C. with regard to the income taxed under Subpart F.[12] An individual U.S. Shareholder, on the other hand, is subject to tax at ordinary rates of up to 37% and an indirect credit of the taxes paid by the C.F.C. on Subpart F Income in its country of incorporation is not allowed. However, the taxes paid by the C.F.C. reduce the earnings from the Subpart F Income and function as a deduction for the individual.

In the present fact pattern, IndiCo is an operating company and therefore predominantly earns income from its business operations. However, let's assume it earns interest income on the excess working capital invested in liquid investments in India. Per se, the interest income – which is not operating in nature – is Foreign Personal Holding Company Income, which is a type of Subpart F Income. Therefore the interest income will be taxed in the hands of U.S. Shareholders as Subpart F Income on current basis in the absence of an exception.

Two primary exceptions that are relevant to the present fact pattern are discussed below:

- *De minimis rule*[13] – If the aggregate of Subpart F Income is less than the lower of 5% of gross income or $1 million, none of the C.F.C.'s income is treated as Subpart F Income.[14]
- *High tax exception* – An item of income taxed at more than 90% of the highest U.S. corporate rate (*i.e.* 21% X 90% = 18.9%) in the country of incorporation is not Subpart F Income.[15]

IndiCo is incorporated in India which has a minimum corporate tax rate of 25% which is more than 18.9%. Assuming the computation of income and the timing or income recognition are materially the same for tax purposes in the U.S. and India, the interest income will not be treated as Subpart F Income under the High Tax Exception.[16] Alternatively, the interest income may also escape the Subpart F regime under the

[12] Code §960(a).

[13] Full inclusion rule, on the other hand, treats the entire gross income of a C.F.C. as Subpart F Income if more than 70% of the gross income constitutes Subpart F Income.

[14] Code §954(b)(3)(A).

[15] Code §954(b)(4).

[16] However, see the discussion on G.I.L.T.I. Income excluded from Subpart F under the High Tax Exception is nonetheless treated as G.I.L.T.I. income.

De Minimis Rule if the interest income together with other Subpart F Income is less than the lower of 5% of gross income of IndiCo or $1 million.

Operating Income Taxed as Global Intangible Low-Taxed Income (G.I.L.T.I.)

The 2017 Tax Cuts and Jobs Act introduced a new tax regime called G.I.L.T.I. that is applicable to U.S. Shareholders of a C.F.C. Although, labeled as a tax on intangible income, the G.I.L.T.I. tax is, in effect, a tax imposed on U.S. Shareholders of a C.F.C. on their share of any income earned by the C.F.C. that is not otherwise subject to U.S. tax in one form or another.

The G.I.L.T.I. regime follows an elimination method to tax the income of a C.F.C. In broad terms, the computation begins with the gross income of the C.F.C. for the current year. Next, the gross income is reduced by current income that is already subject to U.S. tax under other provisions of the Code, such as (i) Subpart F Income, (ii) income that is effectively connected with a U.S. trade or business carried on by the C.F.C., (iii) income that is excluded from Subpart F under the high-tax exception, and (iv) dividend income received from related C.F.C.'s formed in the same country as the C.F.C. receiving the dividend. The residual income of the C.F.C. is subject to a series of adjustment and is taxed at an effective tax rate of 10.5%[17] when the shareholder is itself a corporation. A corporate shareholder is entitled to an indirect credit, but the credit is limited to 80% of the foreign income tax paid on the net G.I.L.T.I. taxable income of the C.F.C. An Individual shareholder is subject to ordinary tax rates of up to 37% without any benefit of indirect foreign taxes paid by the C.F.C.

"The residual income of the C.F.C. is subject to a series of adjustment and is taxed at an effective tax rate of 10.5% when the shareholder is itself a corporation."

Taxation of Subpart F Income and G.I.L.T.I. income have several similarities. Similar to the Subpart F provisions, the income subject to the G.I.L.T.I. provisions is taxed in the hands of U.S. Shareholders in the year earned even if the C.F.C. does not distribute the income to its shareholders on a current basis. In other words, unless an exception applies, the entire income of a C.F.C. is fully taxed in the U.S. on a current basis under the following categories:

- Subpart F Income
- G.I.L.T.I. Income
- Effectively connected income

Like Subpart F, the G.I.L.T.I. regime is also subject to a high tax exception (the "G.I.L.T.I. High Tax Exception"), which, if available and elected, excludes G.I.L.T.I. income from current tax rules. The G.I.L.T.I. High Tax Exception is available if the income is taxed in the country of incorporation at an effective rate that is 90% or more of the U.S. corporate tax rate (*i.e.* 21% X 90% = 18.9%). Income that is excluded from Subpart F under the Subpart F De Minimis Exception discussed above is subject to the G.I.L.T.I. tax regime.[18]

In the present fact pattern, IndiCo is an operating company engaged in the business of manufacturing electric appliances in India. Therefore, subject to the application of the G.I.L.T.I. High Tax Exception, the income of IndiCo that is not otherwise subject

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[17] The income tax rate on G.I.L.T.I. is set increase to 13.125% effective Jan 1, 2026.

[18] Treas. Reg. §1.951A-2(c)(4)(iii).

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to U.S. tax under other provisions of the Code will be subject to the G.I.L.T.I. Tax. As discussed above, India has a minimum corporate tax rate of 25% which is higher than 18.9%. Therefore, if the G.I.L.T.I. High Tax Exception is elected,[19] the G.I.L.T.I. income will not be subject to G.I.L.T.I. tax in the U.S., if the computation of income and the timing or income recognition are materially the same for tax purposes in the U.S. and India.

STAGE 3: REPATRIATION OF PROFITS BY INDICO

Indian Tax and Other Aspects When Repatriating Funds to the U.S.

At this stage, the investor looks to repatriate funds from the target entity to its home jurisdiction on an annual basis. However, repatriation of funds may trigger a tax in India. An investor must consider the following factors for repatriation of target profits from India.

Mode of Repatriation

Each mode of repatriation has its own pros and cons, and an investor must be mindful when selecting the method of repatriation. Typically, funds are repatriated to investors by way of dividends, interest, royalties, fees for technical services ("F.T.S."), or a return of capital ("Buy-Back").

While payments of interest, royalties, and F.T.S. may provide benefit in the form of tax deduction for the Indian target, they are subject to certain caps under the Indian transfer pricing law, must have commercial justification, and meet an arm's length test. In addition, interest payments are not deductible if the subsidiary making the payment is thinly capitalized. The deduction for interest paid to related parties cannot reduce net profit before interest income and expense by more than 30%.

Indian Withholding Tax Requirement

Under Indian tax law, any payment to a nonresident is subject to withholding tax. Under the I.T. Act, interest payments are subject to withholding tax imposed at rate ranging from 5% to 40% depending on factors such as currency of borrowing, nature of instrument, and type of investor. The tax is increased by the applicable surcharge and cess. In comparison, dividends are subject to flat withholding rate of 20% plus applicable surcharge and cess, and royalties, and payments of F.T.S. are subject to flat withholding rate of 10%, plus applicable surcharge and cess.

The above rates of withholding may be reduced under an applicable income tax treaty. Under the India-U.S. Income Tax Treaty, the rates of withholding taxes are reduced as follows:

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19 The G.I.L.T.I. High Tax Exception applies only if the U.S. Shareholder of a C.F.C. elects the application of the exception. The election is made by the majority shareholder and is made at a corporate level which implies that the election is applicable on minority shareholders, as well. The election is made by attaching a statement to the shareholder's U.S. Federal income tax return informing the I.R.S. of the election.

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- For dividends, the rates are 15% where the shareholder is a U.S. corporation that holds shares representing at least 10% of the voting power in the target. In other cases, the tax rate is 25%.
- For interest payments, the rates are 10%, if the lender is a financial institution, and 15% in all other cases.
- For royalties and payments of F.T.S., the treaty rate is 15%, but the rate under domestic law is 10% plus applicable surcharge and cess.

To claim benefits under a tax treaty, an investor must be the beneficial owner of the income. This is determined under a fact-based exercise and requires detailed evaluation of various factors. It becomes more critical in case of I.H.C. structures.

Transfer Pricing Aspects

According to the Indian transfer pricing regulations, any income arising from an international transaction carried on between two or more associated enterprises ("A.E.'s") is computed under the principle of an arm's length price ("A.L.P."). Generally speaking, parties are treated as A.E.'s if one has the power to exert control over the other. In the context of a corporate structure, enterprises would be considered to be associated if any person or enterprise directly or indirectly holds shares carrying 26% or more of the voting power in each of the enterprises.[20] Thus, any transaction between an Indian target and its foreign sole shareholder must be carried out on an arm's length basis in order to be deductible. The I.T. Act prescribes specific methods for determining the A.L.P.

The Indian transfer pricing law also includes provisions relating to secondary adjustments, which provides that if the primary adjustment is not remitted to India within the prescribed time, the unremitted amount is deemed to be a form or loan or advance made to the foreign A.E. and deemed interest accrues on the deemed advance.

In addition, robust documentation in support of transfer prices must be maintained. The law provides for the filing of transfer pricing certification reports (Form 3CEB is an example). Any expenditure incurred in excess of an A.L.P. is not tax deductible. Similarly, where A.L.P. in a transaction with a foreign A.E. produces a loss for an Indian customer, the A.L.P. deemed to be zero.

Finally, like the I.R.S. in the U.S., the tax authorities in India have a robust mechanism in place for obtaining Advance Pricing Agreements to provide tax certainty in relation to transfer pricing matters.

U.S. Taxation of Distributions From a C.F.C.

As discussed above, Subpart F Income and G.I.L.T.I. are subject to U.S. tax in the hands of a U.S. Shareholder in the year in which a C.F.C. generates income. Absent the following rule, this previously taxed income ("P.T.I.") could be taxed again in the hands of the U.S. Shareholder at the time of an actual distribution. Code §959(a) prevents such double taxation by excluding the distributions of P.T.I. from gross income upon actual distribution.

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[20] Section 92 of the I.T. Act.

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Owing to multiple types of P.T.I. (*e.g.*, Subpart F, G.I.L.T.I., and Transition Tax), the Code provides for a specific order in which distributions are deemed to be made out of the earnings and profits ("E&P") of a C.F.C. Generally, the distributions are made under the Last-Inn First-Out method, which implies that the distributions are first made from E&P of the current year and then from the E&P of the immediately preceding year, and so forth until fully exhausted. Moreover, E&P of each year is further divided into the following categories and a distribution is sourced in the following order:

- Previously taxed earnings and profits ("P.T.E.P.") attributable to investments in U.S. property.[21]
- P.T.E.P. attributable to Subpart F Income, G.I.L.T.I. income, and Transition Tax.[22]
- General current and accumulated E&P ("non-P.T.E.P."). This category includes income not subject to tax in the U.S. on account of, *inter alia*, making a high tax exception election to the G.I.L.T.I. income or Subpart F Income, etc.

Distributions that are deemed to be made from the first two categories are not subject to U.S. tax because the income was subject to U.S. tax previously in the hands of a U.S. Shareholder in the year in which the C.F.C. earned the income. Nonetheless, a distribution of P.T.I. may be subject to withholding at source since distributions typically will be treated as dividend to the C.F.C.'s shareholder in the source country.

U.S. taxation of distributions deemed to be made from Category 3 (non-P.T.E.P.) depends on the corporate status of the shareholder. A corporate U.S. Shareholder of a C.F.C. is entitled to a 100% deduction of the foreign-source portion of any dividend received from that C.F.C. ("100% D.R.D.").[23] The foreign-source portion of a dividend generally is the portion of the dividend that is attributable to the non-P.T.E.P. (*i.e.*, distributions deemed to be made from Category 3) of the C.F.C. In other words, a distribution from a C.F.C. that is deemed to be made from non –P.T.E.P is fully exempt by reason of the 100% D.R.D. in the hands of a corporate U.S. Shareholder. Further, the corporate shareholder is not allowed a credit for any foreign taxes paid or accrued with respect to the dividend to which the 100% D.R.D. applies.[24]

A corporation must satisfy the following requirements to qualify for the 100% D.R.D.:

- The corporate shareholder must meet the definition of a U.S. Shareholder, as discussed above.
- The corporate shareholder must have held the stock with respect to which the dividend is made for more than 365 days during the 731-day period beginning 365 days before the date on which the stock is given ex-dividend status.[25]

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[21] Code §959(c)(1).- Investment in U.S. property is not the main focus of this article and therefore has not been discussed here.

[22] Code §959(c)(2).

[23] Code §245A(a).

[24] Code §245A(d)(1).

[25] Code §§246(c)(1)(A), 246(c)(5)(A).

- The foreign corporation must be a specified foreign corporation and the corporate shareholder must be a U.S. Shareholder with respect to that foreign corporation at all times during the period of 365 days.[26]
- The U.S. Shareholder has not diminished its risk of loss through various option arrangements.[27]

An individual shareholder receiving distributions from Category 3 E&P of a C.F.C. is treated as receiving taxable dividends that are subject to preferential tax rate of up to 20% when the dividend is a qualified dividend. For a C.F.C., the dividend would be qualified if the U.S. has an income tax treaty in place with the country of incorporation.[28] In the absence of a treaty, the distribution is taxed at ordinary rates of up to 37%. The individual recipient is allowed to claim a foreign tax credit for foreign taxes withheld from the dividend by the source country. The credit is subject to various limitations of U.S. tax law. Additionally, the Net Investment Income Tax ("N.I.I.T.") of 3.8% is imposed on individuals who receive the dividend directly or through tax transparent entities provided certain income thresholds are exceeded. The N.I.I.T. cannot be reduced by the foreign tax credit for withholding taxes imposed by a foreign country.

In the present fact pattern, U.S. taxation of distributions will depend on several factors, including

- whether IndiCo generates Subpart F Income;
- if so, whether De Minimis Rule or the Subpart F High Tax Exception is applicable; and
- whether the G.I.L.T.I. High Tax Exception is elected.

If the income of IndiCo is not taxed on a current basis (either under Subpart F or G.I.L.T.I. regime), the actual distributions that have not been taxed previously will be deemed to have been distributed from Category 3 E&P (non-P.T.E.P.). Those dividends will enjoy the 100% D.R.D., if applicable, as a result of which the profits of IndiCo will be fully exempt from tax. On the other hand, if the income of IndiCo is treated as Subpart F Income or G.I.L.T.I. Income, U.S.Co will be taxed in the U.S. on a current basis at the rate of 21% or 10.5%, respectively. A subsequent actual distribution to U.S.Co will not be subject to tax in the U.S. to the extent it is treated as a distribution of P.T.I. by virtue of Code §959.

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[26] Code §246(c)(5)(B).

[27] Code §246(c)(4).

[28] Code §1(h)(11)(C)(II).

