RUCHELMAN

the next generation of tax

INSIGHTS

2022: 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.

This year, 17 articles were written by 22 guest authors (in two instances, in collaboration with members of Ruchelman P.L.L.C). Of the 17 articles, topics included recent tax developments in Mexico, taxation of Israeli start-ups expanding to the U.S., the experience of a European law student serving as an extern with a U.S. law firm, the future of shell companies after A.T.A.D. 3, a primer on decentralized finance, issues regarding dividend withholding tax for foreign investors in India, the termination of Bilateral Investment Treaties in wholly European tax disputes, the never-ending dispute between Ecuador and Perenco notwithstanding arbitration awards under a Bilateral Investment Treaty, taxation of remote workers, financial collateralization agreements in Luxembourg, the short-lived U.K. growth plan, the allowance of foreign tax credits when Italian residents receive foreign source dividends, new tax rules in Italy regarding taxation of trusts, the new Franco-Belgian income tax treaty, and Greek tax rules that encourage immigration for people who help the economy. Two articles addressed strictly U.S. tax matters: matching U.S. corporations with beneficial owners and expanded I.R.S. reporting obligations for digital assets.

To our guest authors, we extend our heartfelt thanks. To our readers, we wish you all the best in 2023.

Happy Holidays!

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About Us

MEXICO: RECENT DEVELOPMENTS

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Tags
Anti-Tax Haven
Domain Extinction Law
G.A.A.R.
Mexico
Reportable Transaction
Tax Transparency

INTRODUCTION

This article focuses on certain provisions that have been added to Mexican tax law as part of the 2022 budget that was adopted in late October 2021. The provisions covered in this article place special emphasis on plugging gaps in tax compliance. In particular, more power has been given to the Mexican tax administration when conducting tax examinations, and for those taxpayers who are under examination, imposing more serious penalties where noncompliance is found to exist. Also covered are other changes based on the B.E.P.S. Actions of the O.E.C.D.

Tax authorities have informally let it be known that these changes were in the works for many years but could not be proposed earlier due to political reasons – prior administrations lacked control of both the House of Representatives and Senate, as was the case with A.M.L.O., during the first three years.

Criminal Tax Investigative Provisions

Some provisions adopted during A.M.L.O.'s term seek to aggressively attack non-compliance in tax matters by criminalizing certain acts of tax avoidance. If certain thresholds are met, another applies several investigation tools previously available only to authorities when fighting organized crime. In these cases, the authorities have broad investigative powers such as the power to intercept telephone calls and to apply the law of "domain extinction" to the assets of a targeted individual.

Mexico's domain extinction law is a forfeiture provision applicable when a person cannot prove that his or her assets can be tracked to a legitimate source of income. This law is applicable if criminal conduct is considered to be part of organized crime. Tax evasion, the acquisition of false invoices, and smuggling can be considered part of organized crime in certain cases. If the law of domain extinction applies, the assets are forfeited to the government without any compensation. This is a civil proceeding independent of the criminal procedure against the taxpayer.

As from 2020, tax crimes can also be considered as endangering National Security, the same as terrorism. Therefore, another provision calls for mandatory preconviction detention for some tax crimes if the amounts owed to the government are higher than, approximately 400 thousand dollars. That provision was ruled unconstitutional in 2021 by the Mexican Supreme Court.

Civil Tax Provisions

The most important changes or additions that might affect international clients are the following:

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- Introduction of a general anti-avoidance clause (hereinafter, Mexican G.A.A.R.)
- New regime for foreign transparent entities or foreign legal arrangements without legal personality
- Inclusion of reporting obligations for tax advisors
- Lowering the threshold for applying anti-tax-haven tax rules under which a taxpayer is considered to control an investment in a tax haven and limiting the active-income exception when determining if the anti-tax-haven rules apply
- The introduction of a provision that allows nonresidents to pay Mexican income taxes on a net income basis with regard to certain property gains

Missing from the civil tax revisions is any attempt to impose an annual wealth tax on Mexican individuals. Regarding the taxation of wealth, Mexico currently imposes transfer taxes on gifts. However, those taxes are not imposed when the recipient has any of the following family relations to the donor:

- The recipient is a direct ascendant of the decedent or donor, such as a parent or grandparent.
- The recipient is a direct descendant of the decedent or donor, such as a child or grandchild.
- The recipient is the spouse of the donor.

There is no inheritance tax in Mexico.

No annual wealth taxes are imposed on the federal level or the local level, other than yearly real property taxes imposed on the value of real estate or personal property taxes imposed on the value of vehicles owned. The 2022 budget made no changes to the absence of a Federal wealth tax in Mexico. For many, this was surprising, notwithstanding prior statements of A.M.L.O.

MEXICAN G.A.A.R.

This new rule is included in Article 5-A of the Federal Fiscal Code. It gives Mexican tax authorities the right to recharacterize a transaction where the following two facts exist:

- The transaction lacks a business reason.
- The transaction generates a tax benefit.

Commentators have severely criticized the rule due to its broad nature and lack of clarity. The term "business reason" is not defined in Mexican Law. On the other hand, the term "tax benefit" is defined broadly by this article. It includes any deferral, elimination, or reduction of a tax payment through the application of a deduction, exemption, nonrecognition provision, adjustments to the tax basis, tax credits, recharacterization of a payment or activity, or change of tax regime.

Putting the two conditions together, if a Mexican resident engages in any particular transaction of any kind which, in the eyes of the tax authorities, is not taxed as it

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should be, the individual must articulate a good business reason for the transaction or face disallowance under G.A.A.R.

The effects of this recharacterization are both administrative – payment of taxes – and possibly criminal. A major problem with the G.A.A.R. rule is that taxpayers have the burden of proving the existence of a valid business purpose once the matter is raised by the tax authorities.

INTERNATIONAL TAX TRANSPARENCY REGIME

"Although the law treats these entities as transparent for tax purposes and any transfer of property to those entities or arrangement without legal personality is not considered to be a taxable sale, no tax provision exists that expressly makes that statement."

If a Mexican resident is either

- a member, shareholder, or owner of a foreign transparent entity; or
- a participant in a foreign legal arrangement without legal personality,

the entity or arrangement will be disregarded for tax purposes and the income will be taxed in Mexico as if received directly by the Mexican taxpayer. To encourage compliance and to penalize noncompliance, a Mexican tax resident must file a report of any participation in a transparent entity or legal arrangement even if the percentage of ownership is infinitesimally small. To illustrate, if a Mexican tax resident owns a 0.001 percent (one thousandth of one percent) ownership interest in a transparent investment fund, that investment is reportable for Mexican tax purposes and the Mexican resident's income is taxable in Mexico when and as realized by the fund. A special report must be filed in February following the close of the tax year. This report is the same as the one used to report investments in controlled entities based in tax havens.

Although the law treats these entities as transparent for tax purposes and any transfer of property to those entities or arrangement without legal personality is not considered to be a taxable sale, no tax provision exists that expressly makes that statement. Regrettably, a clarifying provision should have been included in the transparency provision when it was enacted.

These new rules can result beneficial for taxpayers in Mexico. Mexican tax residents that own assets through foreign transparent entities or legal arrangements can continue to qualify for the beneficial 10% tax regime for gains derived from trades effected on the Mexican stock exchange. Often, limited partnerships formed in certain Canadian provinces are used for this purpose. Also, if the Canadian limited partnership elects to be treated as a corporation for U.S. income tax purposes, U.S. situs assets may be held without exposure to U.S. estate tax.

The transparency regime gets more complicated when a Mexican tax resident pays Mexican source income to a foreign transparent entity or legal arrangement. The law establishes that, in this fact pattern, the entities or arrangements will be treated as foreign nontransparent entities. The rule is poorly drafted, and some degree of uncertainty exists as to its scope. Its purpose is to prevent the application of tax treaty benefits when payments are made to or through transparent entities or foreign legal arrangements owned by a person that is tax resident in a jurisdiction with which an income tax treaty is in effect with Mexico. The tax authorities have informally stated that an exception inherently exists to entity treatment if the foreign entity is transparent in its country of residence and an income tax treaty exists between Mexico and that treaty country requiring Mexico to grant tax treaty benefits to payments made through that entity.

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These new rules also establish that when transparent entities or legal arrangements have their main place of administration (*sede de dirección efectiva*) in Mexico, they should be considered Mexican tax residents. Many commentators believe this rule is unnecessary because it contains a tax residency rule that already existed.

TAX ADVISORS REPORTING OBLIGATIONS

Mexican tax law establishes that if a person residing in Mexico regularly gives tax advice to clients, that person must file a report with the Mexican tax authorities describing all reportable transactions that generate a tax benefit in Mexico. The law contains a long list of transactions that are reportable. The list includes any structure that

- allows a taxpayer to avoid reporting obligations,
- eliminates the possibility of exchange of information between tax authorities,
- avoids the application of the transparency regime, or
- effects the transfer of tax loses.

Under an administrative rule issued by the Mexican tax authorities, a transaction that produces a tax benefit of less than MEX$100 million (approximately US$5 million) is not reportable. Under a second administrative rule, transactions that are not reportable trigger an obligation to report the reason reporting is not required. These new provisions include rules as to which a tax advisor should report if several firms or advisors are involved. They also establish when the obligation to report a transaction is shifted to the taxpayer because the advisor failed to file a report. As is readily apparent, this provision reflects concepts that appear in D.A.C.6 in the E.U.

TAX HAVENS

For many years, a tax haven entity was viewed to be controlled by a Mexican resident only where the Mexican resident controlled the timing of the payment of a dividend or income distribution. This rule has been changed significantly. Now, a Mexican tax resident is subject to the tax haven rules if the resident has effective control of the investment. In general, a tax haven entity is considered to be controlled by a Mexican tax resident if any of the following statements is applicable to the resident directly, indirectly or by any arrangement:

- The Mexican resident has the power to unilaterally define or veto management or administrative decisions of the tax haven corporation.
- The Mexican resident holds shares representing more than 50% voting rights.
- The Mexican resident holds shares giving it the right to more than 50% of the assets or 50% of the income of the tax haven corporation.

In the past, the tax haven rules did not apply if the tax haven company generated active business income. Now, the active income test is not applicable in either of the following circumstances:

- More than 20% of the income of the tax haven entity is considered to be passive. For this purpose, passive income includes (i) income from the

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performance of services rendered outside the tax haven country and (ii) income from the sale of goods that are located outside the tax haven country.

- More than 50% of the income of the tax haven entity arises from transactions that directly or indirectly give rise to a tax deduction in Mexico.

If a Mexican tax resident has an investment in a tax haven entity and no exception applies, the resident must file a report in February of the following year. The income of the tax haven is taxable in Mexico as if realized directly by the Mexican resident.

BROADER REQUIREMENTS FOR NET BASIS TAX FOR FOREIGN RESIDENTS

Mexican law allows a foreign resident to pay Mexican income taxes on a net basis when the tax is imposed on gain from sale of shares of a Mexican corporation or from real property located in Mexico. In order to benefit from this provision, the foreign resident must appoint a representative in Mexico that maintains all the accounting information related to the transaction.

Beginning this year, the representative is jointly responsible for the taxes owed to the Mexican government, albeit on net income rather than gross sales proceeds. The Mexican representative must demonstrate that it has sufficient liquid assets available to pay the tax imposed on the nonresident. The tax authorities may collect the taxes directly from the Mexican representative without the need to seek payment from the nonresident.

The new provision is included in Article 174 of the Income Tax Law. It is complex and may not be appropriate for certain foreign taxpayers.

ISRAELI START-UP EXPANSION TO THE U.S.: WHO SHOULD BE ON TOP?

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INTRODUCTION

Congratulations. Your Israeli start-up is doing well enough for you to consider expanding operations to the U.S. market. Now what? The list of things to think of is endless, and tax should be at the top. Among other matters, you will need to consider

- the legal entity to use when expanding to the U.S.;
- whether the workforce should relocate Israeli employees to the U.S., hire locally in the U.S., or have employees work from Israel post-COVID19;
- investigation of appropriate transfer pricing policies for transactions between the U.S. entity and the Israeli entity, acceptable to tax authorities in each country, especially in regard to payments for the use of intellectual property; and
- identifying the group entity that should own the I.P.