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STAGE 4: EXIT FROM INDIA

Indian Tax and Other Aspects on Exiting India

Mode of Exit

An exit can take the form of a simple share transfer, a slump sale,[29] or the liquidation of IndiCo. Under Indian tax law, capital gains earned by a nonresident investor from transfer of assets based in India, including shares of an Indian company, are taxed at a rate ranging from 10% to 40% (plus surcharge and cess), depending on the period for which such assets were held prior to transfer and the type of asset transferred. The tax treatment of the gain realized by a foreign investor may be modified under an applicable income tax treaty. However, tax treaties that have been entered with the U.S. and the U.K. do not provide any relief from Indian capital gains tax.

Valuation Requirement

In respect of certain assets, the Indian income tax law has specific valuation norms and prescribed valuation mechanisms under which the acquisition of assets for less than inadequate consideration could result in tax implications for the acquirer. Recently, such provisions have also been made applicable to slump sale transactions.

From the seller's perspective, the valuation aspect is critical as there are statutory provisions in India's domestic tax law (Section 50CA) that tax the seller on deemed consideration in certain cases.

Thus, sufficient care should be taken to ensure that the valuation aspect of a transaction is handled appropriately, so that there are no adverse income-tax implications for either of the parties.

Successor Liability Risk

Under the Indian income-tax law, there is a risk that upon acquisition of a business, the buyer, as a successor, would inherit the tax liabilities, if any, of the seller. This risk is triggered in cases where the transferor cannot be found or where any tax liability is not recoverable from the transferor, for example, on account of inadequacy of assets.

When the provision is triggered, the buyer may be held liable for the tax liabilities of the transferor for a specific period, typically the financial year in which the transfer of the business takes place and the immediately preceding financial year. Thus, a purchaser must confirm the seller's ability to meet its tax liability.

Clearance From Income-Tax Authorities

In the case of pending tax proceeding against the transferor, the Indian tax authorities have the power to declare a transfer of certain specified assets as void, where such transfer takes place without a prior approval of the jurisdictional tax officer. In this regard, the Indian income-tax law provides a mechanism for obtaining a tax clearance certificate for the transfer of business assets. In secondary transfers

[29] In India, a slump sale is the transfer of an undertaking as a whole for a lumpsum consideration without considering values of individual assets or liabilities contained within the undertaking. That said, for the purpose of merely determining stamp duty or other similar taxes, individual values may be of relevance.

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of business assets, this can become a point of negotiation between the parties because tax clearance certificates can be a time-consuming process. Hence, this aspect should be discussed early in deal negotiation to assess whether mere contractual covenants would suffice.

Tax Indemnities

Merger and acquisition transactions have been steadily growing in India and some of the most highly negotiated provisions are those relating to indemnities in case of breach of representations and warranties. In a secondary transfer, the purchaser takes over the target company together with all its related liabilities, including contingent liabilities. Hence, the purchaser normally requires more extensive indemnities than in the case of an asset acquisition. From a seller's perspective, globally there has been a rapid growth in the use of representations and warranties insurance ("R.W.I.") in relation to these transactions in order to avoid the out-of-pocket costs arising from an unforeseen liability. This has become a popular alternative to an indemnity under an S.P.A. or where indemnity is capped.

"When significant sums are involved, it is customary for the purchaser to initiate a due diligence exercise. Normally, this would incorporate a review of the target's tax affairs."

An alternative approach is for the seller's business to be transferred into a newly formed entity, so the purchaser can take on a clean business and leave its liabilities behind. Such a transfer may have tax implications. When significant sums are involved, it is customary for the purchaser to initiate a due diligence exercise. Normally, this would incorporate a review of the target's tax affairs.

U.S. Taxation of Disposition of Stock in IndiCo

Generally, any gain arising from a sale of stock of a corporation is treated as capital gain in the hands of the seller.[30] In the context of a C.F.C., Code §1248 requires the gain recognized by a U.S. Shareholder on the sale, exchange, redemption of stock, or liquidation of a foreign corporation to be treated as a dividend to the extent of the C.F.C.'s E&P that have not been taxed previously in the U.S.

Code §1248 provides parity of tax treatment for U.S. Shareholders who sell C.F.C. stock in the following two fact patterns:

- In the first, the C.F.C. is a corporation that distributes dividends regularly, providing its U.S. Shareholders with a stream of potentially taxable dividends as provided under U.S. tax law in effect at the time. When the stock of the C.F.C. is sold, the gain reflects solely the increase in value of the business of the C.F.C.
- In the second fact pattern, the C.F.C. is a corporation that accumulates its profits and pays no dividends. When the stock of the C.F.C. is sold, the gain reflects both the increase in the value of the C.F.C.'s business and the retained cash earnings.

In a system where long-term capital gains are taxed at a more favorable tax rate, as was the case in 1962 when Code §1248 was enacted, the second fact pattern resulted in more favorable tax treatment.

The gain is characterized into dividends if, at some time during the five-year period preceding the disposition, the corporation was a C.F.C. while the U.S. Shareholder

[30] Code §1001.

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owned (directly, indirectly, or constructively) shares of stock representing at least 10% of voting power of all shares of the corporation. Although the shareholder's 10% ownership must have coincided with the corporation's status as a C.F.C., Code §1248 applies even though one or both of these conditions is not satisfied when the gain is realized.

In determining the amount of E&P that will cause gain from the sale of shares to be treated as dividends under Code §1248, E&P that was previously included in the shareholder's gross income under Code §951 (*i.e.*, Subpart F and G.I.L.T.I.) and E&P from income that was effectively connected to the conduct of a U.S. trade or business carried on by the foreign corporation are excluded.

The gain treated as a dividend under Code §1248 enjoys the 100% D.R.D. under Code §245A. Hence, it is exempt from U.S. tax for a U.S. corporate seller.[31] Therefore, repatriation of the proceeds from the sale of a C.F.C. into the U.S. can be effected without any U.S. tax, although the gain may be subject to tax in India. The U.S. corporate seller will not be allowed a credit for the Indian taxes in the year of sale or future years.[32] In case of an individual U.S. Shareholder, the gain characterized as dividends are subject to U.S. tax at the rate of up to 20% or 37% (depending on whether the U.S. has signed an income tax treaty with the country of incorporation). The N.I.I.T. of 3.8% is also imposed on the gain in case of an individual shareholder.

CONCLUSION

Based on the above discussion, a parent-subsidiary structure to carry out business in India may result in a zero tax liability in the U.S. in the hands of the U.S. parent. If rules applicable to the computation of income and the timing of recognition of income and expenses are materially identical in both countries, the application of the Subpart F and G.I.L.T.I. H.T.E. could apply to U.S.Co as the Indian corporate tax rate is higher than 18.9%. Where all such factors coalesce, should not be subject to tax on Subpart F Income or G.I.L.T.I. Income in the U.S. on a current basis. As a consequence, any distribution from IndiCo will be treated as being distributed from non-P.T.I. earnings. This distribution will be exempt from U.S. tax if the 100% D.R.D. under code section 245A is available.

As a result, a U.S. investor can carry out business in India and repatriate business profits without incurring any addition U.S. tax. However, any dividend distribution by the U.S. parent to its shareholders will be subject to U.S. tax at the rate of up to 20% if the shareholder is a U.S. citizen or resident or 30% if the shareholder is not a U.S. person and is not entitled to treaty benefits.

U.S.Co will be required to annually file a Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*, to report its ownership interest in the Indian subsidiary and certain financial information of the Indian company to the I.R.S.

On the Indian side, the business profits of the Indian company will be subject to a minimum corporate tax of ~25% on net profits. Any distribution to the U.S. parent from its E&P will be treated as a dividend subject to a withholding tax of 15% (under the India-U.S. income tax treaty) in India.

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[31] Code §245A(a)(1).

[32] Code §245A(d)(1).

SWISS UPDATE ON TRUST REGULATION AND TAXATION

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Tags
Administrative Assistance
Switzerland
Tax
Trust

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INTRODUCTION

Trusts have been and still are of great importance to advisors all over the world. Even though trusts are mostly found in common law systems (*e.g.*, U.S.A.), several civil law jurisdictions have implemented the concept of trusts (*e.g.*, Liechtenstein). In practice, trusts are often used for international tax and/or estate planning as well as for asset protection.

Put simply, a trust is created by a settlor who transfers some or all of his or her assets to a trustee. The trustee holds title to the property in trust for the benefit of the beneficiaries. The trust is governed by a trust deed and other accompanying documents which stipulate the terms and conditions and the applicable law. Trust law may differ from jurisdiction to jurisdiction, with each jurisdiction assigning varying rights and duties to the trustee.

To date, there is no Swiss trust or Swiss trust law. However, Switzerland recognizes the concept of a trust since adopting the Hague Trust Convention, which entered into force in 2007. Following that, Switzerland has enacted rules on how to treat foreign trusts for tax purposes and for registration purposes in the land register. There have been several attempts to enact a Swiss trust law.

In addition, since January 1, 2020, trustees may fall under the new law regulating the business of Financial Institutions including trusts. The question of which trustees fall under the new law as well as what the regulation includes is dealt with below.

This article discusses the current status of an introduction of a Swiss trust law, provides an overview of taxation of trusts in Switzerland, and addresses administrative assistance in tax matters in connection with trusts and their beneficiaries.

INTRODUCTION OF A SWISS TRUST

In Swiss politics, there have been several attempts to introduce a Swiss trust law. However, these have been rejected to date or have not yet been successfully finalized.

Supporters of a Swiss trust law argue that adoption of a domestic provision will strengthen Switzerland's status as a financial center. It will ensure a level playing field with foreign jurisdictions and eliminate competitive drawbacks. Opponents argue that it would be difficult to introduce a Swiss trust law because the differences between common law and civil law cannot be reconciled without major adjustments. It is also suggested that the admission of the family maintenance foundation would be a possible alternative. The need for legal adjustments would be smaller than in the case of the introduction of a Swiss trust.

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As of today, several procedures are running in parallel, which could lead to a Swiss trust law:

- In 2016, a member of the Swiss Parliament proposed an elaborate procedure with the title “Incorporation of the Legal Institute of Trusts into Swiss Legislation.” The responsible committee in parliament would like to follow this proposal, but enactment was postponed. It is expected that the National Council (First Council) will consider this proposal in the spring of 2022.
- In 2018, the Swiss Federal Council was instructed by a committee of the parliament to create the legal basis for a Swiss trust. A group of experts appointed by the Federal Office of Justice has been working on regulation proposals since June 2018. The tax treatment or adjustments of the existing taxation rules are being clarified by a working group of the Federal Tax Administration and other stakeholders. In addition, the Federal Council was authorized to prepare a report on the advantages and disadvantages of a possible introduction of the legal concept of trusts into Swiss private law.

There is still a long way to go before a Swiss trust could become a reality. We believe that a Swiss trust certainly has potential. Of course, implementing a concept that is not familiar to civil law is procedurally difficult. Nonetheless, with adoption of appropriate adjustments, implementation should be possible. We see the major advantage in the fact that succession planning can be reflected in one jurisdiction. In a globalized world, simplifying the number of jurisdictions involved in creating and managing a trust makes sense.

REGULATION OF TRUSTEES

Prior to 2020, trustees were generally not regulated in Switzerland. However, trustees are generally obligated to comply with the Swiss Anti-Money Laundering Act.

As of January 1, 2020, Switzerland enacted the Financial Institution Act (“FinIA”) which regulates the supervision of financial institution, as defined by the law. The main goal of this regulation is the protection of customers.

Financial institutions include, in particular, asset managers, fund management companies as well as trustees. All must be approved by the Swiss Financial Market Supervisory Authority (“S.F.M.S.A.”). Trustees domiciled or resident in Switzerland who operate in Switzerland or from Switzerland fall under the new law. Foreign trustees are subject to the FinIA if they have a branch in Switzerland, establish a permanent establishment here, or are factually managed in Switzerland. In summary, all trustees with a nexus to Switzerland need must determine whether if they fall under the FinIA.

In practice, existing trustees were required to notify S.F.M.S.A. of their presence in Switzerland within six months after entry into force of the, *i.e.*, end of June 2020. Further to that, they must comply with all requirements by end of 2023 and submit a license request to S.F.M.S.A.

The definition of a trust for purposes of Swiss law refers directly to the Hague Trust Convention. Accordingly, a trust means a legal arrangement created by a person, the settlor, applicable during life or as a result of death, in which assets have been placed under the supervision of a trustee for the benefit of a beneficiary or for a

particular purpose. A trustee is a person who, on the basis of a trust deed within the meaning of the Hague Trust Convention, professionally manages or disposes specified assets for the benefit of the beneficiaries or for a specific purpose.

Trustees are deemed to act professionally in any of the following circumstances:

- They generate gross proceeds of more than CHF 50,000 per calendar year.
- They enter into business relations with more than 20 contracting parties per calendar year.
- They have unlimited control over third-party assets exceeding CHF 5 million at any time.

It is not entirely clear if the last alternative (assets exceeding CHF 5 million) is applicable to trustees at all, since one could argue that trusts hold their own assets rather than third-party assets. The law also stipulates some exceptions that apply. For example, for trustees who only manage assets of family members that are related to the trustee or, relatives, spouses or persons who live with the trustee in a long-term relationship are treated as family members.

Protectors may also be subject to FinIA depending on the powers granted to the protector. Generally speaking, where the powers of a protector are similar to a trustee, it is likely that the protector will fall under the new law. Since FinIA is directly linked to the definition of trust, there should be no room to also include board members of foundations under the new regulation.

In order to be licensed by S.F.M.S.A., a trustee must fulfill an extensive list of requirements including

- the adoption of written corporate governance rules,
- the implementation of risk management and internal control systems,
- the maintenance of a minimum capital of CHF 100,000,
- the maintenance of professional indemnity insurance,
- proof of professional qualification, and
- arranging for a yearly external audit.

A trustee that fulfills all requirements is entitled to a license.

By regulating trustees with nexus to Switzerland, the interests of settlors and beneficiaries are protected. At the same time, trustee activity in Switzerland becomes more complex and costly to provide. It is expected that certain trustees with domicile in Switzerland will no longer act as trustee based on the compliance costs involved.

TAXATION OF TRUSTS IN SWITZERLAND

In Swiss tax law, there is no legal basis to consider a foreign trust as being subject to Swiss tax on global income. Trusts are covered in Switzerland by the Hague Trust Convention and for tax purposes by Circular 30 of the Swiss Tax Conference of August 22, 2007. The trust assets are attributed to the settlor or the beneficiaries. It

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should be noted that, despite the existence of a circular, cantonal practice may vary considerably. The following information serves as an overview.

Trust With No Nexus to Switzerland

If the settlor as well as the beneficiaries are not resident in Switzerland and the trust assets do not include any Swiss real estates, there are generally no Swiss tax consequences.