This article considers these and other questions and presents views from both the U.S. and Israel. Like many other things in life, one answer may be preferable in certain circumstances but not others and balancing the conflicting forces is required.

EARLY-STAGE V. ADVANCED

Two early-stage considerations will impact planning latitude:

- Has intellectual property ("I.P.") been developed?
- Has money been raised from investors?

It becomes exceedingly more difficult to revise a structure as operations of the start-up becomes more advanced over time. If Israeli entrepreneurs don't think globally from the very beginning, moving ownership of the I.P. from the Israeli company to a U.S. subsidiary may be very expensive in terms of gain recognition in Israel. And while eventually it may be a necessity, the cost increases as time passes.

If the Israeli company will have very early-stage investors, their consent will be needed for any restructuring. Unless they are U.S. persons – which is not likely in this scenario because U.S. persons would have asked for a U.S. entity at the time of investment – they may resist.

ESTATE TAX

One of the benefits for non-U.S. investors of a structure involving an Israeli parent and a U.S. subsidiary is the avoidance of exposure to U.S. estate tax at the conclusion of life of a non-U.S. shareholder. With planning, U.S. estate tax exposure for a non-U.S. investor can be addressed in several ways, including by the imposition of a personal holding company or obtaining term life insurance. Shares may also be gifted during life without the imposition of gift tax by a non-domiciled individual as they are considered to be items of intangible property. Consequently, limiting estate tax exposure for a non-U.S. investor by demanding an Israeli parent company should not be a driver in the decision-making process.

Removing the U.S. estate tax exposure from the equation, having a U.S. parent company at the top of the structure should be considered from the get-go. Of course, Israel is closer to Europe and there are other incentives to consider, which are discussed below. However, if the market and target investors are in North America, it may be prudent to consider starting out in the U.S. in a structure that will be favored by future investors and where corporate laws are developed and generally friendly. After all, the goal is to maximize the size of a liquidity event, not simply to limit potential U.S. estate tax exposure that results from an untimely death.

Having focused on pleasing potential U.S. investors, it is important to remember that, if I.P. developed in Israel is held by a U.S. parent, the Israeli Tax Authorities ("I.T.A.") may take the position that the economic ownership of the I.P. is in Israel if no sufficient substance exists in the U.S. parent because of an absence of substantial U.S. operations, employees, and facilities.

I.P.

Ownership of I.P. justifies special consideration as it is never easy to move I.P. out of corporate form without triggering gain recognition.

U.S. buyers are likely to want the I.P. to be owned in the U.S. in order to benefit from incentive legislation that can drive the tax rate down or to avoid immediate U.S. taxation of income generated by the I.P. under certain anti-deferral regimes. If I.P. is created in an Israeli entity and eventually the company is acquired by a U.S. buyer, the buyer is not likely to retain the I.P. in Israel and may factor the tax cost of moving the I.P. to a U.S. affiliate when structuring its best offer.

Unless the buyer structures the transaction as an asset deal, post-acquisition extraction of the I.P. would trigger significant amounts of Israeli tax, even if the acquired Israeli start up maintains its operations under the new business model led by the buyer. The tax treatment of a transfer of I.P. from a newly acquired Israeli subsidiary has been a hot topic in the last few years and the I.T.A. argues that such transactions constitute taxable business restructuring pursuant to applicable transfer pricing rules, contending that the company's acquisition price is the proper benchmark for the value of the I.P.

For all the foregoing reasons, I.P. ownership is a consideration to think of in the early stages. At that time, an Israeli start-up may structure its ownership to have a U.S. parent company and an Israeli subsidiary acting as an R&D contractor in developing I.P. for the U.S. parent.

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However, locating the I.P. in the U.S. contains its own risks regarding Israeli tax:

- One is that young entrepreneurs may not have sufficient finances in the early stages to maintain real operations in the U.S.
- A second is that, if the U.S. parent is simply financing I.P. development in Israel, the I.T.A. may claim that the "economic" ownership of the I.P. is in Israel or that substantial income must be allocated to the Israeli subsidiary.
- A third is that the I.T.A. may argue that the Israeli subsidiary transferred I.P. having substantial value to the U.S. parent. If any of these assertions are raised, the Israeli company and its owners may find that they face a more complicated situation than would have existed if the I.P. were located in the Israeli subsidiary from day one.

Punting on the issue is always possible for an early-stage company. It certainly is of no harm if the I.P. fails. It is only when the I.P. appears to be attractive that the early shareholders will have remorse because the opportunity of moving the I.P. with little cost has been missed.

LEGAL ENTITY AND P.E.

If the Israeli start-up is simply testing the waters in the U.S., it may consider hiring an independent contractor to distribute a product or provide other services in the U.S. The issue here is to avoid having that person be considered a dependent agent whose presence in the U.S. could create a permanent establishment ("P.E.") in the U.S. A P.E. can expose a portion of the company's income to U.S. taxation.

While a detailed analysis of the possible existence of U.S. trade or business and a U.S. P.E. is beyond the scope of this article, one benefit that is derived when a treaty applies is that a higher threshold of activity must exist in the U.S. in order for the U.S. to impose income tax. If a treaty applies, the occasional conduct of activity in the U.S. by employees or agents of an Israeli start-up would likely not be enough to give rise to U.S. tax exposure on income generated in the U.S. Without a treaty, any activity conducted in the U.S. may be sufficient for the I.R.S. to characterize income that arises in the U.S. as effectively connected taxable income. Such income is subject to corporate income tax on the Federal and State levels and Federal branch profits tax.

In broad terms, a P.E. exists when the foreign company has a fixed place of business through which it is engaged in activity in the U.S. for an indefinite or substantial period. A company may have a P.E. directly by sending its employees to the U.S. and operating through a branch, or indirectly, through dependent agents that have the power to conclude binding contracts on behalf of an Israeli company. Note that a dependent agent empowered to negotiate the terms of a contract likely will be a P.E. even though the contract is not binding until approved by the head office in Israel. In comparison, the activities of independent agents generally don't give rise to a P.E., provided the agent is independent both economically and legally. An agent is not truly independent if it has only one customer and is integrated in the sales and marketing activity of that sole customer. Nor is an agent independent when its sole customer has control over what the agent does and how it is done, especially when the agent bears no economic risks. In those circumstances, the activities and place of business of the agent may be attributed to the company and could create a P.E.

Forming a U.S. limited liability company ("L.L.C.") that is wholly owned by the Israeli company and operating through it in the U.S. will result in the creation of a U.S. branch of the Israeli company, which results in the existence of a P.E. For U.S. tax purposes, a single member L.L.C. is not regarded to be separate from its sole owner unless an election is made for U.S. income tax purposes to treat the L.L.C. as a corporation. Where that election is made, the L.L.C. is treated as if it were separate from its owner, the Israeli company.

If a corporate subsidiary is formed in the U.S. by an Israeli corporation, the subsidiary does not itself create a P.E. for the Israeli company, provided it does not operate as the Israeli company's agent in the U.S.

Transactions between the Israeli company and its U.S. subsidiary are subject to arm's length transfer pricing rules in both Israel and the U.S., and the application of those rules in any given circumstance may provide different results in each country. In principle, only the income of the U.S. entity would be subject to U.S. taxation, and none of the Israeli company's income would be attributed to the U.S. subsidiary and be taxed in the U.S. However, the views of tax authorities in the U.S. and Israel may not be consistent when determining the scope of the U.S. company's U.S. source income.

COVID19 presented an interesting situation where many workers worked remotely. While, at first, no one thought remote working could be a long-term situation, now it is clearly acceptable, and many companies have adopted hybrid work rules. Full remote, or even hybrid U.S.-Israel remote work may not be easy to sustain in the long term. Nonetheless, those companies that have adopted such working arrangements must consider whether they create a P.E. when the arrangement has lasted for two or more years.

If the start-up intends to hire local employees or send Israeli employees to the U.S., it may be prudent to create a U.S. subsidiary sooner rather than later. putting aside the tax issues and P.E. issues, it is much easier for a U.S. company to maintain a payroll for employees and executives working in the U.S.

FOREIGN OWNERSHIP COMPLIANCE

U.S. ownership of foreign corporations may present significant reporting obligations, and under certain circumstances, may impose unfavorable tax rules. One such rule is the P.F.I.C. regime. Very broadly described, a passive foreign investment company (or 'P.F.I.C.") is a foreign corporation which meets one of two alternative tests:

- The first is an income test, under which 75% or more of the company's gross income is categorized as passive income.
- The second is an asset test, under which 50% or more of the company's assets are passive assets (including cash in excess of 90-day working capital and stock in underlying portfolio companies).

In years during which an Israeli company raises capital, and the cash is the most significant asset reported on a balance sheet, the company may be classified as a P.F.I.C. unless an off-balance sheet asset is identified, and a proper valuation is obtained to support a non-P.F.I.C. position. Even then, the cash must not be invested it short-term liquid assets producing passive income that is greater than the allowed threshold.

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An Israeli company's P.F.I.C. analysis must be conducted annually and if an Israeli company is classified as a P.F.I.C. for any year, it retains its classification under a rule known as "once a P.F.I.C. always a P.F.I.C." P.F.I.C. status is problematic. Any ordinary dividend received from a P.F.I.C.by a U.S. individual is taxed as ordinary income that does not qualify for the lower, long-term capital gains rate which applies to dividend from a qualified foreign corporation. The tax treatment in the U.S. is worse if an "excess distribution" is made. An excess distribution is a distribution that exceeds 125% of the average distributions made by the foreign company in the three years immediately prior to the tested distribution. In computing the current year's tax on an excess distribution, the distribution is allocated to each day in the holding period of the shares. The tax on the deemed increase in income in each such prior year is computed at the highest rate for that year and is deemed paid late. The deemed late payment of tax is subject to an interest charge. Similar treatment is given to capital gains from the sale of P.F.I.C. shares.

A U.S. investor in a P.F.I.C. is subject to annual reporting on Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund.*

Other rules may apply and result in current taxation of the earnings of the foreign corporation irrespective of distributions if the Israeli company is considered to be a controlled foreign corporation ("C.F.C.") for U.S. income tax purposes. And even if the company is not a C.F.C., certain reporting on Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations,* is required. The failure to file Form 5471 or the filing of an incomplete form may trigger significant penalties over time. Note that the I.R.S. view of an incomplete form may not be the same as the view of the U.S. shareholder or its tax return preparer.

"A U.S. investor in a P.F.I.C. is subject to annual reporting on Form 8621 . . ."

Other heightened reporting also applies as a result of a need to report specified foreign assets (including shares in a foreign corporation) and possibly to file an F.B.A.R. form with FinCEN, a branch of the I.R.S. that enforces the Bank Secrecy Act. The F.B.A.R. reports ownership, financial interests, and signatory authority over foreign financial accounts owned by a U.S. company and its overseas subsidiaries.

Q.S.B.S.

Another consideration for having the parent company in the U.S. is the benefit provided in Code §1202. This Code section applies only to shares in a C corporation (*i.e.*, not an L.L.C. electing to be taxed as a corporation). When applicable and all requirements are met, U.S. taxpayers selling shares are eligible to exclude from their long-term capital gain the *higher* of $10,000,000 or 10 times the adjusted basis in the shares. This is a significant benefit that is attractive to investors and managers of U.S. investment funds. They are keenly interested in investing in U.S. corporations and not foreign corporations, and they may ask that the Israeli company invert with its subsidiary.

Acknowledging such situation, the I.T.A. developed a fast track for inverting using the exemptions available under the tax-free reorganization law.

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ENCOUREGEMENT LAWS AND THE I.I.A.

One of the most attractive reasons to base the operation in Israel is the availability of benefits granted under the encouragement of capital law. Companies that qualify under the terms and conditions of such laws and that are based in central Israel will be eligible to pay a 16% corporate tax rate (compared to the standard corporate tax of 23%) and have dividend payments taxed at 20% (compared to 20%-30%). Eligible companies that are based outside of Israel's dense urban center are eligible for a corporate tax rate of only 7.5%, although the rate may be increased considering the forthcoming O.E.C.D 's Global Minimum Tax. Those reduced tax rates may be significant and should keep investors happy, except if those investors are U.S. citizens who then may be unhappy to discover that the Israeli rate does not qualify for the high-tax exception under anti-deferral rules applicable to U.S. persons owning 10% or more of the shares of a controlled foreign corporation.

Additionally, the Israel Innovation Authority ("I.I.A.") offers unique tools for entrepreneurs and start-ups to support the early development stages of technological initiatives. These tools assist in developing innovative technological concepts at the pre-seed or initial R&D stages, transform ideas into reality and reach significant fundable milestones. However, receiving grants from the I.I.A. comes with an obligation to pay royalties to the I.I.A. and penalties are imposed if the I.P. developed eventually is sold to a non-Israeli entity.

TRANSFER PRICING

Regardless of which company is the parent and which is the subsidiary, all transactions between a U.S. company and its Israeli affiliate (including charges for the use of I.P., interest accruing on loans, and inventory purchases) must be carried out in a manner that is consistent with arm's length principles. The taxable income of each entity must be clearly reflected and supported by a transfer pricing study that is based on methodologies allowed under U.S. Treasury Regulations and the Israeli transfer pricing regulations. If the transfer pricing is set at a price that is not deemed to be arm's length -- so that the U.S. company's profits are understated – the I.R.S. and the I.T.A. are authorized to adjust the price and impose penalties on the adjustment. Penalties may be avoided if a proper transfer pricing report is prepared on a timely basis. The report must explain the price determined and the methodology used and the reasons why the price was determined under the best method available under the regulations. In addition, the report must be prepared on a timely basis, which means prior to the date of the filing of the tax return for the year.

The arm's length transfer pricing rules in the U.S. may differ in technical ways from the O.E.C.D. Transfer Pricing Guidelines which the Israeli transfer pricing regulations draw upon. Separate reports must be prepared under both sets of rules, one for the U.S. and the other for Israel. In principle, the transfer pricing result should be the same under both. However, that is not always the case.

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SUMMARY

The answer to the question “so what do you advise me to do” is never an easy answer. Young entrepreneurs are required to act as “fortune tellers” in the process of establishing their new business. The questions that should be asked at the outset include all of the following:

- What markets should we aim for?
- Will Israelis or Americans comprise the bigger share of our investor group?
- Will we need government support at the early stages?
- Will our exit strategy focus on the sale of assets, a private sale of shares, or an I.P.O?
- Where do we intend to live if the business succeeds?
- Who are the employees we want to hire and where do they live?

Those and many other questions may be very difficult to answer at the outset and are somewhat of a guess at the early stage; but they are important and may impact the taxation of their success. One bit of nontechnical advice that should be kept in mind – if difficulty is encountered in answering the foregoing questions, it may be time to purchase a new crystal ball.

OFF TO NEW SHORES – TAX EXTERN AT RUCHELMAN P.L.L.C.

Author
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Tags
Cross-border Transactions
German American Exchange
Internship
U.S. Tax Planning

"We all live under the same sky, but we don't all have the same horizon."

– First Chancellor of the Federal Republic of Germany, Konrad Adenauer

INTRODUCTION

In fact, not having the same horizon sometimes provides a special opportunity for learning and an enriching exchange for all involved. The curiosity of getting to know another "horizon" and approach to law induced me to travel 3,771 miles from Germany to New York City this past fall to participate in a Tax Externship at the New York law firm, Ruchelman P.L.L.C.

In this article, I share some of the thoughts, realizations, and learning opportunities that I was lucky enough to benefit from along the way.

WHO AM I?

My name is Lioba Mueller, and I come from Mönchengladbach, Germany. International law and global economic relations have fascinated me throughout my studies in Germany and the People's Republic of China.

In 2014, I enrolled in the bachelor's degree in Law and Economics at the University of Bonn, the former capital of Germany. The interdisciplinary approach of Law and Economics provided me with a methodology to assess which legal rules are economically efficient, and to understand their effects on human behavior. I also gained insights in areas such as micro- and macroeconomics, mathematics, and statistics. After graduating in 2018 with the LL.B., I continued to study German law. During my law studies I focused on International and European Law of Economic Relations with courses such as Foreign Investment Law and Antitrust Law. My studies were supported by the Konrad Adenauer Foundation's scholarship program for outstanding students. In 2021, I graduated from my German legal studies program with the First State Exam at the higher regional court.[1]

My first encounter with Anglo-American law was in 2015 during the two-year Foreign Law and Language Program at the University of Bonn covering areas like U.S. commercial law, U.S. civil litigation and international arbitration. My interest in international law also led me to participate in the 58th Philip C. Jessup International Law Moot Court Competition in 2016. In preparation for this competition, I drafted oral and written pleadings on issues such as obligations to endangered world cultural

[1] Oberlandesgericht Duesseldorf.

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sites, equitable use of shared natural resources, and repatriation of cultural property. Moreover, I took part in the 2017 summer program of the Xiamen Academy of International Law in China on international economic law and public international law featuring leading scholars, including Alain Pellet, Jean d'Aspremont and Eyal Benvenisti.

My fascination in cross-border matters and foreign trade law also led me to study a semester at the law faculty of Tongji University in Shanghai, China. In small classes, I participated in intense discussions on topics such as Chinese tax law, foreign trade law and intellectual property law. After returning to Germany, I have continued to deepen my knowledge about Asia in parallel with my law studies. In 2019, I received a B. A. in Asian Studies with Chinese Language at the University of Bonn. This allowed me opportunities to improve my fluency in Chinese language, and gain further understanding of Chinese and Asian history, society, and economy.

WHAT DID I EXPECT PRIOR TO THIS EXTERNSHIP?

My externship at Ruchelman P.L.L.C. brought me the opportunity to work at an established international firm with high expertise on cross-border matters.

Going into the externship, I was extremely excited to gain insights into U.S. tax planning and legal services and to become at least a tad more familiar with international provisions of the Internal Revenue Code as well as U.S. inbound and outbound commercial and financial transactions. What made Ruchelman P.L.L.C. further interesting is the team and its diverse client base. I was thrilled to work alongside a highly qualified and experienced set of attorneys with a background in three continents, and the chance to communicate with firm clients in various languages. The firm's diverse international client base was reflected in its broad-based and richly educated team. Clients include both non-U.S. individuals and foreign corporations operating or investing in the U.S., as well as individuals and firms based in the U.S. with operations or investments abroad.

As an extern, my hope was to contribute to the firm with my knowledge of German law, and, more broadly, my training in law and economics, my research skills, and my language skills. My research skills were honed through my six-year work as a student assistant for Prof. Dr Stefan Talmon,[2] Director of the Institute for International Public Law at the University of Bonn. My bachelor thesis was graded highest and term papers earned scores in the 98th percentile. Further, I hoped that my knowledge of English, German, Chinese, French, and Spanish might also be a useful asset.

By assisting the attorneys, I wished also to acquire specific technical knowledge and understanding of U.S. tax law. I anticipated bringing together many of the different skillsets that I have been building over the past few years by working on varied tax research projects and client matters, reviewing commentaries and treatises, assisting in the preparation of memorandums, and perhaps even drafting contracts and other documents required in connection with the firm's projects. In addition, I hoped to develop my tax research skills and to get acquainted with common databases.

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[2] LL.M., M.A.

Moreover, at a higher level I was extremely excited to gain insights into U.S., the working culture and "open-door" policy. Besides work, I looked forward to immersing myself in the American lifestyle and gaining a new perspective on things I may never have thought about. As it was my first time in the U.S., there certainly was a lot to discover everywhere, especially regarding U.S. culture, fan sports, society, and history. No matter where you come from, New York City offers an exceptional place to experience American vibrancy, creative spirit, and the so-called melting pot of cultures and traditions.

WHAT WAS MY EXPERIENCE LIKE?

There it was, my first day. I was filled with excitement and curiosity about the people I would work with. The firm's Office Manager showed me around the office, showed me my working space, and introduced me to the team. I had a first meeting with the Chairman of the firm, who took the time to meet with me, explain the firm's structure and practice, and ask me about my goals and expectations from this experience. Everything was set up including personalized accounts for research databases. The warm welcome and kindness of everyone made me immediately feel I was part of the team. This feeling is particularly memorable and one of the strongest and abiding takeaways – I am grateful to the Ruchelman P.L.L.C. team for including me in so many matters, from the get-go, and for inviting me to actively contribute to a number of them. This was an unforgettable experience!

"My research involved a high variety of topics, from the question of whether there was the need to notify the I.R.S. about repatriation payments to Holocaust survivors, the exit tax applicable after a renunciation of U.S. citizenship, and the voluntary disclosure of unreported foreign financial accounts by U.S. tax residents."

My first days focused mainly on understanding the general concepts of U.S. tax planning. The attorneys introduced me to the contours of their system, answered my questions, and provided me with comprehensive materials about the taxation of cross-border and foreign transactions in the U.S. I learned all about rules for determining residency, dual status for a tax year, the source of income, and more topics. Furthermore, I received the benefit of tutorials and research software for U.S. tax advice, namely Thomson Reuters Checkpoint and Bloomberg BNA. These two research tools are designed to provide answers to a variety of tax, accounting, trade, and finance questions. The introduction was extremely useful for later research, interpretation of rules and understanding cases.

Straight away, I received my first research assignment – in a matter concerning the foreign tax credit. A foreign company was being sold by its owner, after moving to the U.S. I learned about the effect of a bilateral tax treaty and its residence tiebreaker rule. It was fascinating to understand first the relation between the national and international rules, and second, the relation of norms of the treaty itself. It was also thrilling to conduct research for different attorneys and to discuss the results with them afterwards. My research involved a high variety of topics, from the question of whether there was the need to notify the I.R.S. about repatriation payments to Holocaust survivors, the exit tax applicable after a renunciation of U.S. citizenship, and the voluntary disclosure of unreported foreign financial accounts by U.S. tax residents. Through this work, I even learned about subjects, such as the I.P.O. process, and the evolution of cryptocurrency.

Another fascinating research assignment was one focused on the elements required for successful tax rescission. Have you ever wondered what happens for tax matters when attempting to "rescind" a transaction? The I.R.S. has set out two prerequisites in the Revenue Ruling 80-85. First, the parties must be returned to the *status quo* ante, the relative positions they would have occupied had no contract been made.

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Second, the transaction must be restored to the *status quo ante* within the same tax year. Deeper insights are provided in a previous *Insights* article, "Rescission – Undoing a Transaction That Seemed Like a Good Idea at the Time."[3]

While the pandemic had negative impacts on various areas of life, it allowed me to take part in online webinars on tax planning matters. Particularly insightful was a seminar on Tax Planning Considerations When Marrying a Non-U.S. Citizen, part of the Continuing Legal Education ("C.L.E.") program at New York Law School. An introduction was given to different married couples' status for tax filing purposes (which in the U.S. includes filing jointly, separately or as what is referred to as head of household), the non-U.S. citizen spouse's income and pre-immigration planning considerations.

The tax externship allowed me as a German lawyer to gain deeper insights in a very different system of tax law and a common law regime. While working, similarities became apparent, especially in the area of company law. Discussions about inheritance law and gift law revealed some differences between common and civil law concepts, *e.g.*, the impact of disclaiming or renouncing one's inheritance for the benefit of other heirs.

During my daily work, I supported the team with preparation and categorizing of documents, and drafted conference notes. I received tasks from all the attorneys and was supremely grateful that they took the time to explain the background, reflect on the work done and give me timely feedback afterwards. Their legal input, guidance, and, most importantly, the freedom to think through problems in a principled, yet creative manner that they demonstrated to me, were unparalleled learning and growth opportunities for me. As previously mentioned, I was strongly impressed by the way the team welcomed and integrated me, on Day One, as an equal in their endeavors. It was great not only to work together with each of them, but to get to know everyone at work and at after-work events. It provided me with unexpected and enriching lunch discussions, celebration of passing my bar exams, the chance to catch an Israeli birthday song, practice my French and Chinese conversation skills, and even extended to sampling craft beers from Brooklyn and Belgium after work. I attended networking events with colleagues, such as a soirée organized by the British American Business Council ("B.A.B.C."), a transatlantic trade organization, and caught my first concert at the New York Philharmonic. Outside work, I celebrated my first real Thanksgiving with an American family in the Washington D.C. area, stood on the stairs of the Supreme Court while gazing at the resplendent Capitol, and even dug into the historical roots and meaning of America on the freedom trail in Boston. Filled with these rich experiences, it was finally time to say goodbye!