Swiss Withholding Tax

Due to the lack of legal personality, a trust cannot reclaim Swiss withholding tax. At most, the Swiss resident settlor or the beneficiaries can reclaim the withholding tax, provided they are considered to be beneficial owners. In some Swiss double taxation treaties, the trust is mentioned, which is why a refund of the withholding tax based on the double taxation agreements may be possible under certain circumstances.

Where a trust structure holds Swiss assets – such as shares – a question arises as to how and to what extent Swiss withholding taxes may be refunded. The refund depends on the applicable double taxation agreement as well as on the type of the trust.

Transfer of Swiss Real Estate to a Trust

Where real estate is transferred to the trust structure, it should be checked if an entry in the land register will be accepted by the cantonal authority, and if it is, the possibility that real estate gain tax consequences will result from the transfer.

Income, Wealth, Gift and Inheritance Taxes

"If the settlor as well as the beneficiaries are not resident in Switzerland and the trust assets do not include any Swiss real estates, there are generally no Swiss tax consequences."

If the settlor or the beneficiaries are resident in Switzerland, a distinction must be made according to the type of trust. The decisive factor for the classification is not the designation in the trust deed, but the actual structuring of the settlor's control rights. The rights of the settlor should be analyzed not only on the basis of the documents, but also how they are actually practiced.

Swiss tax law simplifies the possibilities of structuring trusts and has defined three different types of trusts:

- Revocable trust
- Irrevocable fixed interest trust
- Irrevocable discretionary trust

For a revocable trust, there are no tax consequences on establishment, because the assets continue to be attributed to the settlor with domicile in Switzerland. Consequently, the settlor must continue to pay taxes on the income and assets of the trust. In addition, distributions to the beneficiaries may be subject to cantonal gift tax. Finally, the tax effect of the demise of the settlor should be analyzed prior to the creation of the revocable trust. Depending on the cantonal law and practice, a trust may become an irrevocable discretionary trust at the time of the settlor's death which may trigger the imposition of substantial inheritance taxes.

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Upon the establishment of the irrevocable fixed interest trust, a gift is assumed and may be subject to gift tax as the assets are no longer attributable to the settlor. Beneficiaries must pay wealth tax on their share of the trust assets. Distributions to the beneficiaries constitute taxable income. Capital gains in private assets and the distribution of the contributed trust capital do not constitute taxable income. In practice this type of trust is rather seldom encountered. Detailed proof is required for a tax-free distribution of capital gains.

Where an irrevocable discretionary trust is established with the settlor domiciled in Switzerland, the assets and the capital gains are attributed to the settlor. Thus, like a revocable trust, there are in general no tax consequences. Where an irrevocable trust is discretionary and the trust is established by a settlor with foreign domicile, the beneficiaries have no enforceable property right and therefore no wealth tax to pay. However, all distributions are subject to income tax.

ASSISTANCE IN TAX MATTERS

The exchange of information in the area of administrative assistance in tax matters is divided into the spontaneous exchange of information, the automatic exchange of information and administrative assistance upon request.

With regard to trusts, there are two possible scenarios of administrative assistance on request. Thus, either a foreign tax authority may request Switzerland to provide information held by a Swiss bank where trust assets are deposited, or the foreign authority may request the Swiss tax authorities to provide information directly held by a trustee domiciled in Switzerland.

Switzerland participates in the exchange of information in tax matters and began adapting its double taxation agreements by accepting the standard O.E.C.D. Model provision. Thus, Switzerland's revised double taxation agreements provide that the competent authorities may exchange information that is foreseeably relevant not only for the application of the provisions of the treaty itself, but also for the enforcement of the domestic tax law of the requesting state. In addition, a Contracting State may not refuse to provide information solely because it is held by a bank, other financial institution, nominee, or person acting in an agency or a fiduciary capacity, or because it relates to ownership interests in a person.

In practice, many individual factors in the request for administrative assistance relating to trusts will affect whether information will be provided, including the type of trust and the wording of the request.

In a decision of the Federal Administrative Court concerning a request for administrative assistance from a foreign state and relating to bank deposits in Switzerland held by an underlying company and the latter held by a trustee, it was decided that the information would not be disclosed if the taxpayer concerned was only a discretionary beneficiary of a clearly irrevocable trust. The decision has been appealed and the matter is pending before the Federal Supreme Court.

CONCLUSION

In Switzerland, adjustments to the family foundation and the introduction of a Swiss trust are being discussed at various political and stake holder levels. Swiss law

does not provide for trusts and concepts of splitting legal ownership from beneficial ownership. Hence, modifying Swiss law to address a family foundation, which is an alternative to a trust, may require fewer legislative adjustments.

As of January 1, 2020, Switzerland enacted the FinIA. As a consequence, all trustees with a nexus to Switzerland need to check if they may fall under the FinIA.

Swiss tax law simplifies the possibilities of structuring trusts. It has defined three different types of trusts: revocable trust, irrevocable fixed interest trust, irrevocable discretionary trust. In determining the classification of any particular trust, the decisive factor for the classification is not the designation in the trust deed, but the actual retention by the settlor of control rights.

The exchange of information in the area of administrative assistance in tax matters is divided into the spontaneous exchange of information, the automatic exchange of information, and administrative assistance upon request.

A foreign tax authority may request Switzerland to provide information held by a Swiss bank where trust assets are deposited, or the foreign authority may request the Swiss tax authorities to provide information directly held by a trustee domiciled in Switzerland. Whether the requested information will be exchanged depends on the facts of the arrangement. Hence, facts and circumstances will influence the administrative decision.

PLANNING FOR NONRESIDENT INVESTMENT IN FRENCH REAL ESTATE – THE CHOICE OF COMPANY MATTERS

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Capital Gain
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Société Civile Immobilière
Wealth Tax

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INTRODUCTION

It is common for nonresidents to own a secondary residence in France through a company. One of the recurring questions posed to a French tax adviser relates to the type of company to choose. Should it be (i) French or foreign and (ii) subject to corporate tax, or not? This article focuses on the French tax consequences for a nonresident individual who owns French real estate through a French or foreign company that is subject or not subject to corporation tax.

OWNERSHIP THROUGH A FRENCH COMPANY

The *société civile immobilière* (an "S.C.I.") is a real estate holding company frequently used by nonresident individuals and foreign corporations. An S.C.I. is a pass-through entity used to hold French real estate.[1] It may carry out an ancillary commercial activity, provided that the income from that activity does not exceed 10% of the total income of the S.C.I.

An S.C.I. is not subject to French tax unless it opts to be liable to corporate income tax or unless it carries out a commercial activity in more than a *de minimis* amount. Although an S.C.I. is a pass-through company, the S.C.I. is not fully transparent for French tax purposes since taxable profit is computed at the entity level before being taxed in the hands of its shareholders. Each shareholder is taxable according to its own tax regime on its *pro rata* share of the profits derived by the S.C.I. This means that the portion of the S.C.I.'s profits that are attributable to corporate shareholders at December 31st of each year, is computed in accordance with the tax provisions applicable to corporate income tax.

The choice of tax regime for the S.C.I. should be made in advance of the purchase of the property. The alternatives are the pass-through tax regime that is common for an S.C.I. (which is recommended when the residence is used for private reasons by the S.C.I. partners) or by expressly opting for corporation tax ("C.I.T."). This choice will depend in part on the existence of a tax treaty and the tax treatment of rental income and capital gains from French sources. Rental income will generate lower taxes in France when the S.C.I. is subject to corporate income tax, due to a lower tax base reflecting the tax benefit of depreciation. However, that benefit will be offset by higher taxation of the capital gain on the sale of the property, assuming the relevant income tax treaty assigns the exclusive taxation right to France based on the location of the property.

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[1] This article addresses the tax character of an S.C.I. from a French viewpoint. A nonresident should seek advice from a home country tax adviser regarding taxation in his or her country of residence.

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The choice will also depend on the use of the property. Generally it is not advisable to hold a secondary residence via a company subject to C.I.T., at least when the property is made available exclusively and free of charge to the partners of the S.C.I. The economic benefit from housing which the taxpayers reserve for themselves is normally exempt from taxation. However, this exemption is reserved for natural persons or partnerships with natural persons as partners. It does not extend to the taxable profits of companies that are subject to C.I.T. When these advantages are provided without the payment of consideration to the company, the company will be deemed to have taxable income for C.I.T. purposes and the partner will be deemed to have received a benefit.

OWNERSHIP THROUGH A FOREIGN COMPANY

Nonresident individuals often hold a secondary residence in France through foreign companies having a registered office outside France. These nonresident companies are often located in the individual's country. Typically, these companies take the form of a commercial company with limited liability for shareholders. In their state of residence, they are subject to tax on profits at rates equivalent to French corporation tax.

The corporate tax status of the foreign company holding French real property must be determined under French tax concepts, especially when the French property is made available to shareholders on a rent-free basis. Different tax results will be result based on the character of the company. In comparison to an S.C.I., a foreign company does not have a choice as to the tax treatment of profits

It is therefore necessary to compare the foreign entity with a French company to determine whether those characteristics allow the foreign entity to be considered translucent – and therefore its income will be passed through to its partners and taxed at that level – or opaque – and therefore it will be the taxpayer and its income will be subject to C.I.T. The principal factors that are taken into account are free transferability of shares and limited liability of shareholders. French case law relates mainly to U.S. L.L.C.'s. that provide limited liability to members while being tax transparent, and Delaware corporations that may have a civil purpose rather than a commercial purposes. In at least one case, the French administrative Supreme Court ruled that a multimember L.L.C. should be treated as a corporation because of its limited liability.

When a foreign entity's form does not cause it to be subject to French C.I.T., it may be subject to C.I.T., nonetheless, because it carries on a "profit-making activity." In making a determination, no bright line exists as a guide. In principle, the provision of free housing by a foreign entity to its principal owner and members of his family would not necessarily cause the entity to be viewed as carrying on a profit-making activity. However, an anstalt and a Liechtenstein *stiftung* were held to carry on a profit-making purpose when a building in France was left at the disposal of their beneficiaries or third parties.

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INCOME TAXATION

Rental Revenues

Individuals not resident in France are taxed in France on their French-source rental income, whether the property is held directly or indirectly through a French S.C.I. or an equivalent foreign company, as determined under French law. The investor has the choice between two tax regimes with radically different consequences, income tax or C.I.T.

Case Where the Company is Not Subject to C.I.T.

When the S.C.I. does not opt to be subject to C.I.T., the income from the rental of bare dwellings is taxed directly at the partner level, regardless of tax residence. Here, care is required to avoid double taxation – one in France as rental income is realized – and a second time in the country of residence, either at the same time income is realized in France or in a later year when distributed as dividends.

These issues of double taxation are governed by income tax treaties concluded by France. Most of these tax treaties attribute the right to tax to the state where the real property is located. In some instances, the right to tax is attributed exclusively to that state. In other instances, the right to tax is concurrent. In these instances, the right to tax that is reserved by the state of residence is subject to provisions in the income tax treaty that are designed to eliminate double taxation.

When the property is located in France directly or through an S.C.I. by a nonresident individual, the nonresident's tax is computed under two methods. The one that produces the lower tax is the method that is used.

- Under the first method, a split rate is applied. Up to a certain amount of income, the rate is 20%. On income in excess of that amount, the rate is 30%. In 2020, the switchover occurred when net income amounted to €25,710.
- Under the second method, the nonresident computes the effective French tax rate on income from sources in France and outside of Franc based on graduated rates ranging up to 45%. The effective rate is applied to the French rental income.

In addition to the income tax, income from real estate is subject to social contributions. The rate is 17.2% for tax residents of a country outside the E.E.A. and Switzerland, and for tax residents of an E.E.A. country or Switzerland who are affiliated to a compulsory French social security system. For tax residents of an E.E.A. country or Switzerland who are not affiliated to a compulsory French social security scheme, property income is subject to a "solidarity levy" at a rate of 7.5%.

Case Where the Company is Subject to C.I.T.

If the company is subject to C.I.T., the tax base in France the net rental income. The company will also be liable, where applicable, for the rental income tax ("C.R.L.") at the rate of 2.5%. C.R.L. is imposed on income derived from the rental of buildings that have been completed for at least fifteen years as of January 1 of the tax year. If the rent is subject V.A.T., either by right or by option, it is not subject to the C.R.L.

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In the event of a distribution by a French company subject to corporate income tax, a withholding tax will be due. The rate is 21% if the shareholder is resident in a Member State of the European Economic Area, 30% if the shareholder is resident outside the E.E.A., or 75% if he is resident in an noncooperative country or territory. The rate may be reduced by income tax treaty and can be eliminated if the Parent Subsidiary Directive is applicable under E.U. law. In practice, most tax treaties concluded by France reduce the rate of this withholding tax. In the event of an actual or deemed distribution of profits by a foreign company, the rates applicable to distributions from French permanent establishment will apply.

Capital Gain

French tax law allows France to tax capital gains on the sale of real estate located in France. The right to tax is subject restrictions, if any, under an applicable income tax treaty.

In the case of a sale of shares of the company, the capital gains tax regime for private individuals will apply in the case of a French company with a majority of real estate assets established in a Member State of the European Union or the European Economic Area. The tax is 19%, and is accompanied by social contributions of 17.2% or 7.5%. In other cases, the standard capital gains tax regime applies. The tax is 12.8% and is accompanied by social contributions of 17.2% or 7.5%.

France retains the right to tax the capital gains from the sale of shares only where the company is considered to be real estate company ("S.P.I.") as a result of its asset mix. In broad terms, a company is treated as an S.P.I. if more than 50% of the value of its gross assets at the close of the three financial years preceding the transfer consists of real estate, shares in other S.P.I.'s, or real estate rights not allocated to its own professional activity, whether such assets are located in France or other states.

In practice, most of the tax treaties concluded by France follow the model treaty proposed by the O.E.C.D. and do not remove France's right to tax these capital gains.

In the case of a sale of real property directly held by a company, two separate tax regimes apply. If the company is subject to C.I.T., C.I.T. will be due. The tax rate is 26.5% in 2021 and will be 25% in 2022. If the company is foreign the tax is collected by means of withholding, subject to adjustment in a final return. If, on the other hand, the company is a translucent company, whether French or foreign, it is the partner who is taxed on the capital gain, according to the tax regime of capital gains on real estate for individuals.

In addition to the levy, nonresidents subject to income tax (individuals or partnerships) are subject to a surtax on capital gains in excess of €50,000 and to the taxes on the sale of land that has become buildable.

Taxation of the Real Estate Assets

3% Tax

Subject to two exceptions, companies that own real estate in France must pay an annual tax of 3% of the market value of the property. It does not matter whether the company maintains its head office in France or outside France. Nor does it matter whether the real property is held directly or through intermediary companies.

The exceptions to the 3% tax are as follows:

- Companies are not subject to the tax if they file Declaration no. 2746-SD each year indicating (i) the location and designation of the buildings, (ii) the value of the real estate as of January 1st, (iii) and the identity of all partners holding more than 1% of the capital.
- Companies are not subject to the tax if, within two months of the acquisition of French real estate, they undertake to report (i) information concerning the real estate and (ii) the names of shareholders holding more than 1% of the share capital at the first request of the French tax administration.

An S.C.I. that is engaged in bare rental activities is required to file Declaration no. 2072 each year. Providing this declaration exempts the company from making the undertaking described in the second bullet above.

Real Estate Wealth Tax ("I.F.I.")

Nonresidents of France are subject to a real estate wealth tax ("I.F.I.") on real estate assets located in France. This includes shares in domestic or foreign companies that own directly or indirectly real estate in France. Regarding tax on shares of companies, the tax is levied only on the portion of the value of the company's shares attributable to the real estate assets. If the nonresident owns shares representing less than 10% of the voting rights and capital of the company, the wealth tax does not apply, unless he or she controls the foreign company. In determining whether control exists, the shares held by a spouse and by children are treated as if owned by the nonresident.

In the case of a chain of companies, the taxable value is assessed on the basis of the real estate owned by all member companies in the chain and by all structures in which chain members participate.

As with income tax, a nonresident of France potentially faces wealth tax in two jurisdiction – France and the person's country of residence. Double taxation may be eliminated by an applicable income tax treaty that covers wealth taxes. Most income tax treaties addressing wealth tax allow both states to impose wealth tax. Double taxation is avoided by a tax credit. Some income tax treaties assimilate the shares of real estate companies to real estate. The state in which the real estate is located has exclusive right to tax. Other income tax treaties do not distinguish between real estate companies and other companies. The right to impose wealth tax is allocated exclusively to the state of residence of the person owning the shares.

As a planning point for nonresidents, the tax base on which I.F.I. is imposed will be reduced when real estate in France is held by an S.C.I. that has financed the holding through the issuance of debt. The debt reduces the value of the shares.

Donation and Successions

Inheritance or gift tax is levied on the market value of shares received as a gift or as an inheritance. When computing the fair market value of the shares, the amount of the company's debt obligations will reduce the value of the shares. As with the I.F.I., holding the real estate assets through a company carrying a significant debt load will reduce the value of the shares given away during life or at its conclusion.

CONCLUSION

Foreign investors choosing to own real estate assets in France are well served to plan the structures by which French real estate is held in advance of the purchase and to monitor the structure after an acquisition has been completed. There is no miracle solution, but choosing the proper structure may minimize the taxes that are paid in France during the period of ownership and at the time of sale.

"Foreign investors choosing to own real estate assets in France are well served to plan the structures by which French real estate is held in advance of the purchase and to monitor the structure after an acquisition has been completed."

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TAXATION OF FOREIGN PENSIONS IN IRELAND – WALKING THE TRICKY TIGHTROPE

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INTRODUCTION

As more and more individuals come home to Ireland or relocate to Ireland, the taxation of assets brought with them takes on importance once Irish tax residence is established. What tends to be of most concern is the myriad of pension products that individuals accumulate while living and working outside of Ireland. The tax treatment of overseas pensions, and in particular, the taxation of lump sum payments from foreign pensions is an increasingly complex affair in the Emerald Isle.

This article will examine the tax treatment of overseas pension income and overseas pension lump sum payments, together with the current Irish Revenue position on such lump sum payments.

TAXATION OF FOREIGN PENSION INCOME

Irish Domestic Legislation

The good news is that the taxation of foreign pension income (*i.e.*, regular, ongoing payments) is relatively straightforward for Irish resident taxpayers. Foreign pension income is chargeable to Irish income tax under Schedule D Case III by virtue of Section 18(2) Taxes Consolidation Act ("T.C.A.") 1997. There are some rules particular to non-Irish domiciled taxpayers which are discussed later in this article.

Ireland has 3 charges on income - Income tax, Universal Social Charge ("U.S.C.") and Pay Related Social Insurance ("P.R.S.I."). The Irish income tax system has been labelled as progressive, in that the tax rates progressively increase as income increases.

Pension income is liable to income tax and U.S.C. However, P.R.S.I. is normally not levied on pension income. An Irish tax resident individual is entitled to a personal tax credit of €1,650 per tax year, and the first €35,300 of income is subject to income tax at 20%, the standard rate band. Taxpayers jointly assessed with a spouse can avail of a higher standard rate band, the precise amount of which is determined by the extent of the income of the spouse. Both the taxpayer and spouse must be tax resident in Ireland to avail of joint assessment.

The U.S.C. charge graduates from 0.5% to 8%. The 8% rate currently applies to pension income exceeding €70,044. Social welfare income, including both Irish and foreign social welfare pension income, is exempt from U.S.C. and this can be relevant in optimizing the tax position for a non-domiciled taxpayer remitting income to Ireland.

Individuals are also entitled to an age tax credit once the taxpayer reaches the age

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of 65 and a married couple may be entitled to a joint credit of €490. Certain foreign pension income may also qualify for a further tax credit of up to €1,650.

Once an individual becomes Irish tax resident and is in receipt of foreign pension income within the charge to tax in Ireland, the individual will need to

- register for income tax,
- include details of the pension income on a self-assessment tax return filed with the Irish Revenue on an annual basis, and
- pay tax to Irish Revenue.

The annual Irish tax return is due for filing by October 31 each year, and tax payments are due on the same date. The deadline is generally extended to mid-November where returns and payments are made electronically.

International Considerations

In general, most tax treaties with Ireland will allocate the taxing rights of foreign pension income by reference to where the recipient of the pension is resident at the time the pension payment is received. Therefore, typically, foreign pension income is only taxable in Ireland if the individual is Irish tax resident under both Irish domestic legislation and the tax treaty in question. There can however be anomalies in some treaties.

For example, the Ireland-U.S. Income Tax Treaty allows the U.S. to continue to tax pension income of U.S. citizens who are tax resident in Ireland as there is a specific provision applying to anyone that is Irish tax resident and a U.S. citizen. It is known as the "saving clause" because the U.S. saves the right to tax its citizens as if the treaty had not come into effect. Depending on the treaty, limited exceptions to the saving clause may exist. The U.S. effectively included a clause in the Ireland-U.S. Income Tax Treaty to ensure that the U.S. can continue to tax its citizens even if they become tax resident in Ireland. Therefore, for individuals that have retained US citizenship and are Irish tax resident, both Ireland and the U.S. have taxing rights on U.S. pension income. This should be read in conjunction with the Irish taxation of U.S. Social Security pensions which is dealt with later in this article.

The Ireland-U.S. Income Tax Treaty permits a credit for double taxation and this generally operates by allowing a credit in the U.S., allowing Irish tax paid on U.S. pension income to be set off against the U.S. tax liability on the same income. Typically, the Irish tax rate exceeds the U.S. tax rate, so there should be no additional tax on U.S. pension income when filing U.S. tax returns when the income is also chargeable to tax in Ireland in the same taxable period. While there may be no U.S. tax cost, from a compliance perspective, the requirement to file returns in both jurisdictions can be a burden.

EXEMPTIONS UNDER IRISH DOMESTIC LEGISLATION

As already noted, pension payments to Irish residents from a foreign pension source are taxable under Schedule D Case III, as *per se*ction 18 T.C.A. 1997. However, section 200 T.C.A. 1997 provides that certain foreign pensions are exempt from Irish tax. Several conditions must be satisfied before the exemption applies:

- It must be a pension, benefit or allowance which is

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- ○ given in respect of past services in an office or employment; or
- ○ payable under the provisions of the law of a foreign country in which the pension arises which correspond to certain Irish legislation which governs Ireland's pensions, benefits and allowances for the purposes of our Social Welfare legislation.

- The country in which the pension, benefit or allowance arises has a tax which is chargeable and payable under the law of that country, and which corresponds to income tax in Ireland.
- If that pension, benefit or allowance were received by a person who is resident in the country in which it arises in and not resident elsewhere, it would not be regarded as income for income tax purposes in that country.

This can be a very useful exemption where Irish individuals who have been living abroad for several years return to Ireland to retire. It is key to determine if the foreign pension would have been exempt from income tax in the foreign jurisdiction had it been received by the person as a resident of that foreign country. In practice, this exemption has been seen to operate in Ireland on pension payments from Australia and Switzerland, where payments have been received by Irish residents.

For the purposes of section 200 T.C.A. 1997, the term "tax" in relation to any country means the tax that is chargeable and payable under the law of that country and which corresponds to income tax in Ireland. It is necessary for the country in which the benefit arises to have a tax meeting the foregoing criterion. Countries that do not have an income tax system like Ireland would not satisfy the conditions for the exemption to apply. The United Arab Emirates is an example.

Some Australian pension funds are structured so Australian residents are not subject to tax in Australia once the pension fund starts to pay out. This is because contributions are not relieved from tax with relief applied on payments from the pension instead. On this basis, some Australian pension income may be exempt from Irish tax under section 200 T.C.A. 1997 once an individual becomes Irish tax resident.

It is important to note that some foreign pension payments are not taxable in a foreign jurisdiction for individuals who are considered to be nonresident, however, the payments would be taxable if the individual were resident in that country at the time of receipt. The exemption would not apply in these circumstances as the person cannot be subject to income tax in the foreign jurisdiction were they resident there.

It is important to distinguish between the different types of pensions, benefits and allowances that can be paid by a social security regime in a relevant jurisdiction. For example, Irish residents in receipt of a U.S. Social Security pension will be subject to tax in Ireland as these payments are specifically excluded from the exemption. The reason for excluding U.S. Social Security pensions from the exemption is that the U.S. allows for an exemption from tax in the U.S., on the basis that the U.S. Social Security pension would be subject to tax in Ireland. In effect, the taxing rights have been transferred from the U.S. to Ireland in this regard.

Prior to April 6, 1998, U.S. Social Security pensions that were paid to nonresident aliens were subject to a 25.5% withholding tax in line with the U.S. rules. This gave rise to issues as withholding tax in many cases that resulted in a higher effective rate of tax than would normally have applied if the pensions were only taxable in

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Ireland. Accordingly, from April 6, 1998, an Irish resident recipient of a U.S. Social Security pension is chargeable to tax on such pensions for income tax purposes, with no income tax charge in the U.S.

It is also important to distinguish between the different types of pensions that can be paid by a social security system. There may be other types of pensions paid to Irish residents which are not covered by article 18 of the Ireland-U.S. Income Tax Treaty. Those other types of pensions could potentially benefit from this exemption. Examples of such pensions could be items such as disability payments, war-related pensions, and other gratuity payments.

As you can see, understanding the type of payment that is received by an individual is important to determine the tax treatment. A payment from a private pension may be taxable in Ireland (and the U.S.) while a benefit, state pension or allowance may be exempt under Irish domestic legislation. Alternatively, the source country may retain taxing rights over the payment or relinquish such rights.

TAXATION OF FOREIGN PENSION INCOME AND THE INTERACTION WITH REMITTANCE BASIS TAXATION IN IRELAND

As noted, foreign pensions are a taxable source of income in Ireland. In general, the taxation of such pensions is determined by reference to the individual's tax residence position in Ireland. However, in Ireland an individual's domicile is relevant for determining the extent of that person's exposure to Irish taxation. In this context, individuals living in Ireland can be classified broadly into two categories for determining taxation status: non-Irish domiciled and Irish domiciled.

An individual who is resident in Ireland but who is not Irish domiciled is liable to Irish tax on all income and gains arising in Ireland. However, for most types of income and gains, there is no Irish tax on foreign income and gains provided that the income/gains are not remitted into Ireland. This is known as remittance basis taxation.

Foreign source pension income is subject to tax under Schedule D Case III. This can have either favorable or unfavorable consequences. The favorable consequence is that the pension income could benefit from the remittance basis of taxation. The unfavorable consequence is that treaty benefits in the source country may be lost if the income is not taxed in Ireland because it remains offshore. Some income tax treaties contain provisions that are designed to curb double nontaxation by permitting an override of benefits in one country or the other. The purpose of those provisions is to ensure that the pension income is either taxed in Ireland if remitted or the source country if the income is not remitted.

If an individual remits pension income to Ireland where a clause like this exists with the source country treaty, Ireland will tax this income in the year of remittance. One planning point that should be considered is to confirm the tax rate that applies in each country. If the rate of tax is lower in the source country it may be beneficial to leave this pension income to be taxed in the source country and not remit it to Ireland. Alternatively, if the Irish tax rate is lower, the pension should be remitted.

LUMP SUM DRAWDOWNS FROM A FOREIGN PENSION IN IRELAND

Background

To appreciate the taxation of lump sum drawdowns in Ireland it is important to understand the historical position regarding the Irish taxation of lump sum drawdowns.

Prior to December 7, 2005, Ireland did not have any domestic legislation which taxed lump sum drawdowns from pension funds. This meant that lump sums of 25% of the value of a pension fund could be taken tax-free regardless of the value of the pension fund. In Finance Act 2006 the Irish Revenue introduced section 790AA T.C.A. 1997 which put an end to this treatment. Section 790AA T.C.A. 1997 is the section which governs the taxation of lump sum payments in excess of a tax-free amount. This meant that the tax-free amount was capped at a value of €200,000 and any excess over and above €200,000 would be taxed at 20% up to a total drawdown of €500,000. Any balance over and above €500,000 would be taxed at marginal rates.

For the purposes of the legislation, "a lump sum" is a reference to a sum that is paid to an individual under the rules of a "relevant pension arrangement." A "relevant pension arrangement" means any one or more of the following:

- A retirement benefit scheme within the meaning of Irish legislation which has been approved by the Irish Revenue Commissioners
- An annuity contract or trust scheme or part of a trust scheme approved by the Irish Revenue Commissioners
- A P.R.S.A. contract, within the meaning of Irish legislation
- A qualifying overseas pension plan
- A public service pension scheme within the meaning of Irish legislation
- An Irish statutory scheme

"For the purposes of lump sum drawdowns from foreign pension schemes, the only category that is relevant to consider is a qualifying overseas pension plan."

For the purposes of lump sum drawdowns from foreign pension schemes, the only category that is relevant to consider is a qualifying overseas pension plan.

An "overseas pension plan" is defined in Irish legislation to mean a contract, an arrangement, a series of agreements, a trust deed, or other arrangements – but not a state social security scheme – which is established in, or entered into under the law of the United Kingdom or a Member State of the European Communities, other than Ireland itself.

For the purposes of the Irish legislation, a "qualifying overseas pension plan" means an overseas pension plan (i) which is established in good faith for the sole purpose of providing benefits of a kind similar to those referred to in Irish legislation, (ii) in respect of which tax relief is available under the law of the Member State of the European Communities in which the plan is established (or the United Kingdom) in respect of any contributions paid under the plan, and (iii) in relation to which the relevant migrant member of the plan complies with the requirement in Irish legislation in order for it to qualify as a qualifying overseas pension plan.