CONCLUDING REMARKS, SPECIAL THANKS AND... WHAT COMES NEXT?

I came to New York City full of curiosity and the simple wish to extend my horizons. My expectations were far and away exceeded. Working at Ruchelman P.L.L.C. gave me practical insights in the U.S. tax planning and the legal system that I could not obtain anywhere else. The externship allowed me to grow intellectually, professionally, and personally. With the team at Ruchelman P.L.L.C., I found wonderful

[3] See Ruchelman, Rastogi, "Rescission – Undoing a Transaction That Seemed Like a Good Idea at the Time," *Insights* 8 no 6 (2021): p. 40.

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colleagues with whom I will delight to remain in touch. Special thanks go to Stanley C. Ruchelman and Galia Antebi, willing to accept me as a tax extern, as well as to the whole team – they included, from partners to staff (in alphabetical order), Andreas Apostolides, Nina Krauthamer, Wooyoung Lee, Claire Melchert, Simon Prisk, Zoë Ragoonanan, Neha Rastogi, and Julissa Rodriguez. I also wish to give my sincere thanks to the University of Bonn for supporting such an externship, through the PROMOS scholarship,[4] offered by the German Academic Exchange Service, under the German Ministry of Education and Research, and designed for the purpose of promoting students to go on short stays abroad.

Having returned to Germany just before the New Year, I am now ready to begin my legal training as a "*Rechtsreferendarin*," or Legal Trainee, at the Regional Court of Aachen, in the city which served as the Emperor Charlemagne's capital over 1,200 years ago. The experience of the legal externship at Ruchelman P.L.L.C., which I bring with me, is a highly precious one, which helps me not only in ultimately being a better and more well-rounded lawyer, but also by giving me tools of critical thinking and analysis that will help me in deciding the path that my career will take, and how to do that career better. In a globalized world, my sense is that it behooves us all to become more acquainted with different systems of law, and my immersion in U.S. tax and legal principles at this firm has incomparably extended my thinking, and my horizons!

[4] "PROMOS" stands for "*Programm zur Steigerung der Mobilität von deutschen Studierenden*," meaning "Program to Increase the Mobility of German Students."

USE IT OR LOSE IT: THE FUTURE OF SHELL ENTITIES IN THE E.U.

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Tags
A.T.A.D. 3
D.A.C.
Directive
European Union
Gateway Indicators
Shell Company
Unshell

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INTRODUCTION

Shortly before Christmas,[1] the European Commission published a proposal for a Directive (the "Directive") laying down rules to prevent the misuse of shell entities for improper tax purposes and amending Directive 2011/16/E.U. – the directive on administrative cooperation (the "D.A.C.").

Given that the proposed rules are intended to enhance and complete two previous iterations of the anti-tax avoidance directive (the "A.T.A.D."), the proposed Directive is commonly referred to as "A.T.A.D. 3." In the view of the Commission, this extension of the A.T.A.D. is required to create a fair and effective taxation system in the E.U. However, the main purpose of the draft is to prevent the misuse of shell entities, and for that reason, it is commonly known as the "Unshell Directive."

Prior to the release of the Directive, on May 18, 2021, the European Commission published its 'Communication on Business Taxation for the 21st Century' (the "Communication") with the stated aim of setting out a long-term vision to provide a fair and sustainable business environment and E.U. tax system as well the E.U. Tax Policy Agenda, announcing actions that could potentially be taken to increase transparency and substance requirements for corporations used in implementing tax plans.

At that moment, it was clear that one of the most relevant proposals on the Commission's Agenda was the initiative regarding the fight against the perceived misuse of shell companies, which are companies with not more than minimal substance and without real economic activity. According to the Commission, initiative is necessary given the extent to which shell entities continue to be used, despite the measures taken at the E.U. level over recent years, including the two earlier iterations of the A.T.A.D. and various extensions of the D.A.C. Before launching the Unshell directive, the European Commission initiated a Public Consultation entitled "Fighting the Use of Shell Entities and Arrangements for Tax Purposes,' which takes the form of a questionnaire.

Within that context, less than four months after closing its Public Consultation, the Commission published a concrete proposal for a Directive. The purpose of A.T.A.D. 3 is to increase the level of scrutiny for shell companies within the E.U. in order to prevent them from being used for purposes of tax evasion and avoidance.

If adopted by the Council, the Directive would introduce certain reporting requirements for E.U. resident companies that generate largely passive income streams that are highly mobile and that lack adequate substance. Failure to submit a full or correct report will subject the company to severe penalties.

[1] December 22, 2021.

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In a nutshell, A.T.A.D. 3 lays down certain gateway indicators to determine which entities must report on their substance. In case such reporting indicates that the company is a shell entity which lacks adequate substance, the benefits of tax treaties and E.U. Directives may be denied, potentially resulting in an increased withholding tax burden and other tax disadvantages.

This article describes the relevant mechanism embodied in A.T.A.D. 3 and analyzes its potential impact.

OVERVIEW

Scope

The proposed Directive will apply to any company that is considered tax resident in a Member State of the E.U. and is eligible to receive a tax residency certificate, regardless of its legal form. For simplicity, use of the term "company" will include a company within the meaning of the proposed directive. The proposed Directive targets entities that have the following characteristics:

- They lack real economic activities.
- They are involved in certain cross-border arrangements forming a scheme to avoid and evade taxes.
- They allow their beneficial owners or parent company to access a tax advantage.

General Exemptions

In its Communication, the European Commission recognized that valid reasons may exist for the use of shell companies. Based on this notion, entities established to perform certain specific functions are explicitly carved out from the scope of the Directive. Included are

- certain regulated financial companies, such as investment funds;
- companies with transferable securities listed on a regulated market; and
- companies having at least five full-time equivalent employees or members of staff exclusively carrying out the activities which generate the relevant income.

Moreover, general exemptions apply to holding companies based in the same country as their beneficial owners or shareholder(s) – or the ultimate parent entity.

According to the impact assessment carried out within the context of this initiative, it is expected that less than 0.3% of all E.U. companies will fall within scope of the Directive.

Gateway Indicators

A.T.A.D. 3 provides three gateway indicators in the prior two years that are used to determine whether a company may be at-risk of being a shell company. If all gateway indicators are present, the entity is considered to be at-risk of being a shell company.

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Generally, a company is considered to be at risk where

- more than 75% of its revenue is characterized as mobile or passive income, referred to a relevant income;
- the company is mainly engaged in cross-border activity, meaning that more than 60% of its relevant assets are located abroad or at least 60% of its relevant income is earned or paid out via cross-border transactions; and
- the company has outsourced the administration of its day-to-day operations and decision-making on significant functions, while its own resources to perform core management activities are inadequate at best, and for that reason, are outsourced.

Where the three gateway indicators are present, a company faces a choice of two next steps:

- It becomes an at-risk company that is subject to further reporting requirements to determine whether it meets certain minimum substance requirements. If substance is not present, the company is a shell company. The scope of the reporting is addressed below.
- It may request an exemption from the reporting obligation if it can provide sufficient evidence that its existence does not reduce the tax liability of its beneficial owner or the group of companies to which it belongs. If the exemption is granted, it is not a shell company.

"The third test can be met in only two fact patterns."

Reporting Obligations

Where a company is considered to be at risk and the exemption is not applicable, the company must indicate whether it has adequate substance. For this purpose, adequate substance exists based on the cumulative presence of the following three factors:

- It has its own premises, meaning that it possesses an office space or the exclusive use of an office space,
- It has its own bank account located in the E.U. that has regular activity in the form of receipts and disbursements.
- It has qualified local management or employees.

The third test can be met in only two fact patterns. The first is that the company has at least one statutory director who is a resident in the jurisdiction of residence of the company or is a resident of a neighboring jurisdiction and his or her home is in relatively close proximity to the office of the company. Here, the term "director" is used in an operational sense rather than in the sense of being a representative of the shareholder group. The director must be qualified to carry out the responsibilities of his or her office and must be authorized to make relevant management decisions. Moreover, the director must exercise responsibility actively, independently, and on a regular basis. In addition, the duties of the local director must be performed on the basis of exclusivity, meaning that he or she cannot be an employee of an unrelated third party, such as a fiduciary trust company, and cannot function as a director of any other unrelated entity at the same time.

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The second fact pattern is that the majority of the company's employees are resident in the jurisdiction of residence of the company or are resident of a neighboring jurisdiction and live in relatively close proximity to the office of the company. An example is a frontier worker living in one Member State and commuting to an office in another Member State. The local employees must be qualified to carry out the activities that generate the relevant income.

If a company fails to meet any of the three substance indicators, it will be presumed to be a shell company for A.T.A.D. 3 purposes.

A company that is at risk of being a shell company must make a determination as to its substance and declare its status in its annual tax return. This entails a determination of whether the presumption can be rebutted.

REBUTTAL AND EXEMPTION

Rebuttal of Presumption

In principle, the above criteria only lead to the presumption of having inadequate substance. This implies that a company may still rebut the presumption by substantiating the business rationale of its activities within the relevant Member State. However, within the context of the rebuttal process, the burden of proof will be on the company, meaning that the right to rebut is subject to further evaluation by the tax authorities at the time of an examination.

Where a company that is deemed to be a shell company decides to rebut the presumption, it must produce concrete evidence of activities it performs. It must provide information with respect to the commercial reasons behind its existence, the human resources available to the company, and any other element that verifies the economic nexus between the company and the Member State of residence, typically where management decisions are taken in relation to the activities that generate value.

Moreover, within the context of a rebuttal, the taxpayer must be able to demonstrate that it has actually performed the business activities that generate the relevant income (or – in the absence of income – relate to the assets) and continuously had control over the related risk that it born.

If the tax authorities in the relevant E.U. Member State are satisfied, they must certify the outcome of the rebuttal for the relevant tax year. Provided the legal and factual circumstances remain unchanged, the validity of such certificate may be extended for another five years. Once the maximum period of six tax years has expired, the process would start all over again.

Exemption for Lack of Tax Motives

While a company that meets the three gateway indicators is generally considered to be at risk, it may request an exemption from the reporting obligation if it can provide sufficient evidence that its existence does not reduce the tax liability of its beneficial owner or its group of companies. If granted, the exemption applies for one year and can be extended up to five years.

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As part of a request for exemption, a company must provide evidence of comparable tax treatment in two fact patterns. The first is the combined tax due for the company, its owner, and the group resulting from the actual fact pattern. The second is the combined hypothetical tax that would have been due for the owner and group if the transaction were carried on without the participation of the company. To meet the burden of proof, the combined hypothetical tax in the latter fact pattern must not be greater than the actual tax in the actual fact pattern.

As is the case for the procedure regarding the rebuttal of presumption, if the tax authorities in the relevant E.U. Member State are satisfied that the existence of the company does not create any tax benefits, they may grant an exemption for the relevant year. Again, provided the legal and factual circumstances do not change, the validity of the exemption can be extended for another five years.

CONSEQUENCES OF FAILING THE TEST

If, on the basis of its self-assessed reporting or a failed rebuttal process, a company that is resident in a particular E.U. Member State is presumed to be a shell company, several adverse tax consequences will follow:

- Other Member States are to disregard the application of tax treaties, the Parent-Subsidiary Directive, and the Interest and Royalties Directive in relation to transactions with the shell company.
- If the shell company has a shareholder established in an E.U. Member State, the shell company should be treated as if tax transparent so its income will be taxed by the Member State of residence of the owner, as if the income accrued to the owner directly with a foreign credit for any taxes paid by the shell company.
- The tax authorities of the E.U. Member State where the shell company is resident cannot issue a certificate of tax residence for the company or may issue a conditional tax residence certificate stipulating that the shell company is not entitled to the benefits of an income tax treaty or any E.U. Directive.