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The above requirements mean the administrator of the pension plan must have the overseas pension plan "blessed" by the Irish Revenue Commissioners for it to fall within the definition set out in section 790AA T.C.A. 1997. As a result, most foreign pensions schemes are considered nonqualifying overseas pension plans because they haven't been blessed by the Irish Revenue Commissioners. Therefore, lump sums from such pension schemes are not taxable in Ireland as we have no domestic legislation to tax lump sums.

Current Irish Revenue Position

The foregoing historical background sets the scene in relation to the history of this topic. However, the Irish Revenue's position has changed over the years in relation to this matter.

The Revenue's current interpretation is that income from foreign securities and possessions is charged under Schedule D Case III, which is correct. However, they state that it includes the profits or gains arising from any kind of property the person possesses, including pension lump sum payments. The Revenue's current position is that the commutation of such lump sums is subject to income tax under Schedule D Case III as they are considered to be "foreign possessions." Accordingly, if a payment (even a lump sum) is paid from a foreign pension fund, the Revenue considers it to be income arising from possessions outside the State. As pension payments to Irish residents from a foreign source are normally taxable under Case III of Schedule D, the receipt of a lump sum from a foreign pension is a taxable source of income liable to Income Tax and U.S.C.

This stance is a fundamental change in Revenue practice. Of greater import, the Revenue have not formally notified practitioners of this change, nor have any of the appropriate manuals been updated to reflect this change. Irish practitioners are currently challenging the Revenue's position on the matter.

Current Irish Practitioner's View

Income tax in Ireland can be imposed only if there is a domestic charging provision. The Revenue are attempting to impose an income tax charge under Schedule D Case III. Income tax is chargeable on income and not capital. Schedule D applies to income only. As there is no income arising, a charge under section 18(2) T.C.A. 1997 cannot arise. Under section 18(2) T.C.A. 1997, the foreign possession is the foreign pension plan. Therefore, from a technical perspective, it is difficult to see how the Irish Revenue can legitimately view lump sum drawdowns as taxable income under Schedule D Case III. Lump sum payments are capital, not income. The ultimate conclusion is that a charge under Schedule D Case III cannot arise.

Looking at first principles, if a pension fund has been accumulated while an individual was neither Irish tax resident nor ordinary tax resident in Ireland, the taxation of any lump sum drawdowns from this pension fund is outside the scope of Irish taxation. This is because it is a well-accepted principle that capital accumulated before an individual becomes resident in Ireland is outside the scope of Irish tax.

The lump sum cannot be classed as employment related income because the employment related to the funding of this pension was carried out wholly outside of Ireland. Moreover, it was accumulated from contributions out of foreign income in respect of which no Irish tax relief was provided.

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As discussed above, the foreign lump sum drawdown is not taxable under section 790AA T.C.A. 1997 because this section relates only to "relevant pension arrangements." As the pension arrangement is not within the definition of a qualifying overseas plan, the drawdown is not taxable under this section.

Another section which should be considered is section 781 T.C.A. 1997 which deals with the taxation position for individuals who decide to commute their entire pension in one lump sum. This section applies to an approved pension scheme and specifically does not apply where the employment was carried on outside Ireland.

Finally, there is an old Revenue Precedent, Precedent 28, dated July 30, 1987, which states that the tax-free lump sum in commutation of foreign pensions is not taxable in Ireland should an individual come to live in Ireland following retirement. Because this precedent is more than 5 years old, the Revenue are no longer willing to confirm the application of this precedent to lump sum drawdowns of foreign pensions by Irish residents. Nonetheless, precedent 28 is widely relied upon by practitioners.

CONCLUSION

As is evident from this article, the taxation of pensions in Ireland is complex. The trend we are seeing is that each foreign pension plan becomes more complex than the next. Individuals are returning from places such as the U.K. and the U.S. with pensions such as 401(k) plans, 529 plans, and 527 plans, all of which have a firm and certain purpose in relation to the source country in which they originated. Difficult tax issues arise when individuals move from one jurisdiction to the next, bringing along their entitlement to pension payments. On a global basis, it seems unfair to penalize an individual merely because of a change in the country of residence.

A wider implication of this stance by the Revenue is the principle that capital accumulated by an individual prior to becoming an Irish tax resident is within the scope of Irish taxation. Submissions have been made to the Irish Revenue requesting it to identify the domestic charging provisions that are applicable in Irish that authorize the imposition of an income tax charge in respect of overseas lump sum payments. At least one case has been appealed to the Tax Appeal Commission in Ireland.

We wait to see the outcome of the lobbying and the appeal to the Tax Appeal Commission on behalf of taxpayers to see how the taxation of foreign lump sums will evolve. It is likely that we will have a firm view on the position sooner rather than later.

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FIVE REASONS WHY THE LEGAL PROFESSIONAL PRIVILEGE OF BELGIAN LAWYERS IS INCOMPATIBLE WITH THE MANDATORY REPORTING UNDER D.A.C.6

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Tags
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Charter of Fundamental Rights
D.A.C.6
Legal Professional Privilege
L.P.P.

INTRODUCTION

The European Union's Council Directive 2018/822 of May 25, 2018 (better known as "D.A.C.6") requires Member States to impose a disclosure obligation on intermediaries who advise on, or are involved in, implementing aggressive cross-border arrangements.[1] The conundrum faced by some intermediaries is that they are bound by legal professional privilege ("L.P.P."), and therefore, are not allowed to share privileged information.[2] This is typically the case for persons who are engaged in the active practice of law. As a solution, the Directive allows Member States to exempt such "privileged intermediaries" from their reporting obligation where the reporting would breach L.P.P. under national law.[3] While most European legislators used this option to exempt lawyers from their reporting obligation, the rules in each Member State have unique twists and turns.[4]

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[1] Council Directive (E.U.) 2018/822/E.U. of 25 May 2018 as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements, OJ L 139/1 (hereinafter: the "Directive"). The acronym "D.A.C." stands for "Directive on Administrative Cooperation."

[2] The protection of L.P.P. is a common legal tradition of all E.U. Member States, even though legal basis, type, and scope may differ. What is identical, however, is that the protection is not absolute. Encroachment may be permissible (i) where defense rights are not at stake (see Section 6 E.C.H.R.) and (ii) the encroachment is in accordance with the law and is necessary in a democratic society because it is (a) in the interests of national security, public safety or the economic well-being of the country, (b) for the prevention of disorder or crime, (c) for the protection of health or morals, or (d) for the protection of the rights and freedoms of others (proportionality principle, see Section 8 E.C.H.R.).

[3] See Directive, Section 8ab(5), which provides as follows

> Each Member State may take the necessary measures to give intermediaries the right to a waiver from filing information on a reportable cross-border arrangement where the reporting obligation would breach the legal professional privilege under the national law of that Member State. In such circumstances, each Member State shall take the necessary measures to require intermediaries to notify, without delay, any other intermediary or, if there is no such intermediary, the relevant taxpayer of their reporting obligations * * *.

[4] For a comparative view of D.A.C.6's implementation in different Members States, see, K. Resenig, "European Union - The Current State of DAC-6 Implementation in the European Union," Vol. 60, n° 12 *European Taxation*, pp. 527-535 (2020).

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In this article, the authors identify five inconsistencies between the reporting obligation imposed by the Belgian Implementation Law of the Directive[5] and the L.P.P. of Belgian lawyers.[6]

INCONSISTENCIES OF THE BELGIAN IMPLEMENTATION LAW WITH THE L.P.P. OF BELGIAN LAWYERS

Belgium made use of the option offered by the Directive to exempt privileged intermediaries by implementing Section 326/7 in the Belgian Income Tax Code ("B.I.T.C."), which states as follows:

> Section 326/7.
>
> § 1. Where an intermediary is bound by a L.P.P., he must:
>
> 1° [if there is one or multiple other intermediaries involved,] inform him or them, in writing and in a motivated manner, that he [read: the privileged intermediary] cannot comply with the reporting obligation, whereupon the reporting obligation automatically shifts to the other intermediary or intermediaries;
>
> 2° in the absence of another intermediary, inform [directly] the taxpayer or taxpayers, in writing and in a motivated manner, that the reporting obligation shifts to him or them. The exemption from the reporting obligation [for the privileged intermediary] is effective only from the moment [such] intermediary has fulfilled the obligation referred to in paragraph 1 [*i.e.*, inform in writing and in a motivated manner any other intermediary or the taxpayer].
>
> § 2 The taxpayer may, by written authorisation, allow the [privileged] intermediary to [nevertheless] fulfil the reporting obligation […]. If the taxpayer does not give any authorisation, the reporting

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[5] Law of 20 December 2019, *Belgian State Gazette*, 30 December 2019 (hereinafter: "Belgian Implementation Law"); for further details, see Belgian Circular Letter, "*F.A.Q.: DAC 6 - Déclaration des dispositifs transfrontières*," available in French and Dutch at www.myminfin.be; See also, W. Heyvaert and V. Sheikh Mohammad, "European Union's New Reporting Obligations for Tax Intermediaries: Key Features of the Belgian Administrative Guidance - D.A.C.6," Vol. 8, No 2 *Insights*, pp. 3-10; D.-E. Philippe and E. Yuksel, "Mandatory Disclosure of Aggressive Cross-Border Tax Planning Arrangements: Implementation of DAC 6 in Belgium," Vol. 60, No 4 *European Taxation*, pp. 121-128 (2020); J. Malherbe, "*La déclaration obligatoire des dispositifs transfrontières – Directive DAC 6 du 25 mai 2018 et loi du 20 décembre 2019*," 1-2 *Revue Générale du Contentieux Fiscal,* pp. 29-40 (2020).

[6] The L.P.P. of Belgian lawyers is an essential feature of the profession and the obligation to comply with it is formally set out in the professional rules of conduct (see Section 1.2.(b) of the French and German Code (O.B.F.G./Avocats.be); Section I.1.1. and Title I.3, of the Flemish Code (OVB)). Violation of the L.P.P. is criminally sanctioned under Section 458 of the Belgian Criminal Code; for an overview of the regulation of the legal profession in Belgium, see here.

> obligation remains with the taxpayer, and the [privileged] intermediary shall provide to the taxpayer the information necessary to comply with the reporting obligation […].
>
> § 3 [The reporting exemption for privileged intermediaries] does not apply for marketable devices, that give rise to a periodic reporting […]" [Unofficial translation.]

The foregoing provision of the B.I.T.C. is incompatible with the L.P.P. of Belgian lawyers for several reasons.

- The provision mandates disclosure of protected confidential communication.
- The provision fails to recognize that the scope and obligations of the L.P.P. for lawyers is broader than for other professions.
- Allowing a client to waive rights under the L.P.P. is invalid (even if the attorney agrees to the waiver).
- The reporting obligation for marketable arrangements is overly broad.
- The assertion that the L.P.P. does not apply to tax advice is without merit.

Each is discussed below.

The Provision Mandates Disclosure of Protected Confidential Communication

Belgium exempts lawyers from their reporting obligation *provided* they inform another intermediary or, if there is no other intermediary, the relevant taxpayer of its reporting obligations.[7] In other words, lawyers are exempt from their "duty to report" only after they accomplish a "duty to inform." However, the mere circumstance that a lawyer shares privileged information with someone other than the client (here, another intermediary, say an accountant or consultant or a bank) breaches the Belgian L.P.P. At a minimum, the mere fact that a client has chosen a specific lawyer is privileged. Moreover, the privilege not only covers advice given to the client by the lawyer, but also covers information received by the lawyer from the client. In sum, the exemption for Belgian lawyers is flawed, as it is incompatible with the L.P.P.[8]

The Provision Fails to Recognize that the Scope and Obligations of the L.P.P. for Lawyers is Broader Than for Other Professions

Belgium does not make any distinction between the various types of privileged intermediaries. This shortcoming goes against long-established case-law of the Belgian Constitutional Court ("*Cour Constitution-nelle/Grondwettelijk Hof*"), which sets apart the L.P.P. of lawyers from that of other professions:

> [Lawyers] are subject to strict ethical rules * * *. It follows from the special status of lawyers, established by the Belgian Judicial Code

[7] B.I.T.C., Section 326/7, § 1 (which is in line with Section 8ab(5) of the Directive).

[8] This mechanism also goes against primary E.U. law, see Belgian Association of Tax Lawyers, Issues Related to the European Directive 2018/822 (D.A.C.6) and its Transposition into National Law, spec. pp. 11-12.

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> and by the regulations adopted by the [Bar Associations] that lawyers in Belgium are distinct from other independent legal professions. [Unofficial translation.][9]

For the Belgian Constitutional Court, the lawyer's L.P.P. is the cornerstone that guarantees the right of a legal defense against challenges by the government.[10] The protection against self-incrimination depends on the confidential bond between the lawyer and the client and the confidentiality of their written and oral conversations.

Allowing a Client to Waive Rights Under the L.P.P. is Invalid (Even if the Attorney Agrees to the Waiver)

Belgium allows a taxpayer to waive the L.P.P. and to authorize the lawyer to comply with his or her reporting duty.[11] However, the waiver is incompatible with the public policy (*ordre public/openbare orde*) that exists in the L.P.P. covering Belgian lawyers. Under Belgian law, when a statutory provision reflects public policy, one cannot derogate from it unilaterally or by mutual agreement. If it were otherwise, government pressure imposed on the taxpayer could easily jeopardize a taxpayer's right of defense, including the presumption of innocence.

"Under Belgian law, when a statutory provision reflects public policy, one cannot derogate from it unilaterally or by mutual agreement.'"

For more than a century, the Belgian Court of Cassation explicitly acknowledges the L.P.P.'s public policy nature:[12]

> Legal professional privilege relates to public order and protects a specific interest, which is to ensure the practicability of certain professions necessary for the proper functioning of [a democratic] society, the exercise of which necessarily implies a guarantee for the confidant that the trust in the person to whom he confides is not betrayed. [Unofficial translation.]

The Reporting Obligation for Marketable Arrangements is Overly Broad

Belgian lawyers cannot invoke their L.P.P. rights where the reporting obligation relates to a marketable arrangement.[13] In contrast with a bespoke arrangement, the Belgian Implementation Law defines a "marketable arrangement" as "a cross-border arrangement that is designed, marketed, ready for implementation or made available for implementation without a need to be substantially customised."[14]

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9 Belgian Constitutional Court, No. 126/2005 of 13 July 2005, available on www.const-court.be, see spec. points B.6.1.-B.6.3.

10 Belgian Constitutional Court, No 127/2013 of 26 September 2013, available on www.const-court.be, spec. points B.29.2, B.29.3 and 30.