Since the Member State of residence of the shell company may issue only a tax residence certificate including a warning that the company is a shell, the introduction of A.T.A.D. 3 may have an effect on the shell company's transactions with third countries. However, as regards the allocation of taxing rights between source countries and home countries, for the time being A.T.A.D. 3 should have an effect on transactions only between E.U. Member States. Nonetheless, it is anticipated that the Commission contemplates extending the Unshell Directive to cover transactions with third countries.

CERTAIN FORMAL ASPECTS

Penalties

The draft Directive provides that Member States may impose penalties for failure to comply with the reporting obligations arising from A.T.A.D. 3. Such penalties must be effective, proportionate, and dissuasive. It is anticipated that the penalties for failing to report or for filing incorrect reports will not exceed 5% of annual revenues.

Tax Audits

In addition to domestic sanctions, the draft Directive provides that a Member State may also request another Member State to initiate a tax audit if there is suspicion that a company resident in that other Member State is not complying with the provisions of A.T.A.D. 3.

Exchange of Information

The proposed Directive aims to amend the D.A.C. so that information gathered pursuant to A.T.A.D. 3 will be exchanged between the Member States automatically. Consequently, a robust exchange of information program will exist and will include information on taxpayers that have rebutted the presumption or applied for exemption. Consistent with earlier amendments of the D.A.C., the information that is reported by taxpayers in accordance with A.T.A.D. 3 will be stored in a central databank accessible to all Member States.

"It follows from the above description of the mechanics that A.T.A.D. 3 creates a filter system for shell companies throughout the E.U."

Implementation

If A.T.A.D. 3 is adopted by the Council, E.U. Member States will be required to implement the Directive by June 30, 2023, for the new rules to apply with effect from January 1, 2024.

To some extent, A.T.A.D. 3 has retroactive effect from January 1, 2022, because of the two-year look-back rule that applies to Gateway Indicators. This suggests that presumed shell companies may want to implement appropriate actions in 2023 in order to be in position to prevent application of the Gateway Indicators in a 2024 filing.

OBSERVATIONS

It follows from the above description of the mechanics that A.T.A.D. 3 creates a filter system for shell companies throughout the E.U. The trigger for the filter system is that that any entities resident for tax purposes in the E.U. that qualifies for a residence certificate issued by an E.U. Member State, is covered by A.T.A.D. 3., no matter the form taken by the entity.

All these entities enter a funnel, with the first stop being exemption. Where an intermediate vehicle is used within a regulatory framework or in a truly active manner, it is removed from the filter system. Those entities that are not removed, enter the second step of the filter, which concerns the three cumulative gateways. In principle, any company that meets all three gateways has an obligation to report on substance. It then moves to the next step, which is to rebut the presumption of being a low substance conduit vehicle by proving additional evidence. That evidence will be entity specific, requiring bespoke solutions. Those entities having proper rebuttals are removed from immediate effect of shell company classification, but their information is maintained in a central database.

In principle, each entity based in the E.U. falls within scope of the Directive. However, this element of overkill is addressed through the filter system. Nonetheless, one of the main concerns is that not all special purpose entities having a business purpose for its insertion into a particular business transaction will be able to adequately rebut the presumption that would result from the three gateway indicators. Though it would

seem that A.T.A.D.3 is not intended to hit special purpose entities that have been set up for completely valid reasons, such as asset protection or simply because legal separation is required by a bank, it would be useful if concrete examples would be provided by the Commission or within the context of implementation into domestic law.

From the outset, it would appear that A.T.A.D. 3 is aimed to tackle the typical type of shell entities managed by fiduciary trust companies. The European Commission indicates that pure holding companies established in the same country as their operating subsidiaries and beneficial owners are unlikely to be affected by the Directive, since these are normally not set up to derive an abusive tax benefits. Nevertheless, it cannot be ruled out that tax authorities may apply a broader interpretation of the Unshell Directive.

It is noteworthy that A.T.A.D. 3 is not yet a fait accompli. The European Parliament and the Member States must still respond to the draft. Even if the draft Directive were to be adopted in its current form, Member States must still transpose it into national law, which provides an opportunity to add some couleur locale where possible. This means that the political game is only just beginning. The general expectation is that the proposal will not be adopted without changes.

This raises the question parts of the proposed filtering system can be revised during the remaining steps of the process. In principle, several provisions can still be revised, such as the exemption categories and the criteria for the three gates. These are all political decisions which eventually will have an impact on the entities that will be caught up in the A.T.A.D. 3 funnel.

It is also conceivable that the various minimum substance requirements may be adjusted. For over a decade, the Netherlands has applied a system which is comparable to A.T.A.D. 3 to service entities functioning as a conduit for interest and royalty payments. The relevant legislation contains a more extensive list of substance requirements, including the criteria listed in the proposed Directive as well as others.

For the Netherlands, the open issue is whether the government will replace its own criteria with the requirements of A.T.A.D. 3 or attempt to operate with two sets, each used for its own purposes. It is conceivable that within the context of the decision-making process at E.U. level, the Netherlands would make a case for its extensive set of criteria to be implemented within the framework of A.T.A.D. 3. Even though the number of criteria would increase, the focus on the three substance criteria laid down in the draft Directive – office space, bank account and location of management or key personnel – would be expanded to address other aspects. That might open the door for somewhat more nuanced approach to substance.

Finally, it will be interesting to see how the same-country approach in the Directive will develop. If a country-by-country approach would become the guiding principle, a group of companies could have many entities with different economic activities in one single Member State without having to worry about the fact that an entity which has a pure holding function is set up with somewhat leaner in terms of substance. If by contrast an entity-by-entity approach would eventually prevail, such holding company may well qualify as a shell entity, even though it has access to an organization with extensive substance in the country where it is based. In sum, the same country approach clearly has the benefit that it immediately recognizes the fact that there may well be commercial or legal reasons to use multiple entities in one and the same country, without the need to go through a cumbersome rebuttal process.

Even though the political game of playing with the various elements of A.T.A.D. 3 has not yet begun, the general expectation is that the proposed Directive will eventually make it across the finish line. That said, even though tackling tax avoidance continues to be high on the E.U.'s agenda, at this moment the proposed timing seems somewhat optimistic, particularly now that the E.U. clearly has other geopolitical issues to face.

As mentioned, the draft assumes the Member States will implement the Directive in their national legislation prior to July 1, 2023, with January 1, 2024, as the intended date of entry into force. It remains to be seen whether this timeline will be met. If a corporate group believes it will be adopted at some point, management may find it prudent to adopt indicia of substance in all group members sooner rather than later.

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THE DOOR TO A NEW WORLD: DECENTRALIZED FINANCE (DEFI)

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> *"If crypto succeeds, it's not because it empowers better people. It's because it empowers better institutions."*
>
> – Vitalik Buterin, co-founder of Ethereum

WHAT IS DEFI ABOUT?

The world of crypto is fast-moving. An exciting development in this space is Decentralized Finance ("DeFi"), which entered the scene in March 2020, and its use has exploded ever since. The term refers to the offering of traditional financial services not by centralized players such as banks, insurance companies, and exchanges, but through smart contracts running on blockchains. In other words, central intermediaries are being replaced by an immutable computer code. If users indeed choose to go "bankless", this could disrupt the world of finance as it is currently known.

WHAT ARE THE PROS AND CONS OF DEFI?

The advantages of DeFi include the following:

- Access to financial services around the clock and from anywhere in the world (no old-fashioned bank opening hours)
- Access to financial services without having to fulfill K.Y.C./A.M.L. requirements (no filling in paper forms and disclosing personal circumstances)
- Access to financial services offered in a non-discriminatory manner (nobody is excluded from using DeFi services, so that even previously "unbanked individuals" can open a bank account)
- Access to financial services without having to trust a counterparty (no risks resulting from mismanagement of a bank's assets or fraudulent actions on the part of its employees)

The disadvantages of DeFi include the following:

- Risks of bugs in smart contracts (which can lead to a loss of assets deployed if the bugs are found by hackers)
- Certain technical skills are required of users (currently, a lack of user friendliness exists for DeFi)

WHAT VOLUME HAS DeFi REACHED?

As of early March 2022, the DeFi ecosystem had a volume of approximately U.S. $209 billion.[1] This figure refers to the value of assets locked in smart contracts (total value locked, or "T.V.L."). While this is literally nothing compared to traditional finance, the growth rate of T.V.L. is exponential. Exponential growth of that magnitude is a typical sign of disruptive tech.

ON WHICH BLOCKCHAINS DOES DeFi RUN?

Blockchains are a kind of infrastructure used to run smart contracts. In the realm of DeFi, smart contracts mostly run on Ethereum (54% of T.V.L.), followed by Terra (11% of T.V.L.), BNB Chain (6% of T.V.L.), Avalanche (5% of T.V.L.) and Fantom (5% of T.V.L.). While the future is probably "multi-chain" (rather than "one chain to rule them all"), Ethereum will likely continue to capture a large part of market share, in particular due to network effects. One of the buzzwords of DeFi is "money lego", meaning that various DeFi applications can be put together like LEGO bricks. Composability in turn requires DeFi apps to reside on the same blockchain, making it advantageous to be on the Ethereum blockchain. However, while blockchains were traditionally unconnected islands, they are becoming more and more interconnected through so-called bridges.

WHAT ARE STABLECOINS?

Crypto assets are extremely volatile. Although the top two – Bitcoin with a market share of 41% and Ether with a market share of 17% – are considered "conservative" assets, even they have often experienced double-digit drawdowns within a 24-hour timeframe.[2] Taking the volatility into account, it makes no sense to invest crypto assets in DeFi protocols with a view to generating say an annual 10% yield, if there is a risk that the capital invested will depreciate by 10% within the next day. Enter stablecoins: these are crypto assets without volatility, pegged to a fiat currency such as the U.S. Dollar. These are ideal assets for the usage in DeFi.

There exist three different types of stablecoins:

- Fiat collateralized stablecoins, such as Tether ("USDT"), TrueUSD ("TUSD"), Binance USD ("BUSD"), USD Coin ("USDC"), Pax Dollar ("USDP"), and Gemini Dollar ("GUSD")
- Crypto collateralized stablecoins, such as Dai ("DAI"), mStable USD ("MUSD"), Magic Internet Money ("MIM"), and Frax ("FRAX")
- Not-collateralized stablecoins, such as Ampleforth ("AMPL")

Fiat collateralized stable coins are easy to understand but rely on a hopefully trustworthy intermediary who holds the collateral (U.S. Dollars) and issues stable coins against the collateral deposited. The most important representative by far of this category is Tether ("USDT"). Crypto collateralized stablecoins are more complex to understand but get rid of intermediaries and are thus truly decentralized. In stress

[1] See https://defillama.com.

[2] Investors in crypto need nerves of steel, or they die a premature death.

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situations, crypto collateralized stablecoins might not be able to hold the peg at all times. Not-collateralized stablecoins are an interesting monetary experiment utilizing an elastic money supply.

WHAT CATEGORIES OF DEFI EXIST?

DeFi is slowly but surely replicating all services being offered in traditional finance. Currently, the five most important categories of DeFi comprise the following:

- Decentralized savings deposits and loans
- Decentralized insurance
- Decentralized derivatives
- Decentralized investment funds
- Decentralized exchanges

The following discussion provides examples for each category.

Decentralized Savings Deposits and Loans

Compound[3] is an example of a decentralized marketplace for capital. Lenders can lend crypto assets, thereby earning interest, and borrowers can borrow crypto assets, thereby paying interest. Lending and borrowing does not take place between individual users. Rather, lenders lend directly to the platform and borrowers borrow directly from the platform. Thus, this is not peer-to-peer, but peer-to-protocol lending and borrowing. The protocol functions like a bank, earning interest spread.

On Compound, possible crypto assets for lending and borrowing include the stablecoins Tether ("USDT"), TrueUSD ("TUSD"), USD Coin ("USDC"), Pax Dollar ("USDP"), and Dai ("DAI"), but also volatile crypto assets such as Ether ("ETH") and Wrapped Bitcoin ("WBTC"). The applicable interest rates depend on the crypto asset concerned and are algorithmically determined by supply and demand, with rates changing constantly. Interest rates are stated as Annual Percentage Yields ("APY"), and interest is settled every block, which is every 15 seconds. At the time of writing, yields on stable coins were between 1.61% and 2.99% – which is a far cry from the typical yields on bank accounts. Lending and borrowing are extremely flexible, there exist no maturities: deposits can be withdrawn, and loans can be repaid at any time.