11 B.I.T.C., Section 326/7, § 2.

12 Belgian Court of Cassation, 20 February 1905, *Pasicrisie (Pas.),* I, 1905, p. 141; For a more recent case, see Belgian Court of Cassation, 19 January 2001, *Journal des tribunaux (J.T.),* 2002, p. 9; The Belgian Constitutional Court also acknowledges the public policy nature of the L.P.P., Belgian Constitutional Court, 3 May 2000, *Jurisprudence Liège Mons Bruxelles (J.L.M.B.).,* 2000, p. 868; Belgian Constitutional Court, 24 March 2004, *Jurisprudence Liège Mons Bruxelles (J.L.M.B.).,* 2004, p. 2080.

13 B.I.T.C., Section 326/7, §3.

14 B.I.T.C., Section 326/1, 6°, unofficial translation.

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The rationale for this provision is that the Directive orders Member States to require intermediaries to report on a quarterly basis each marketable arrangement in which the intermediary participated. Since the first intermediary is the only one who has the knowledge and ability to make a quarterly report of marketable arrangements, he cannot pass this reporting obligation to another intermediary or to the taxpayer. Moreover, he or she cannot invoke any rights related to the L.P.P. for lawyers.

This looks quite similar to the German "*kurieren am Symptom*." Since no effective solution can be found for the quarterly reporting of marketable arrangements, the first intermediary must breach his L.P.P. But why should the first intermediary not be able to provide the taxpayer with the information required to file the quarterly report? This mechanism works well for the first report and should work equally well for the quarterly reports.

When a lawyer advises a client (such as a bank or an insurance company) on a marketable arrangement, the client is rarely the end-user since he in turn sells the arrangement to the actual end-user. Such clients are sufficiently equipped to make the quarterly reporting themselves and may even be in a better position than the lawyer who merely provides legal or tax advice on the marketable arrangement.

The Assertion that the L.P.P. Does Not Apply to Tax Advice is Without Merit

the Explanatory Memorandum of the Belgian Implementation Law suggests that a lawyer's tax planning advice would not be covered by the L.P.P., as the privilege only covers the legal defense or representation in court and/or the determination of the legal position of a taxpayer.[15]

> The * * * implementation of cross-border arrangements * * * is not immediately related to any secret entrusted to an intermediary by his client but is more a matter of assistance or advice provided by the intermediary to the client. The protection of the trust that a client puts in an intermediary as a result of the exercise of his professional activity can only concern the assistance or advice provided by the intermediary to the client insofar as it relates to the determination of the legal position of a taxpayer or the defense of the taxpayer in a judicial action, which can also be found in the Law of September 18, 2017 on the prevention of money laundering and terrorist financing and the limitation of the use of cash. In particular, this refers to purely legal advice, excluding tax planning of a potentially aggressive nature. It is only for these activities that a statutory exemption from the reporting obligation may apply for the intermediary. On the other hand, an adviser who limits himself to the above-mentioned legal advice and who has at no time directly or through other persons provided help, assistance or advice concerning the design, marketing or organization of a reportable cross-border scheme or concerning its provision for implementation or the management of its implementation, will not be considered an intermediary, as defined in the Directive, and will therefore not be subject to the reporting obligation.

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[15] Belgian Parliamentary Documents, House of Representatives, 2019-2020, n° 55-791/001, pp. 18-22, spec. p. 19 (hereinafter: "Explanatory Memorandum"); To be read in parallel with the Law of 18 September on the prevention of money laundering and terrorist financing and the limitation of the use of cash, Belgian State Gazette, 16 October 2017, spec. art. 53.

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> This view is therefore consistent with Section 53 of the Law of September 18, 2017, as it implicitly recognizes that, in the context of the determination of the legal position and legal defense/representation, the L.P.P. applies. In this context, a statutory exemption from the reporting obligation for the intermediary can indeed be granted within the limits of the aforementioned regulation. [Unofficial translation.]

This reasoning of the Belgian legislator disregards the case-law of the Belgian Constitutional Court, which takes the opposite view:[16]

> [I]nformation known to the lawyer in the course of the exercise of the essential activities of his profession * * *, namely the assistance and defense of the client in court, and legal advice, even outside of any legal proceedings, are covered by the L.P.P., and may not be brought to the attention of the authorities. [Unofficial translation.]

In the Explanatory Memorandum, the Belgian legislator ventures into a hazardous comparison with the reporting obligation in money laundering cases and to the fact that the L.P.P. is subordinated to a higher value ("*motif d'intérêt supérieur/reden van hoger belang*").

No one disputes that even fundamental rights are subject to exceptions and must give way to an overriding interest. In this instance, however, the Belgian legislator is comparing apples to oranges. The mandatory reporting in money laundering cases relates to criminal offenses that the client is suspected of, whereas D.A.C.6 concerns legitimate cross-border arrangements that are neither fraudulent nor even abusive.

Moreover, when lawyers suspect a client of money laundering, they report it to the President of the Bar Association, not to the Belgian Financial Information Processing Unit ("C.T.I.F./C.F.I.") and definitely not to the Public Prosecutor. For D.A.C.6, the Belgian legislator does not mention any overriding interest that would be proportionate to the objective to be achieved and justify lifting the L.P.P.

LEGAL CHALLENGE TO B.I.T.C. SECTION 326/7

At the time this article was written, the Belgian Bar Councils (the Flemish (O.V.B.) and the French and German (O.B.F.G.) Bars) and the Belgian Association of Tax Lawyers have challenged the restrictive interpretation of the L.P.P. in the Belgian Implementation Law before national and European courts. The identity of the appellants is no coincidence since the L.P.P. is a concept of great importance to all members of the legal profession.

On August 31, 2020, they lodged claims for the suspension and annulment of the Flemish Decree implementing the Directive before the Belgian Constitutional Court. On December 21, 2020, the Belgian Constitutional Court requested a preliminary

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[16] Belgian Constitutional Court, Case No. 10/2008 of 23 January 2008, available on www.const-court.be, spec. point B.9.6; The Belgian Constitutional Court also rules that the L.P.P. is a general principle of law that can only be overridden by an urgent reason of general interest and the lifting of it must be strictly proportionate to that general interest (see Case No 127/2013 of 26 September 2013, spec. point B.31.2).

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ruling from the European Court of Justice on the Belgian implementation of D.A.C.6. The request for a preliminary ruling concerns the compatibility of the Directive with Section 7 (right to respect private life) and Section 47 (right to a fair trial) of the Charter of Fundamental Rights of the E.U. insofar as it requires legal counsel to notify other intermediaries of a need to report under D.A.C.6.

The Court's ruling is highly expected, as it will be important not only for Belgium, but also for all other Member States.

CONCLUSION

The important take-aways for the reader may be summarized as follows:

- The Belgian L.P.P. covers the mere fact that a taxpayer/client has chosen a specific lawyer to provide him with legal or tax advice. The L.P.P. covers both advice given to the client by the lawyer and information received by the lawyer from the client. Requiring a lawyer to inform another intermediary of confidential information received from a client as a condition to applying the L.P.P. is simply a gutless a breach of the L.P.P. by the government.
- •The Belgian L.P.P. reflects time honored public policy. A taxpayer cannot be forced to waive the privilege unilaterally or mutually, by reason of an agreement with his or her lawyer, and even if the taxpayer would be allowed to do so or do so on a voluntary basis, his or her consent would not be valid and would not be a sufficient legal basis for the lawyer to breach the L.P.P.
- The Belgian L.P.P. should apply to marketable arrangements, unless reasonable justification exists in a fact pattern for their exclusion, *quod non*.
- The Belgian L.P.P. applies equally when a lawyer gives tax advice to a client. The L.P.P. is not limited to legal defense or representation in court and/or the determination of the legal position of a taxpayer. The asserted comparison to anti-money laundering legislation is flawed because (i) the reporting obligation under D.A.C.6 relates to legitimate acts that are neither fraudulent nor abusive, and are not directed to facts constituting a criminal offense, (ii) no "filter" exists between the lawyer and the authorities as exists in anti-money laundering cases, where the President of the Bar serves as an intermediary, and (iii) the lifting of the L.P.P. is not proportional to any overriding interest.

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HOW NEW YORK COURTS PROVIDE BROAD SUPPORT TO PARTIES ENGAGED IN INTERNATIONAL ARBITRATION AND LITIGATION

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Tags
Arbitration
Attachment
Discovery
Litigation
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INTRODUCTION

The State and Federal courts of New York provide critical means of obtaining a wide range of discovery in, as well as enforcement of, foreign or international arbitral and judicial proceedings. Even if the parties, the contract, or the dispute at issue have little or no connection to New York, but potential documents, assets, or witnesses are located within the State, New York courts can provide tools (i) to obtain broad information vital to a pending foreign proceeding, (ii) to attach assets to secure an ultimate recovery or incentivize settlement, or (iii) to enforce final judgments or awards, including seizure of assets and other post-judgment remedies.

OBTAINING DISCOVERY IN NEW YORK FEDERAL COURTS THROUGH 28 U.S.C. §1782

U.S. Federal law provides a means by which parties to foreign arbitrations and litigations can obtain discovery in the United States. Specifically, Title 28, Section 1782 of the United States Code ("28 U.S.C. §1782" or "Section 1782") is designated "Assistance to foreign and international tribunals and to litigants before such tribunals." This statute specifically provides that a U.S. district court having jurisdiction over a person or entity within that district can order that person or entity to provide testimony or produce documents or other items "for use in a proceeding in a foreign or international tribunal." Section 1782(a). Such an order from a U.S. district court can be made pursuant to a letter rogatory or request from the foreign tribunal. It can also be based "upon the application of any interested person." Such an order can adopt the "practice and procedure" of the foreign tribunal for the discovery sought, or it can be governed by the Federal Rules of Civil Procedure applicable to U.S. litigants. In other words, Section 1782 can give parties to foreign litigations and arbitrations access to the liberal methods and broad scope of discovery available in U.S. proceedings.

As articulated by the U.S. Court of Appeals for the Second Circuit, the Federal appellate court in New York, the "twin aims" of the statute are "providing efficient means of assistance to participants in international litigation in our Federal courts and encouraging foreign countries by example to provide similar means of assistance to our courts."[1] Consistent with these goals, there are three requirements to obtaining discovery through application of this statute:

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[1] *In re Application of Al-Attabi.*

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- The person from whom discovery is sought resides (or is found) in the district of the district court to which the application is made.
- The discovery is for use in a foreign proceeding before a foreign [or international] tribunal.
- The application is made by a foreign or international tribunal or any interested person.[2]

Each of these three requirements can be addressed briefly.

First, the scope of "discovery" and "evidence" to be sought is broad, encompassing both testimony in a deposition or documents or other items having any potential relevance to the proceeding. The statute also allows for such testimony or documents to be sought from either a party or a non-party to the proceeding. In fact, there is no requirement that the testimony or documents being sought even be discoverable or admissible in the foreign tribunal – it need only be discoverable under the expansive U.S. standards of discovery. However, there is a territorial limitation. The person or entity from whom the discovery is sought must reside in or be found in the district for which the district court has jurisdiction. This simply means that, for example, if the person resides in or the entity has an office in Manhattan, the application must be made to the U.S. District Court for the Southern District of New York, not any other Federal court.

Second, the discovery sought must be "for use in a foreign proceeding," and both "use" and "foreign proceeding" are broadly defined. As for "use," this is not a requirement that the discovery is necessary for the requesting party to prevail; no such necessity need be demonstrated. "The plain meaning of the phrase 'for use in a proceeding' indicates something that will be employed with some advantage or serve some use in the proceeding — not necessarily something without which the applicant could not prevail."[3] The discovery must merely serve some purpose at some stage in a foreign proceeding. And the "foreign proceeding" can be a foreign litigation, a foreign arbitration, a foreign appeal, or even a proceeding that has not even been initiated yet, but which is within "reasonable contemplation" of the requesting party.

Third, the request must be made by a foreign tribunal *or* by "any interested person." A request from an "interested person" (such as one of the parties) will likely take less time and allow for the requesting party to seek a broader scope of discovery than would be requested in a letter of request or letters rogatory issued by a foreign court.[4] But either option will satisfy this requirement.

If these three broad requirements are met, the U.S. district court has wide discretion to order discovery. Section 1782 "entrusts to the district courts many decisions about the manner in which discovery under the statute is produced, handled, and

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2 *Mangouras v. Squire Patton Boggs.*

3 *Mees v. Buiter.*

4 Note that both the United States and the United Kingdom have ratified the 1970 Hague Convention on the Taking of Evidence Abroad in Civil and Commercial Matters, the 1965 Hague Service Convention, and the 1961 Hague Apostille Convention, all facilitating the requests for and use of legal evidence across national jurisdictions.

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used."[5] In the exercise of such discretion, there are several factors for which the district court can take account. The U.S. Supreme Court (in *Intel Corp. v. Advanced Micro Devices, Inc.*) has identified four such factors:

- Whether the person from whom discovery is sought is a participant in the foreign proceeding, in which case the need for §1782(a) aid generally is not as apparent.
- The nature of the foreign tribunal, the character of the proceedings underway abroad, and the receptivity of the foreign government or the court or agency abroad to U.S. Federal-court judicial assistance.
- Whether the request conceals an attempt to circumvent foreign proof-gathering restrictions or other policies of a foreign country or the United States.
- Whether the request is unduly intrusive or burdensome.

In addition, "a district court [can] condition relief upon that [requesting] person's reciprocal exchange of information," but it is not required to do so.[6]

However, the question of whether the sought-after evidence is *admissible* in the foreign proceeding is *not* a valid consideration when determining whether to order discovery pursuant to Section 1782. The Second Circuit has consistently held "that §1782 [does] not require that the discovery material be admissible in the foreign proceeding, on the ground that, '[a]s in *Intel*, there is no statutory basis for [such a] requirement.'"[7]

OBTAINING ATTACHMENT OF ASSETS IN NEW YORK STATE AND FEDERAL COURTS

One highly useful tool available under New York State and Federal law before reaching a final judgment or final determination in arbitration is attachment of assets located in New York. This tool can ensure that sufficient assets are available to provide a full recovery should the party obtain a successful decision, and the act of freezing such assets may prompt the parties to consider settlement or another resolution of the matter.

There are four types of attachment of New York assets that are relevant here:

- Attachment prior to reaching a decision in a U.S. or foreign arbitration.
- Attachment while a motion is pending in a New York court to recognize an arbitration award (U.S. or foreign) or a foreign judgment.
- Attachment before a judgment has been reached in a litigation commenced in New York.
- Attachment pursuant to U.S. Federal maritime/admiralty law ("Rule B") prior to a final decision or judgment.