In order to borrow crypto assets, collateral exceeding the loan amount must be provided, *e.g.*, to the extent of 150%. This over-collateralization is a necessary consequence of the pseudonymous nature of the blockchain and the resulting lack of a possibility to determine a borrower's creditworthiness.

Compound has several competitors: noteworthy other names include AAVE,[4] which offers a slightly larger menu of crypto assets that can be deposited and borrowed, and Anchor,[5] which offers only one single stablecoin and at the time of writing had a

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[3] See https://app.compound.finance.

[4] See https://app.aave.com/#/markets.

[5] See https://app.anchorprotocol.com/earn.

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whopping deposit interest rate of 19.46% p.a. Notional[6] allows for fixed-rate borrowing and BarnBridge[7] offers fixed-rate deposits.

Decentralized Insurance

DeFi is based on crypto assets locked in smart contracts. In the event of programming errors in the smart contract, there is a risk of losing the capital invested. It is possible to insure against this risk, for example, with the application Nexus Mutual,[8] a kind of mutual insurance company. As of early March 2022, 115 different insurance contracts are being offered that provide protection against bugs in a protocol or against risks with centralized exchanges or custodial wallets. Premiums start at 2.6% p.a. for low-risk projects. For example, to insure 100,000 Dai ("DAI") invested in AAVE over a period of one year, a payment of exactly 2,600 Dai was required as a form of insurance premium. Interestingly, on Nexus Mutual, insurance coverage can be obtained without crypto assets locked in the insured smart contract; this is of course different with traditional insurance. In addition to policyholders, there are also investors who provide risk capital to the protocol and receive compensation in return, in the form of premiums. If the insured event occurs, the protocol makes the insurance payment from these funds provided.

Nexus Mutual has a number of competitors: Unslashed[9] is a decentralized insurance platform on Ethereum that offers 25 different insurance products. InsurAce[10] is a similar solution that offers protection for 114 DeFi applications on 16 different blockchains. Armor[11] is a kind of insurance broker on Ethereum: instead of having to procure decentralized insurance protection for various DeFi applications on different blockchains individually and to constantly adjust the policies, Armor can be used to dynamically adjust the insurance protection as an investor moves across different platforms.

Decentralized Derivatives

Mirror Protocol[12] is a platform for decentralized derivatives on which synthetic assets can be created and traded. Shares such as Alphabet, Apple, Airbnb, Advanced Micro Devices, Amazon.com, Alibaba, Coinbase, Facebook, Goldman Sachs, Robinhood, Johnson & Johnson, Coca-Cola, Microsoft, Netflix, NVIDIA, PayPal, Starbucks, Square, Tesla and Twitter can be purchased in the form of an ERC-20 token. An ERC-20 token is an asset on the Ethereum blockchain which can be sent and received. The above-mentioned tokens can be traded 24/7 and can be held directly in a crypto wallet without having to trust an intermediary like a bank. A competitor of Mirror Protocol is UMA,[13] which offers similar functionality.

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6 See https://notional.finance.

7 See https://app.barnbridge.com.

8 See https://app.nexusmutual.io/cover.

9 See https://app.unslashed.finance/cover.

10 See https://app.insurace.io/Insurance/BuyCovers.

11 See https://armor.fi/protect.

12 See https://mirrorprotocol.app/#/trade.

13 See https://umaproject.org.

Decentralized Investment Funds

Set Protocol[14] is a DeFi application on Ethereum through which one can buy or sell Sets. A Set is a decentralized investment fund whose composition of crypto assets is managed automatically. The Sets are designed in the form of an ERC-20 token and embody the underlying crypto assets. Sets can be held directly in a wallet without an intermediary. Investors are not subject to any minimum investment amounts.

Index Coop[15] is a decentralized provider of various crypto indices. Important indices are, for example, the DeFi Pulse Index or the Metaverse Index. These indices enable an efficient investment in a basket of tokens.

Enzyme Finance[16] is a decentralized asset management platform. Asset managers can set up investment funds quickly and easily based on their investment strategies. They can also determine a specific fee structure. There is full transparency regarding the development in value of the funds and the crypto assets they hold. There exist currently around 100 funds to choose from.

Decentralized Exchanges

One of the most important categories of DeFi is the decentralized exchange ("DEX"). With a DEX, there is no central operator, such as Coinbase or Kraken, who holds the crypto assets in question and who must therefore be trusted as there is counterparty risk. Instead, smart contracts are used: if you send a certain amount of Ether to an Ether/USDC smart contract, you automatically get back the equivalent in USDC, and vice versa. Nobody holds your crypto assets, and accordingly, no one can run away with your crypto assets. On a DEX, anyone can list a new trading pair, while on a traditional exchange, a listing is subject to a decision by the exchange, sometimes only possible upon payment of a listing fee, and can also be revoked. Also, trading fees on a DEX accrue to the liquidity providers, while on a traditional exchange, they accrue to the operator alone. In addition, KYC/AML provisions are not applied on DEXes, while these may be applicable on a traditional exchange. Initially, tokens were listed on traditional exchanges and then gradually on DEXes. Now, the reverse is true. Projects list their tokens on a DEX, which is easier and cheaper, and if they are successful, the tokens eventually come to the traditional exchanges. Historically, the first example of a DEX was Uniswap.[17] Beginning early in March 2022, U.S. $7.5 billion of liquidity was available there in a wide variety of trading pairs. Other well-known examples of DEXes are Curve (U.S. $19.9 billion T.V.L.)[18] and SushiSwap (U.S. $3.9 billion T.V.L.).[19]

WHAT ABOUT REGULATORS?

Apps in the field of DeFi will often engage in regulated activities, such as deposit-taking, lending, or insurance businesses, without complying with the current need

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14 See https://www.tokensets.com/explore.

15 See https://app.indexcoop.com.

16 See https://app.enzyme.finance.

17 See https://uniswap.org.

18 See https://curve.fi.

19 See https://app.sushi.com/en/swap.

for obtaining a license. The question arises as to whether such noncompliant apps could simply be switched-off by a regulator or whether they are so far decentralized that regulators are powerless to intervene. Here it is necessary to distinguish

- the underlying smart contract runs on a blockchain that normally cannot be stopped; and
- the corresponding website of the DeFi application, which is the frontend, can be shut-down. Ultimately, however, this will not be a successful move: because the website is an interface, anyone can build a new interface that accesses the same unstoppable smart contract in the background, often by simply copying the publicly available code.

"DeFi is one of the most interesting applications of blockchains and smart contracts. We have opened the door to DeFi for you, now it is up to you to enter."

WHAT COMES NEXT?

DeFi is one of the most interesting applications of blockchains and smart contracts.[20] We have opened the door to DeFi for you, now it is up to you to enter.[21]

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[20] Other interesting applications are Non-Fungible Tokens ("N.F.T.'s") and Decentralized Autonomous Organizations ("D.A.O.'s").

[21] For more information please see this webinar.

EXPANDED I.R.S. REPORTING OBLIGATIONS FOR DIGITAL ASSETS

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Tags
Broker Reports Crypto
Crypto
Cryptocurrency Tax
Digital Assets
I.R.S. Reporting Crypto
Virtual Currency
Voluntary Disclosure

Lawrence S. Feld concentrates his practice in federal and state criminal and civil tax controversies and white collar criminal defense. Mr. Feld is a co-author of Tax Fraud and Evasion, a com-prehensive two volume treatise on criminal and civil tax fraud and money laundering, which is published by Thomson Reuters. He is an adjunct professor at New York Law School where he teaches an advanced seminar on criminal tax enforcement.

INTRODUCTION

Advances in digital and distributed ledger technology for financial services in recent years have resulted in dramatic growth in markets for digital assets. This transformation has profound implications for consumers, investors, and businesses in a broad spectrum of areas of vital interest to the United States and the global community. These areas include data privacy and security; financial stability and systemic risk; crime; national security; the ability to exercise human rights; financial inclusion and equity; and energy demand and climate change. In November 2021, non-state issued digital assets had a combined market capitalization of $3 trillion, an extraordinary increase from an estimated $14 billion in November 2016. Surveys indicate that approximately 16% of adult Americans – about 40 million people – have invested in, traded, or used cryptocurrencies. More than 100 nations are exploring or, in some cases, introducing Central Bank Digital Currencies ("CBDCs"), a digital form of sovereign currency.

Expansion of I.R.S. Reporting Obligations

I.R.S. reporting requirements for cryptocurrency and other digital assets have been substantially expanded, and as a result, are expected to have a significant impact on the wide range of businesses and individuals to which they apply. Two of these new reporting obligations were enacted as part of the Infrastructure and Jobs Act, signed by President Biden on November 15, 2021. First, the information reporting requirements for certain brokers have been extended to digital assets. Second, digital assets valued at more than $10,000 are now treated as "cash'' under IRC § 6050I and must be reported to the I.R.S. when received by any person engaged in a trade or business, in the course of that trade or business.

The third disclosure obligation relates to the I.R.S. Voluntary Disclosure Practice.

On February 15, 2022 the I.R.S. announced that Form 14457, *Voluntary Disclosure Practice Preclearance Request and Application*, has been revised to include an expanded section on reporting cryptocurrency.

Executive Order

On March 9, 2022, President Biden signed the "Executive Order on Ensuring Responsible Development of Digital Assets." Section 1 of the Order explains the government's policy with respect to digital assets as follows:

> While many activities involving digital assets are within the scope of existing domestic laws and regulations, an area where the United States has been a global leader, growing development and adoption of digital assets and related innovations, as well as inconsistent

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> controls to defend against certain key risks, necessitate an evolution and alignment of the United States Government approach to digital assets. The United States has an interest in responsible financial innovation, expanding access to safe and affordable financial services, and reducing the cost of domestic and cross-border funds transfers and payments, including through the continued modernization of public payment systems. We must take strong steps to reduce the risks that digital assets could pose to consumers, investors, and business protections; financial stability and financial system integrity; combating and preventing crime and illicit finance; national security; the ability to exercise human rights; financial inclusion and equity; and climate change and pollution.

The new I.R.S. disclosure obligations may be viewed as important beginning steps in effectuating the policy objectives of the United States with respect to digital assets.

This article provides an introductory explanation of these new disclosure duties and discusses some of the many intriguing questions presented by these reporting requirements.

DIGITAL ASSETS

The Internal Revenue Code now defines "digital asset" as follows:

> Except as otherwise provided by the Secretary, the term 'digital asset' means any digital representation of value which is recorded on a cryptographically secure distributed ledger or any similar technology as specified by the Secretary.[1]

The I.R.S. is drafting regulations that will explain and amplify the statutory definition. The effective date of the new definition is January 1, 2023.[2]

It is useful to compare this definition of "digital asset" with the definition contained in the Executive Order. Section 9 of the Order states as follows:

> (a) The term 'blockchain' refers to distributed ledger technologies where data is shared across a network that creates a digital ledger of verified transactions or information among network participants and the data are typically linked using cryptography to maintain the integrity of the ledger and execute other functions, including transfer of ownership or value.
>
> (b) The term 'central bank digital currency' or 'CBDC.' refers to a form of digital money or monetary value, denominated in the national unit of account, that is a direct liability of the central bank.

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1 Code §6045(g)(3)(D). References to the Secretary that appear in the Code relate to the Secretary of the Treasury or a delegate, which typically means the I.R.S.

2 Code §6045(g)(C)(iii).

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(c) The term 'cryptocurrencies' refers to a digital asset, which may be a medium of exchange, for which generation or ownership records are supported through a distributed ledger technology that relies on cryptography, such as a blockchain.

(d) The term 'digital assets' refers to all CBDCs, regardless of the technology used, and to other representations of value, financial assets and instruments, or claims that are used to make payments or investments, or to transmit or exchange funds or the equivalent thereof, that are issued or represented in digital form through the use of distributed ledger technology. For example, digital assets include cryptocurrencies, stablecoins, and CBDC. Regardless of the label used, a digital asset may be, among other things, a security, a commodity, a derivative, or other financial product. Digital assets may be exchanged across digital asset trading platforms, including centralized and decentralized finance platforms, or through peer-to-peer technologies.