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5 *In re Accent Delight Int'l Ltd.*

6 *Sampedro v. Silver Point Capital.*

7 *Mees v. Buiter.*

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Although the first three are remedies provided under New York State law, a Federal court in New York can and will invoke any or all of those three state-law remedies, so long as diversity of citizenship exists between the parties.

For the **first** type of attachment, pursuant to New York Civil Practice Law and Rules ("N.Y. C.P.L.R.") 7502 provides that a participant in a U.S. or foreign arbitration can seek an order from a New York court to attach assets in New York before a decision is reached in the arbitration. It must be an arbitration that is currently pending or will be commenced within 30 days. The arbitration can be taking place in the U.S., the U.K., or nearly anywhere else worldwide. The relevant New York court "may entertain an application for an order of attachment or for a preliminary injunction in connection with an arbitration that is pending or that is to be commenced inside or outside this state, whether or not it is subject to the United Nations convention on the recognition and enforcement of foreign arbitral awards . . . ."[8]

The basis for an application must be "upon the ground that the [arbitration] award to which the applicant may be entitled may be rendered ineffectual without such provisional relief."[9] Examples of an appropriate ground include

- a risk that the other party may become insolvent before an award is reached and satisfied,
- the other party is a nonresident of New York or a foreign corporation not qualified to do business in New York, or
- the other party, "with intent to defraud his creditors or frustrate the enforcement of a judgment [or award] that might be rendered in [the other party's] favor, has assigned, disposed of, encumbered or secreted property, or removed it from the state or is about to do any of these acts * * * ."[10]

If any of those grounds exists, an order of attachment can be granted both before any arbitration award is reached, as well as before any foreign arbitration award is domesticated as a New York judgment.

Procedurally, a party to a foreign arbitration can apply to a New York court having jurisdiction over the assets in issue, though an *ex parte* motion or a motion on notice.[11] The application or motion can seek to attach any tangible or intangible property held by the opposing party or by a third party on behalf of the opposing party.[12] However, the application requires the applicant to "give an undertaking, in a total amount fixed by the court."[13] This means the applicant must post a bond or make a cash deposit, typically 5-7% of the value of the assets to be attached, although the amount is wholly subject to the discretion of the court. The undertaking can be waived by contract, so an arbitration agreement that does so would eliminate that requirement.

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[8] N.Y. C.P.L.R. §7502(c).

[9] *Id.*

[10] N.Y. C.P.L.R. §6201.

[11] N.Y. C.P.L.R. §§6210-6211.

[12] N.Y. C.P.L.R. §6202.

[13] N.Y. C.P.L.R. §6211(b).

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“Significantly, there is one form of property that cannot be subject to attachment under Admiralty Rule B. This property is ‘E.F.T. funds,’ meaning funds that are in the hands of an intermediary bank processing them as a result of an electronic funds transfer. . .”

When faced with an application, the court will consider various factors, including

- the possibility of irreparable harm, as described above,
- the likelihood of success on the merits for the applicant, and
- a balance of the equities in favor of the applicant.[14]

These are the same three elements used when ruling on motions seeking temporary restraining orders or preliminary injunctions, which are discussed below.

For the **second and third** types of attachment, Article 62 of the N.Y. C.P.L.R. can be invoked to seek attachment of assets in New York (a) while a motion is pending in a New York court to recognize a foreign arbitration award or foreign judgment or (b) while an action is pending in New York but has not yet reached a judgment. An applicant would use the same procedures outlined above, and the court will apply similar standards in determining whether to issue an order, namely, looking for irreparable harm in the absence of attachment, the likelihood of success on the merits, and a balance of equities.[15]

For the **fourth** type of attachment, it is Federal admiralty law, specifically “Admiralty Rule B,” that provides a basis for attaching property in New York. It allows for attachment of such property having a value up to the value of the claim in the foreign arbitration or foreign litigation. To seek such relief in the relevant U.S. District Court in New York, the applicant must demonstrate that (i) it has a valid claim under admiralty law against the other party and (ii) the other party does not reside and cannot be found in the district. If those elements are met, the Federal court can grant an order of attachment, and will, again, look for irreparable harm, the likelihood of success on the merits, and a balance of the equities.

Significantly, there is one form of property that *cannot* be subject to attachment under Admiralty Rule B. This property is “E.F.T. funds,” meaning funds that are in the hands of an intermediary bank processing them as a result of an electronic funds transfer – as opposed to funds simply sitting in the other party’s account at the other party’s bank.

Each of these forms of attachment of New York assets is potentially available in New York courts to a party to a foreign arbitration or foreign litigation.

OBTAINING A PRELIMINARY INJUNCTION OR TEMPORARY RESTRAINING ORDER IN NEW YORK COURTS

In addition to attachment, a party to a foreign arbitration or foreign litigation could seek other preliminary, prejudgment relief in the form of a preliminary injunction or a temporary restraining order. Pursuant to N.Y. C.P.L.R. §6301

> [a] preliminary injunction may be granted in any action where it appears that the defendant threatens or is about to do, or is doing or procuring or suffering to be done, an act in violation of the plaintiff’s

[14] N.Y. C.P.L.R. §§6212(a), 6201, 7502.

[15] N.Y. C.P.L.R. §§6212(a), 6201.

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> rights respecting the subject of the action, and tending to render the judgment ineffectual, or in any action where the plaintiff has demanded and would be entitled to a judgment restraining the defendant from the commission or continuance of an act, which, if committed or continued during the pendency of the action, would produce injury to the plaintiff. A temporary restraining order may be granted pending a hearing for a preliminary injunction where it appears that immediate and irreparable injury, loss, or damage will result unless the defendant is restrained before the hearing can be had.

A preliminary injunction can be granted only upon a motion on notice to the other side in which the applicant shows that

> * * * the defendant threatens or is about to do, or is doing or procuring or suffering to be done, an act in violation of the plaintiff's rights respecting the subject of the action and tending to render the judgment ineffectual; or that the plaintiff has demanded and would be entitled to a judgment restraining the defendant from the commission or continuance of an act, which, if committed or continued during the pendency of the action, would produce injury to the plaintiff.[16]

It requires an undertaking to be given, as described above. In addition to this showing of irreparable harm, the applicant must also show a likelihood of success on the merits and a balance of equities in the applicant's favor.

A temporary restraining order ("T.R.O.") is typically sought based upon an *ex parte* motion in which the applicant "shall show that immediate and irreparable injury, loss or damages will result unless the [other party] is restrained before a hearing can be had."[17] It also requires an undertaking to be given, as described above. If a T.R.O. is granted, the court "shall set the hearing for the preliminary injunction at the earliest possible time." If this is in New York state court, it will be scheduled within a "reasonable" time after the grant of the T.R.O. If in New York Federal court, it will be scheduled within 10 days of the grant of the T.R.O.

Each of these tools is potentially available in New York courts to a party to a foreign arbitration or foreign litigation.

RECOGNITION OF FOREIGN JUDGMENTS AND ARBITRAL AWARDS IN NEW YORK COURTS

Generally, once a party reaches a final judgment in a foreign litigation or a final award in a foreign arbitration, New York courts will readily recognize and enforce the judgment or award. The rules for recognition are quite liberal in both New York state and Federal courts, and, when recognized, a foreign judgment or arbitration award is treated identically to any judgment originating from such courts.

First, regarding foreign judgments, New York courts will presumptively recognize monetary judgments deriving from other countries having legal systems similar to that of the United States. New York state courts will follow the Uniform Recognition

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16 N.Y. C.P.L.R. §§6311-6312.

17 N.Y. C.P.L.R. §6313.

of Foreign Country Money Judgements, codified in Article 53 of the N.Y. C.P.L.R., and New York Federal courts will invoke comity to provide recognition in a similar manner. More specifically, except as provided in N.Y. C.P.L.R. §5304

> [a] court of this state shall recognize a foreign country judgment to which this article applies as conclusive between the parties to the extent that it grants or denies recovery of a sum of money.[18]

To do so, a party to a foreign judgment can file an action on the judgment or a motion for summary judgment in lieu of a complaint. If such recognition is sought in an action already pending in New York, the issue can be raised by counterclaim, crossclaim, or affirmative defense.

Thus, Per Article 53, the foreign monetary judgment will be recognized in New York state court, or in New York Federal court applying comity or applying state law when there is diversity of citizenship, unless an exception from N.Y. C.P.L.R. §5304 applies. Per the terms of N.Y. C.P.L.R. §§5303 and 5304, there is no requirement of reciprocity in foreign recognition of judgments from U.S. courts. There is no requirement that the country in which a court rendered the judgment at issue is a country officially recognized by the United States, such as Taiwan is not. A New York court could recognize a foreign judgment even if that judgment is on appeal in the foreign forum. Also, the application of comity and the liberal standards of recognition can often lead to recognition of foreign nonmonetary judgments to enforce legal concepts such as collateral estoppel and *res judicata*.

N.Y. C.P.L.R. §5304 provides several exceptions to recognition of foreign judgments. It sets forth three mandatory grounds for non-recognition, based on complete lack of due process or jurisdiction, as follows:

> A court of this state may not recognize a foreign country judgment if:
>
> 1. the judgment was rendered under a judicial system that does not provide impartial tribunals or procedures compatible with the requirements of due process of law;
>
> 2. the foreign court did not have personal jurisdiction over the defendant; or
>
> 3. the foreign court did not have jurisdiction over the subject matter.[19]

The statute also provides nine discretionary grounds for nonrecognition of a foreign judgment, based largely on procedural irregularities or conflicts with due process or U.S. public policy, as follows:

> A court of this state need not recognize a foreign country judgment if
>
> 1. the defendant in the proceeding in the foreign court did not receive notice of the proceeding in sufficient time to enable the defendant to defend;

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[18] N.Y. C.P.L.R. §5303.

[19] N.Y. C.P.L.R. §5304(a).

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2. the judgment was obtained by fraud that deprived the losing party of an adequate opportunity to present its case;

3. the judgment or cause of action on which the judgment is bases is repugnant to the public policy of this state or of the United States;

4. the judgment conflicts with another final and conclusive judgment;

5. the proceeding in the foreign court was contrary to an agreement between the parties under which the dispute in question was to be determined otherwise than by a proceeding in that court;

6. in the case of jurisdiction based only on personal service, the foreign court was a seriously inconvenient forum for the trial of the action;

7. the judgment was rendered in circumstances that raise substantial doubt about the integrity of the rendering courts with respect to the judgment;

8. the specific proceeding in the foreign court leading to the judgment was not compatible with the requirements of due process of law; or

9. the cause of action resulted in a defamation judgment obtained in a jurisdiction outside the United States, unless the court before which the matter is brought sitting in this state first determines that the defamation law applied in the foreign court's adjudication provided at least as much protection for freedom of speech and press in that case as would be provided by both the United States and New York constitutions.[20]

"The use of the N.Y. Convention is subject to some restrictions. The United States limits the application of the N.Y. Convention to commercial matters."

A New York court confronting one of these discretionary grounds for recognition could choose (i) to refuse to recognize the judgment, (ii) to simply stay the motion seeking recognition pending further inquiry or analysis, or (iii) to recognize the judgment despite this issue. Importantly, the party resisting recognition of a foreign judgment in New York bears the burden of establishing that one of these grounds for nonrecognition exists, without which the judgment will be recognized.[21]

Second, regarding foreign arbitration awards, New York courts will presumptively recognize and enforce arbitration awards issued in many foreign or international forums under either New York state law or pursuant to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (known as the "N.Y. Convention") adopted by the U.S., U.K., and 148 other countries.

The use of the N.Y. Convention is subject to some restrictions. The United States limits the application of the N.Y. Convention to commercial matters. Further, there

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[20] N.Y. C.P.L.R. §5304(b). This ninth ground could prevent the recognition of certain libel or defamation judgments issued by courts in the U.K.

[21] N.Y. C.P.L.R. §5304(c).

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are seven grounds set forth in the N.Y. Convention for non-recognition of a foreign arbitral award, even if it is from a commercial matter. Those grounds, per Article V(1)-(2), are

> [1] The parties to the agreement [to arbitrate] were, under the law applicable to them, under some incapacity, or the said agreement is not valid under the law to which the parties have subjected it or, failing any indication thereon, under the law of the country were the award was made; or
>
> [2] The party against whom the award is invoked was not given proper notice of the appointment of the arbitrator or of the arbitration proceedings or was otherwise unable to present his case; or
>
> [3] The award deals with a difference not contemplated by or not falling within the terms of the submission to arbitration, or it contains decisions on matters beyond the scope of the submission to arbitration, provided that, if the decisions on matters submitted to arbitration can be separated from those not so submitted, that part of the award which contains decisions on matters submitted to arbitration may be recognized and enforced; or
>
> [4] The composition of the arbitral authority or the arbitral procedure was not in accordance with the agreement of the parties, or, failing such agreement, was not in accordance with the law of the country where the arbitration took place; or . . .
>
> [5] The award has not yet become binding on the parties, or has been set aside by a competent authority of the country in which, or under the law of which, that award was made.
>
> [6] The subject matter of the difference is not capable of settlement by arbitration under the law of that country [*i.e.*, the country where recognition and enforcement is sought]; or
>
> [7] The recognition or enforcement of the award would be contrary to the public policy of that country.

If the limitations of the N.Y. Convention pose an issue, Article 75 of the N.Y. C.P.L.R. provides even broader authority to recognize and enforce foreign arbitral awards. Indeed, any arbitration agreement

> * * * is enforceable without regard to the justiciable character of the controversy and confers jurisdiction on the courts of the state [and on New York Federal courts applying state law] to enforce it and to enter judgment on an award. In determining any matter arising under this article, the court shall not consider whether the claim with respect to which arbitration is sought is tenable, or otherwise pass upon the merits of the dispute.[22]

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[22] N.Y. C.P.L.R. §7501.

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New York courts thus routinely recognize and enforce virtually all arbitration awards. In fact, per N.Y. C.P.L.R. §7510

> * * * [t]he court shall confirm an [arbitration] award upon application of a party made within one year after its delivery to him, unless the award is vacated or modified upon a ground specified in section 7511.

An award may be vacated if the rights of a party were prejudiced in some way or the arbitration agreement was invalid or breached or it may be modified if there was a miscalculation or an error in form, outside of the merits.[23] In any event, the party opposing the recognition of the foreign arbitral award again bears the burden of demonstrating a basis for non-recognition, or it will be confirmed, per the presumption in N.Y. C.P.L.R. §7510.

Once an arbitration award is recognized by a New York state or Federal court, it becomes a judgment of that court.[24] "A judgment shall be entered upon the confirmation of an award." As such, it is then entitled to identical treatment and enforcement, including in other U.S. states, as an original judgment originating from that court.

Third, once a foreign judgment or foreign arbitral award is recognized by a New York court, there is a myriad of tools available for post-judgment enforcement in New York.