(e) The term 'stablecoins' refers to a category of cryptocurrencies with mechanisms that are aimed at maintaining a stable value, such as by pegging the value of the coin to a specific currency, asset, or pool of assets or by algorithmically controlling supply in response to changes in demand in order to stabilize value.

TAX CONSEQUENCES OF VIRTUAL CURRENCY

In I.R.S. Notice 2014-21, the I.R.S. announced the position that virtual currency, including cryptocurrency, is treated as property for Federal income tax purposes. The Notice provides examples of how well-established tax principles applying to transactions involving property apply to virtual currency. Virtual currency is defined by the I.R.S. as a digital representation of value, other than a representation of the U.S. dollar or foreign currency, that functions as a unit of account, a store of value, and medium of exchange. Cryptocurrency is a type of virtual currency that uses cryptography to secure transactions that are recorded on a distributed ledger, such as a blockchain.[3]

The I.R.S. expanded its guidance on virtual currency with the issuance of Frequently Asked Questions on Virtual Currency Transactions,[4] which includes useful information for individuals who hold cryptocurrency as a capital asset and are not engaged in the trade or business of buying and selling cryptocurrency.

I.R.S. Form 1040 now asks the following question: "At any time during 2021, did you receive, sell, exchange or otherwise dispose of any financial interest in virtual currency?" The taxpayer must answer this question. A willfully false response to this question on a tax return filed with the I.R.S. is a felony.[5]

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[3] See here for more information.

[4] See here.

[5] Code §7206(1).

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BROKERS

Code §6045 establishes reporting obligations for persons doing business as a broker. Section 6045 requires brokers that are dealers/middlemen in "covered security" transactions to issue a Form-1099-B to both the brokers' customers and the I.R.S., identifying the sales of securities through the broker, the customer's adjusted basis in the security, and the proceeds of the transaction. The amended statute expands the definition of a broker and expands the definition of a "covered security" to include digital assets. As a result, the Form 1099-B reporting obligation extends to digital asset transactions conducted through brokers.

The term "broker" has been expanded to include:

> [A]ny person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another.[6]

This definition clearly applies to cryptocurrency exchanges, which are digital platforms that allow users to trade cryptocurrency and other digital assets for other digital assets as well as fiat currencies such as the U.S. dollar or foreign currency. Questions have been raised as to whether this new definition of a "broker" extends to other participants in the development of digital assets, such as miners, providers of digital wallets and developers of new digital assets. The scope of the term "digital assets" is uncertain. The regulations may amplify these definitions and there may be additional legislation that clarifies these new reporting obligations.

As a result of the new reporting obligations of brokers, the underreporting of cryptocurrency gains is expected to diminish. The Joint Committee on Taxation estimates that these new reporting requirements will raise more than $27 billion over ten years.[7]

TRADES AND BUSINESSES THAT RECEIVE DIGITAL ASSETS

Code §6050I, enacted in 1984, requires that any person who is engaged in a trade or business and who, in the course of that trade or business, receives more than $10,000 in cash in one transaction (or two or more related transactions) must file a return reporting certain required information. The return is Form 8300, and it currently requires information concerning

- the identity of the individual from whom the cash was received,
- the person on whose behalf the transaction was conducted,
- a description of the transaction and method of payment, and
- the business that received the cash.

Cash for purposes of the statute now includes any digital asset as defined in Section 6045(g)(3)(D).

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[6] Code §6045(c)(1)(D).

[7] Report, Joint Committee on Taxation, JCX-33-21 (Aug. 2, 2021).

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According to the Form 8300 Reference Guide,[8] the information contained in the form assists law enforcement in its anti-money laundering efforts. Compliance by businesses with this reporting obligation provides authorities with an audit trail to investigate possible tax evasion, drug dealing, terrorist financing and other criminal activities. The willful failure to file I.R.S./FinCen Form 8300 by a recipient is punishable by up to five years in prison, and a maximum fine of $250,000 for an individual and $500,000 for a corporation.[9] A recipient who willfully files a materially false or incomplete Form 8300 is punishable by up to three years in prison and a maximum fine of $250,000 for an individual and $500,000 for a corporation.[10] Civil penalties for knowing violations Code §6050I can be severe.[11] The I.R.S. adjusts the penalty amounts annually for inflation.

"A voluntary disclosure does not guarantee immunity from prosecution. Rather, it will be considered along with all other facts and circumstances in deciding whether to recommend prosecution to the Department of Justice."

I.R.S. CRIMINAL INVESTIGATION (I.R.S.–CI) VOLUNTARY DISCLOSURE PRACTICE

I.R.S.-CI Voluntary Disclosure Practice refers to the long-standing practice of I.R.S.-CI that provides taxpayers with potential criminal exposure for the willful failure to comply with tax or tax related obligations a means to come into compliance with the law and potentially avoid criminal prosecution. A voluntary disclosure does not guarantee immunity from prosecution. Rather, it will be considered along with all other facts and circumstances in deciding whether to recommend prosecution to the Department of Justice. A voluntary disclosure requires the applicant to be timely, truthful, and complete in making the disclosure. During the voluntary disclosure process, the applicant also must

- cooperate with the I.R.S. in determining the tax liability and compliance reporting requirements;
- cooperate with the I.R.S. in investigating any enablers who aided in the noncompliance or were in any way involved in the noncompliance;
- submit all required returns, information returns and reports for the disclosure period; and
- make good-faith arrangements to fully pay the tax, interest, and penalties determined by the I.R.S. to be applicable.

Taxpayers who did not commit any tax or tax related crimes and wish to correct mistakes or file delinquent returns have other options available to comply with their tax and reporting obligations.

The starting point for making a voluntary disclosure is the submission of Form 14457, *Voluntary Disclosure Practice Preclearance Request and Application*. On February 15, 2022, the I.R.S. announced that Form 14457 had been revised, including an expanded section on reporting virtual currency. The previous version of Form 14457 provided checkboxes for applicants to disclose cryptocurrency noncompliance that they wanted to report. Disclosing cryptocurrency under the old form did not always apply well to virtual currency holdings.

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8 See here.

9 Code §7203.

10 Code §7206(1).

11 Code §§6721 and 6722.

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The revised Form 14457 has a separate section for reporting virtual currency holdings. The taxpayer is required to disclose all domestic and foreign noncompliant virtual currency owned or controlled by the taxpayer or which the taxpayer beneficially owned directly or indirectly during the disclosure period. For each virtual currency holding the taxpayer must report the following information:

- The name of the virtual currency
- The acquisition and disposition dates
- The identifying number or other designation for the holding
- The account holders

The instructions for line 13 in revised Form 14457 note the following about virtual currencies:

> Virtual Currency is a dynamic area, and for purposes of this form encompasses assets beyond what many would define as virtual currencies.

The instructions also explain that the listings of virtual currency for the disclosure period must include assets acquired or disposed of during the disclosure period and include those held through entities.

The applicant is further instructed that if a "mixer" or "tumbler" were used in connection with any virtual currency transaction, the taxpayer is required to identify the "mixer" or "tumbler" used and the reason for its use. A "mixer" or "tumbler" is a service offered by certain providers that is employed to conceal or disguise the source of funds used in a transaction. They are frequently used to hide an illegal source of income or assets. The I.R.S. Voluntary Disclosure Practice is not available to taxpayers with illegal source income determined under applicable Federal law. Consequently, the involvement of a mixer or tumbler is a "red flag'' that the taxpayer may not qualify for a voluntary disclosure.

CONCLUSION

Technological advances in the digital asset sector and the transactions which they affect are occurring at a rapidly growing pace. Recent developments in I.R.S. reporting obligations for digital assets are part of a new effort in this dynamically evolving area to safeguard the revenue system on which our nation depends. The stakes are high for the I.R.S. and the risks may be higher for those who fail to comply with the new rules.

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THE LAST DAYS OF DUMMY COMPANIES

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Ibn Spicer

Tags
C.T.A.
F.A.T.F.
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Recommendation 24
Responsible Party
Ultimate Beneficial Owner

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INTRODUCTION

The use of anonymous shell companies or "dummy companies" that may be availed of to conceal the true identities of the ultimate beneficial owners is viewed by financial regulators as a tool to facilitate money laundering and the financing of terrorism. Their existence may soon become a thing of the past. The globalization of world trade and finance has meant that law enforcement agencies and other competent authorities must be able to identify the responsible individuals whenever dummy corporations are used in criminal activity, be it terrorism, drug trafficking, arms dealing, or corruption of government officials. Recently international governmental authorities have promoted the concept of beneficial ownership transparency as a major component in combatting bad actors that hide behind shells.

F.A.T.F. RECOMMENDATON 24

Following enactment of Corporate Transparency Act ("C.T.A.") and the proposed regulations published by the Financial Crimes Enforcement Network of the I.R.S. ("FinCEN") seeking to implement identification rules for determining beneficial ownership information ("B.O.I."), the Financial Action Task Force ("F.A.T.F.") adopted amendments to its Recommendation 24 on beneficial ownership earlier this month. The revisions are designed to help address the lack of beneficial ownership information that is vital for money laundering investigations.

In General

The F.A.T.F. is the intergovernmental policymaking body whose purpose is to establish international standards, and to develop and promote policies designed to combat fraud, money laundering, and the financing of terrorism. The F.A.T.F. works to generate the political will necessary to bring about national legislative and regulatory reforms to combat these international corrupt and criminal acts. There are currently 37 member countries in the F.A.T.F., including the United States, and two regional organizations – the European Commission and the Gulf Cooperation Council. The F.A.T.F. sets the global anti-money laundering standards through its 40 recommendations. More than 200 countries and jurisdictions are committed to implementing those regulations, and failure to adhere to them can have serious consequences. Countries that are black-listed or grey-listed may have challenges in accessing the global financial system.

Recommendation 24 states that countries should ensure that competent authorities such as law enforcement, financial intelligence units, and tax agencies have access to adequate, accurate, and up-to-date information on the true owners of companies operating in their country.

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According to the F.A.T.F., the amendments to Recommendation 24 are in response to evolving money laundering risks and widely publicized failures to prevent misuse of legal entities. The amendments seek to strengthen the international standards on beneficial ownership of legal entities to ensure greater transparency about their ultimate ownership and control and to mitigate the risks of their misuse. One of the concrete goals in this regard is to create an up-to-date, efficient beneficial ownership register that would be accessible to competent authorities.

Amendments

Specifically, the F.A.T.F. recommended the following action steps.

Countries should

- require companies to obtain and maintain adequate, accurate and up-to-date information on their own beneficial ownership;
- make such information available to competent authorities in a timely manner; and
- require beneficial ownership information to be held by a public authority or body functioning as beneficial ownership register or may use an alternative mechanism that provides competent authorities efficient and timely access to accurate information.

In implementing the action steps, countries should apply any supplementary measures that are deemed necessary to ensure the determination of beneficial ownership of a company. One example is the maintenance of a beneficial ownership information database using information obtained by regulated financial institutions and professionals or held by regulators or stock exchanges.

The amendments include measures to prevent legal entities from misusing bearer shares and nominee arrangements by prohibiting the issuance of new bearer shares and bearer share warrants and the conversion or immobilization of the existing ones, while setting out stronger transparency requirements for nominee arrangements.

Centralized Registers

The amended Recommendation 24 says countries should create a centralized register of the beneficial owners of companies using a public authority, but it falls short of an explicit mandate. Instead, countries may consider alternative mechanisms if those provide efficient access by competent authorities. One would be hard-pressed to come up with an effective alternative to a centralized register. the use of a wide variety of mechanisms among participating countries could impair the effectiveness of the global database of beneficial ownership information.

Risk-Based Approach for Selection of Legal Entities Subject to Reporting

Both domestic legal entities and foreign entities with sufficient links to a country should be included in assessing whether registration is required. The risk-based approach recommendation to determine which legal entities should be required to report beneficial ownership information will allow countries the flexibility to exempt certain entities from any reporting requirements.