As noted above, attachment of funds and assets in New York can be sought via an *ex parte* motion while seeking the New York court's recognition of a foreign arbitration award or foreign judgment. In fact, "when a judgment debtor is subject to a New York court's personal jurisdiction, that court has jurisdiction to order the judgment debtor to bring property into the state" under that authority.[25]

Additional discovery can be obtained post-judgement or post-award, in order to gather information about funds and other assets that may be needed to satisfy the judgment or award. New York courts will generally allow wide latitude to find such information. A judgment creditor or an award creditor can seek documents, answers to interrogatories or requests for admission, and even deposition testimony from the judgement debtor, from garnishees, and from third parties potentially having relevant knowledge, all to access such information and learn the best avenues to pursue for collection. Such discovery can be sought from a bank used by the judgment debtor to obtain credit. Also available is information provided to the bank by the judgment debtor that details his income, investments, property, other assets, debts, and liabilities.

Discovery can be used to obtain account statements from financial services companies or fund managers to track where funds may have been transferred. Discovery can also be used to gather information from or about spouses, family members, business partners, etc., to whom assets may have been transferred to hide them from the judgment creditor. Often at this point there are many questions in need of answers, and post-judgment or post-award discovery can provide some of those answers to ensure full recovery.

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23 N.Y. C.P.L.R. §§7511(b)-(c).

24 N.Y. C.P.L.R. §7514.

25 *Koehler v. Bank of Bermuda Ltd.*

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In addition to obtaining information about assets and attaching assets, a judgment or award creditor potentially can seek a restraining notice issued to the judgment debtor and third parties. Once a foreign judgment or arbitral award has been recognized in a New York court, it becomes a judgment of that court, and, per N.Y. C.P.L.R. §5222(a), an attorney for the judgment creditor (or a clerk of the court) can issue a restraining notice to enforce that judgment. Such a notice will bar the judgment debtor or third parties, such as banks, broker/dealers, suppliers, vendors, business partners, etc., from "any sale, assignment, transfer or interference with any property" to which the notice applies.[26]

Other tools available in New York courts include (i) orders of seizure or levy on tangible property, such a real property, and intangibles, such as shares of stock and other investment holdings; (ii) income executions or garnishment; (iii) installment payment orders; (iv) receivership, if deemed necessary to prevent dissolution of assets; and (v) enforcement by contempt, meaning the judgment debtor is held in contempt of court as a result of failing to comply with the court's directives and is thereby subject to further orders and restrictions.

CONCLUSION

There are a wide range of methods and processes readily available in New York state and Federal courts to gather information in, secure resources for, and enforce decisions of foreign or international arbitrations and litigations. Parties to such proceedings should take full advantage of these many tools available to reach a positive resolution and maximize recovery.

[26] N.Y. C.P.L.R. §5222(b).

ISRAEL TAX AUTHORITY PROPOSES CHANGES FOR INDIVIDUALS WITH CROSS-BORDER CONNECTIONS

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Tags
Basis Step-Up
C.F.C.
Exit Tax
Foreign Tax Credit
Israel
L.L.C.
New Residents
Residence

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INTRODUCTION

The Israel Tax Authority (the "I.T.A.") has proposed major international tax reform (the "Reform") that may have a great influence on the residence of individuals and companies having economic operations in Israel or personal ties to Israel. The reform may influence foreign-resident individuals considering a move to Israel and Israeli resident individuals considering a departure from Israel. This article summarizes the main points relating to individuals

CHANGE IN DETERMINATION OF TAX RESIDENCY OF INDIVIDUALS

As of today, an individual is considered to be an Israeli tax resident if the individual's "center of vital interests" is in Israel. This is a facts-and-circumstances test that examines the individual's family, economic, and social ties. In addition, there are two rebuttable presumptions based on the number of days the individual spends in Israel. Under the presumptions, an individual is considered a resident when

- more than 183 days of presence in Israel exists in a tax year, or
- 30 days or more of presence in Israel exists in a tax year and the total number of days of presence in Israel in the three most recent tax years amount to at least 425 days.

The presumptions can be rebutted, by both the individual and the I.T.A., and the party that wishes to rebut the presumption has the burden of proof as to the country in which the individual's center of vital interests is located.

The Reform introduces the concept of irrebuttable presumptions in order to determine the tax residence of individuals who are present in Israel. Under the Reform, an individual will be considered an Israeli tax resident in any of the following fact patterns:

- The individual stays in Israel for more than 183 days in each of two consecutive tax years.
- The individual stays in Israel for more than 100 days in the current tax year and more than 450 days over the course of the three most recent tax years. This presumption will not apply if the individual stays 183 days or more in a country with which Israel has an income tax treaty in effect (a "Treaty Country") and the individual obtains a certificate of residency from the tax authority of that country.

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- The individual stays in Israel for more than 100 days in the current tax year and the individual's spouse is an Israeli tax resident or the individual with whom a mutual household is maintained is an Israeli tax resident.

At the same time, the Reform introduces conclusive presumptions determining that an individual is a foreign tax resident. Consequently, an individual will be considered to be a foreign tax resident in either of the following fact patterns:

- The individual spends less than 30 days per tax year in Israel during each of the four most recent tax years. In such instance, the individual will be considered a foreign tax resident from the first day of the four-year period. This presumption applies only if not more than 15 days are spent in Israel during the first month of the first tax year in the measuring period or during the last month of the last tax year in the measuring period.
- The individual spends less than 30 days per tax year in Israel during each of the three most recent tax years. In such instance, the individual will be a foreign tax resident from the first day of the second tax year. This presumption applies only if not more than 15 days are spent in Israel during the first month of the first tax year in the measuring period or during the last month of the last tax year in the measuring period.
- An individual and spouse spend less than 60 days per tax year in Israel during each of the four most recent tax years. In such instance, they will be foreign tax residents from the first day of the four-year period. This presumption will apply only if not more than 30 days are spent in Israel by the couple during the first two months of the first tax year or during the last two months of the last tax year in the measuring period.
- An individual and spouse spend less than 60 days per tax year in Israel during each of the three most recent tax years. In such instance, they will be foreign tax residents from the first day of the second tax year. This presumption will apply only if not more than 30 days are spent by the couple in Israel during the first two months of the first tax year or during the last two months of the last tax year.
- An individual and spouse spend less than 100 days per tax year in Israel during each of the four most recent tax years. In such instance, they will be foreign tax residents from the first day of the four-year period, provided they spend more than 183 days in a Treaty Country and obtain a certificate of residency from the tax authority of that country. This presumption will apply only if not more than 50 days are spent by the couple in Israel during the first 100 days of the first tax year or the last 100 days of the last tax year.
- An individual and spouse spend less than 100 days per tax year in Israel, during each of the three most recent tax years. In such instance, they will be foreign tax residents from the first day of the second tax year, provided they spend more than 183 days in a Treaty Country and obtain a certificate of residency from the tax authority of that country. This presumption will apply only if not more than 50 days are spent by the couple in Israel during the first 100 days of the first tax year or the last 100 days of the last tax year.

The Reform retains the center of vital interests test for cases where the conclusive presumptions are not applicable.

TAX BENEFITS TO NEW ISRAELI RESIDENTS AND RETURNING RESIDENTS

Since 2007, an individual who has become an Israeli tax resident, whether for the first time or after spending considerable time outside Israel as a foreign tax resident, is entitled to material tax and reporting benefits. New Israeli residents and returning residents are entitled to tax and reporting exemptions with respect to foreign income and assets for a period of 10 years, commencing on the date they became Israeli tax residents. The Reform is expected to abolish the exemption from reporting with respect to foreign income and assets, thereby eliminating a contentious issue with the O.E.C.D. and the E.U., but to date, there is no suggestion of any changes to the substantial tax exemption.

EXIT TAX

Israeli tax law imposes an exit tax on an individual who ceases to be a tax resident, which means that the assets of an Israeli who terminates his residency are considered to have been sold on the day prior to the day of departure. Current law allows the postponement of the tax payment until the date of an actual sale. The Reform provides additional reporting obligations on assets and the posting of guarantees by individuals who wish to postpone the tax payment to the sale event. It also cancels the option to postpone the tax payment in certain circumstances. The proposals are as follows.

If the value of the assets subject to exit tax as of the date of departure is less than NIS 3 million (approximately €840,000 as of November 30, 2021), the taxpayer may elect to postpone the tax payment to the realization date. However, the taxpayer must file a financial report for the year of departure that includes all assets owned and the unrealized gain as of the date of departure.

If the value of the assets subject to exit tax as of the date of departure exceeds NIS 3 million, the assets owned will be allocated to several categories, each having its own rule:

- The first category is readily marketable securities. Assets in this category will be treated as if sold on the departure date and will be taxed and reported accordingly.
- The second category is real estate located outside of Israel. Assets in this category may be treated in one of two ways, at the election of the taxpayer. The first calls for the immediate payment of exit tax and the second allows for postponed payment. Should the individual choose to postpone the payment, reporting obligations will be imposed to ensure proper reporting of the gain when due. In addition, if the tax is estimated to exceed NIS 1.5 million (approximately €420,000 as of November 30, 2021), an interest in the property may be required to be registered in favor of an Israeli nominee.
- The third category is other assets. Assets in this category may be treated in one of two ways at the election of the taxpayer. The first calls for the immediate payment of exit tax and the second allows for postponed payment. Should the individual choose to postpone the payment, title to the assets may be required to be held by an Israeli nominee.

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The Reform also includes additional provisions to prevent tax avoidance. For example, the exit tax may be imposed on dividend income distributed by a foreign company to an individual after that individual's departure. The tax would continue to be imposed until the postponed exit tax is fully paid. Another recommendation is to impose taxes on assets that are sold during a specified period commencing from the day the individual ceases to be an Israeli resident. That period under consideration is four years. The tax would be calculated as though the individual remained an Israeli tax resident.

CONTROLLED FOREIGN CORPORATION ("C.F.C.")

Under current law, C.F.C. rules provide that passive income of a foreign corporation controlled by Israeli residents result in a deemed dividend distributed to the Israeli shareholders in certain circumstances. The Reform will expand the definition of passive income to include income derived from interest, insurance, or royalties received from related parties in specified circumstances. In addition, the Reform proposes to increase the tax base by reducing the passive income threshold to one third of the total income or profits of the foreign company from the current threshold, which is of one third of total income or profits.

The reform would apply the C.F.C. rules on a broader basis for a corporation resident in a country on the black and grey lists of the E.U. (except where the country has an income tax treaty in effect with Israel) or a resident of a country that does not have an agreement with Israel that allows the exchange of information. Under the Reform, the C.F.C. rules would apply once Israeli share ownership reaches 30%, rather than 50% under current law. In addition, the C.F.C. rules would be applied to all passive income of a C.F.C., no matter the percentage which passive income bears to total income or profits.

Also, as part of the Reform, the holdings of new residents and returning residents will be considered holdings of Israeli residents that are taken into account when determining whether a foreign corporation is a C.F.C. Under current law, those holdings are not considered to be owned by Israeli residents for when determining whether a foreign company is a C.F.C. This provision would apply only with respect to assets purchased after the arrival in Israel.

FOREIGN TAX CREDIT

The Reform proposes reducing the current number of foreign tax credit baskets to five. They would be baskets for

- passive income,
- active income,
- capital gains,
- C.F.C.'s, and
- professional foreign corporations ("P.F.C.'s").

In addition, the rules under which credits are provided would be tightened for taxes paid to countries included in the black or grey lists of the E.U. Also under

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consideration is the elimination of the five-year carryforward for unused foreign tax credits that exists under current law, except is specified circumstances.

TREATMENT OF L.L.C.'S

The I.T.A.'s current approach to U.S. L.L.C.'s treats an Israeli member of a U.S. L.L.C. as the owner of the LLC's taxable income only for the purpose of claiming foreign tax credits in Israel for the U.S. taxes paid at the member level. The I.T.A.'s approach explicitly states that an L.L.C. will not be regarded as a pass-through entity for all tax purposes. Consequently, the losses of an L.L.C. cannot be claimed by an Israeli resident as an offset to taxable income.

The Reform proposes to revise the I.T.A.'s approach so that losses derived by an Israeli resident from an L.L.C. formed under U.S. tax law will be available to offset income of that Israeli resident derived from U.S. sources and U.S. situs assets, provided the losses are available in the U.S. to reduce U.S. taxable income. This treatment will be elective and once elected will be irrevocable.

TAXATION OF EXERCISE OF OPTIONS AND WORK INCOME THAT ARE PARTIALLY VESTED WHILE THE INDIVIDUAL IS A FOREIGN TAX RESIDENT

According to the I.T.A.'s approach, an employee's income is calculated on a cash basis so that on the date the employee receives the income, the tax treatment is determined according to the employee's residence on that date. This rule applies also with respect to options granted or vested while the employee is a foreign tax resident. In order to encourage overseas Israelis to return to Israel, the I.T.A. is considering the adoption of a rule under which the employee will be exempt from tax in Israel in respect of the portion that was vested abroad, even if the income was received after the return of the employee to Israel.

BASIS STEP-UP FOR INHERITED PROPERTY

As of today, the I.T.A. allows a step-up in the basis of foreign assets received by an Israeli tax resident as a gift or inheritance made by a foreign tax resident. The I.T.A. is considering modifying the step-up rule. While no decision has yet been taken, several options are on the table. The first is to abolish the existing mechanism regarding foreign assets entering the Israeli tax net. Under this approach the pre-transfer appreciation in an asset received from a nonresident would be taxed in Israel at the time of sale by an Israeli donee or legatee according to the original cost basis. The second is a mechanism to tax overseas legatees when they receive a bequest from an Israeli decedent. This may be analogized to an inheritance or estate tax.

REPORTING OBLIGATIONS

The I.T.A. is considering the adoption of a mandatory information report that would be filed annually by an Israeli shareholder who holds, directly or indirectly, more

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than 50% of the controlling shares of a foreign corporation. The profit and loss statement of the foreign corporation and its P&L would be attached to the report. Also to be attached would be the names and other information of directors, management members, and shareholders. Finally, the I.T.A. is considering the imposition of a reporting obligation on resident individuals who receive a payment or a gift from abroad in an amount above NIS 500,000 (approximately €140,000 as November 30, 2021).

CONCLUSION

"Whether it is B.E.P.S., Pandora Papers, E.U. blacklists, or the Biden Administration tax proposals, governments and tax authorities are examining new ways to fund operating costs of government and to raise the level of examination for the wealthy, especially those with one foot at home and another abroad."

Whether it is B.E.P.S., Pandora Papers, E.U. blacklists, or the Biden Administration tax proposals, governments and tax authorities are examining new ways to fund operating costs of government and to raise the level of examination for the wealthy, especially those with one foot at home and another abroad. The Reform under consideration by the I.T.A. is in line with the current trend.

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