Public Procurement

The revisions also require public authorities to collect beneficial ownership information of legal entities for purposes of public procurement. Since the U.S. federal government is the largest purchaser of goods and services in the world, this could potentially be one of the largest sources of beneficial ownership information.

Prohibiting New Bearer Shares

Bearer shares and nominee shareholder arrangements are some of the instruments used to move, hide, and launder illicitly acquired assets. Bearer shares are company shares that exist in certificate form. Whoever is in physical possession of the bearer shares is deemed to be the owner. Since the transfer of shares requires only delivery of the certificate from one individual to another, they permit anonymous transfers of control and create a serious impediment to investigations of financial crime.

The revised Recommendation 24 states that countries should prohibit the issuance of new bearer shares, as their ownership is essentially unverifiable. However, the revisions do not explicitly require the official identification of holders of existing bearer shares.

A nominee shareholder refers to the holder of shares on behalf of another person, or a beneficial owner, or the original holder of shares. The revisions call for stronger transparency requirements for nominee arrangements.

BENEFICIAL OWNER FOR C.T.A. PURPOSES

While there is no single beneficial ownership definition in F.A.T.F. Recommendation 24, the C.T.A. defines a "beneficial owner" as a natural person who

- exercises substantial control over a company,
- owns at least 25% of a company's ownership interests, or
- receives substantial economic benefits from a company's assets.

The proposed regulations from FinCEN clarify elements inherent in "substantial control." See Proposed 31 CFR 1010.380(d)(1).

The beneficial owner is the individual that exercises substantial control and receives substantial economic benefits from a company's assets. The proposed FinCEN regulations define "substantial control" using three specific indicators:

- Senior officer of a reporting company
- Authority over any officer or dominant majority of the board of directors of a reporting company
- Substantial influence over the management of any principal assets, significant contracts, major expenditures, and investments and compensation schemes for senior officers

Additionally, the proposed regulations include a "catch-all" provision to make clear that substantial control can take additional forms not specifically listed in the regulations and to prevent individuals from evading identification by hiding behind formalisms.

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RESPONSIBLE PARTY FOR E.I.N. PURPOSES

The increased governmental effort to mandate corporate transparency can also be found in the changes made by the I.R.S. in connection with the term "responsible party" for purposes of obtaining an Employer Identification Number ("E.I.N."). In comparison to the meaning of the term "substantial control," the I.R.S. form adopts the term "responsible party." The terms are not identical, but they appear to be defined in similar ways.

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Definition in Instructions

According to the instructions for the current revision of Form SS-4, *Application for Employer Identification Number (EIN)*, the I.R.S. defines the term "responsible party" as follows:

> **Responsible party defined.**
>
> The "responsible party" is the person who ultimately owns or controls the entity or who exercises ultimate effective control over the entity. The person identified as the responsible party should have a level of control over, or entitlement to, the funds or assets in the entity that, as a practical matter, enables the person, directly or indirectly, to control, manage, or direct the entity and the disposition of its funds and assets. **Unless the applicant is a government entity, the responsible party must be an individual (that is, a natural person), not an entity.**
>
> - For entities with shares or interests traded on a public exchange, or which are registered with the Securities and Exchange Commission, "responsible party" is (a) the principal officer, if the business is a corporation, (b) a general partner, if a partnership. The general requirement that the responsible party be an individual applies to these entities. For example, if a corporation is the general partner of a publicly traded partnership for which Form SS-4 is filed, then the responsible party of the partnership is the principal officer of the corporation.

Definition on I.R.S. Website

However, the I.R.S. website[1] provides an enhanced definition of the term "responsible party" which approaches the definition of the term "beneficial owner" for purposes of the C.T.A. by emphasizing that a nominee cannot be a responsible party.

> **Nominees**
>
> A "nominee" is someone who is given limited authority to act on behalf of an entity, usually for a limited period of time, and usually during the formation of the entity. The "principal officer, general partner," etc., as defined by the IRS, is the true "responsible party" for the entity, instead of a nominee. The "responsible party" is the individual or entity that controls, manages, or directs the entity and the disposition of the entity's funds and assets, unlike a nominee,

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[1] See here.

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> who is given little or no authority over the entity's assets.
>
> The Internal Revenue Service has become aware that nominee individuals are being listed as principal officers, general partners, grantors, owners, and trustors in the Employer Identification Number (EIN) application process. A nominee is not one of these people. Rather, nominees are temporarily authorized to act on behalf of entities during the formation process. The use of nominees in the EIN application process prevents the IRS from gathering appropriate information on entity ownership, and has been found to facilitate tax non-compliance by entities and their owners.
>
> The IRS does not authorize the use of nominees to obtain EINs. All EIN applications (mail, fax, electronic) must disclose the name and Taxpayer Identification Number (SSN, ITIN, or EIN) of the true principal officer, general partner, grantor, owner or trustor. This individual or entity, which the IRS will call the "responsible party," controls, manages, or directs the applicant entity and the disposition of its funds and assets.
>
> To properly submit a Form SS-4, the form and authorization should include the name, Taxpayer Identification Number and signature of the responsible party. Third party designees filing online applications are reminded of their obligation to retain a complete signed copy of the paper Form SS-4 and signed authorization statement for each entity application filed with the IRS. Nominees do not have the authority to authorize third party designees to file Forms SS-4, and should not be listed on the Form SS-4.

CONCLUSION

Overall, the amendments made to Recommendation 24 significantly strengthen the F.A.T.F. standards, and in so doing, enables competent authorities in countries and territories to tackle money laundering and terrorist financing around the world. As the U.S. faces new national security threats and increased focus on Russian ownership of shell companies, and the real property and other assets owned by overseas entities, there is renewed political urgency to act against anonymous ownership of companies. The likelihood of success for the F.A.T.F. recommendations will depend on how effectively and timely they are implemented. The details, the method of enforcement, are all hugely important, and are yet to be worked out.

In the U.S., significant steps have been taken towards implementation through the proposed FinCEN regulations on beneficial owner and the I.R.S. website advising that the responsible party for E.I.N. purposes will be the same person who is considered the beneficial owner for C.T.A. purposes. The definitions and specific indicators of substantial control under the proposed FinCEN regulations means that a person who exercises substantial control and receives substantial economic benefits from a company's assets is likely the proper person to be the responsible party for purposes of obtaining an E.I.N. Nominees are not welcome.

DIVIDEND INCOME FROM INDIA: TAX TREATY ISSUES FOR NONRESIDENT SHAREHOLDERS

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INTRODUCTION

Prior to April 1, 2020, dividend income of nonresident shareholders of an Indian company was exempt from tax in India. However, Indian companies paid dividend distribution tax (the "D.D.T.") on the payment of a declared dividend. That changed in April 2020, when dividend income of shareholders became taxable in India in the hands of such shareholders. For dividends paid to nonresident shareholders, Indian companies must withhold appropriate withholding tax when paying dividends.

The rate of direct tax and withholding tax on dividend income of nonresidents, as per Indian Income Tax Act 1961 (the "Act") is 20%, plus applicable surcharge and cess. A taxpayer is permitted to apply the provisions of a tax treaty, if such provisions are more beneficial than the provisions of the Act.[1] The nonresident shareholder must furnish a tax residency certificate ("T.R.C.") from the tax authority of its country of residence along with other documentation to claim tax treaty benefits in India.

Prior to the change in law, the issue of claiming tax treaty benefits in India for Indian dividend income was not relevant. Consequently, neither the existence of tax nexus over a shareholder nor the shareholder's residence country were relevant issues. Now, however, nonresident shareholders face several issues when seeking relief from withholding tax under an income tax treaty in effect between India and a particular treaty partner. This article aims to provides insights into typical situations and issues being faced.

TAX TREATY RELIEF FOR DIVIDENDS

India has in effect income tax treaties with over 90 countries. Generally, the withholding tax rate on dividend income is lower under an income tax treaty than that provided under domestic law. In addition, several of India's tax treaties contain a most-favored-nation ("M.F.N") clause. The M.F.N. clause permits a qualifying tax resident of the treaty partner country to apply a lower withholding tax under an income tax treaty between India and another treaty partner country, provided that the other country is a member of the O.E.C.D. The language of the M.F.N. clause varies among the income tax treaties in effect. In particular, some provide that its application is automatic, while others provide that the benefit depends on further agreement between tax authorities of both countries.

Hence, it is in the interest of nonresident shareholders to seek access to the applicable tax treaty and reduce their tax liability in India, if possible. Broadly speaking, the tax rates under some of India's popular tax treaties, without considering the M.F.N. clause, are as follows:

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[1] Section 90(2) of the Act.

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Country	Tax Rate on Dividend Income
United States	15% (25%, depending on facts)
United Kingdom, Singapore	10% (15%, depending on facts)
Belgium *(M.F.N. clause)*	15%
France, Hungary, Netherlands, Switzerland, Sweden *(all with M.F.N. clause)*	10%
Germany	10%
Portugal	10% (15%, depending on facts)
Mauritius	5% (15%, depending on facts)
Slovenia, Lithuania	5% (15%, depending on facts)
Colombia	5%

As the above table indicates, the tax rates on dividend income from India can be reduced under an income tax treaty from 20%, plus applicable surcharge and cess, to as low as 5%. However, Indian tax authorities can invoke the provisions of India's General Anti-Avoidance Rule ("G.A.A.R.") in certain circumstances to deny the tax treaty benefit in India if they find that the main purpose of the arrangement is to obtain an impermissible tax benefit in India considering the principle of substance over form.

TAXATION OF DIVIDEND INCOME UNDER SELECT INCOME TAX TREATIES

Mauritius

Historically, Mauritius has been one of the most popular jurisdictions for routing investments to India. The rate is 5%, if the beneficial owner is a Mauritius company that directly holds at least 10% of the capital of the Indian company paying the dividends. The rate is 15% in all other cases.

The Multilateral Instrument ("M.L.I.") does not yet apply to the India-Mauritius Income Tax Treaty. While ratifying the M.L.I., Mauritius has not covered the treaty with India. Accordingly, the principal purpose test ("P.P.T.") under the M.L.I. does not apply to the India-Mauritius tax treaty.

Coupled with the tax regime in Mauritius, Mauritius continues to be a favored jumping-off point for making a direct investment in shares of an Indian company. Nonetheless, the provisions of India's G.A.A.R. should be analyzed before structuring investments through Mauritius. Also, if the M.L.I. becomes applicable to the India-Mauritius tax treaty in the future, the requirement of economic and commercial substance under the P.P.T. test will be crucial for availing tax treaty benefits in India.

United States

The rate of tax on dividend is 15%, if the beneficial owner is a U.S. corporation that owns at least 10% of the voting stock of the Indian company paying dividends. The rate is 25% in all other cases.

Although the U.S. has not ratified the M.L.I., Article 24 (Limitation on Benefits) of the India-U.S. Income Tax Treaty provides a set of simplified limitation on benefits ("L.O.B.") tests that must be met in order for a corporation to claim the benefit of the treaty.

Under the first test, a U.S. tax resident other than an individual must meet the following ownership and base erosion tests. More than 50% of the beneficial interests in the entity must be owned directly or indirectly by

- one or more individual residents of India or the U.S.;
- one of the Contracting States, including political subdivisions or local authorities;
- other individuals subject to tax in India or the U.S. on worldwide incomes; or
- citizens of the U.S.

Under the base erosion test, the income of the entity must not be used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are not

- residents of the U.S. or India;
- residents of one of the Contracting States, including political subdivisions or local authorities; or
- citizens of the U.S.

Under the second test, the income from India must be derived in connection with, or be incidental to, the active conduct by the U.S. corporation of a trade or business in the U.S., other than the business of making or managing investments. Under an exception, activities carried on in the banking or insurance sectors are acceptable.

Under the third test, a U.S. corporation will qualify for treaty benefits if its principal class of shares are publicly traded. This means that there is substantial and regular trading on a recognized stock exchange, including NASDAQ and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Act of 1934.

If none of the foregoing tests are met, a U.S. corporation may make a request to the Indian competent authority for relief and access to treaty benefits.

Limited liability companies ("L.L.C.'s") may qualify for treaty benefits based on certain judicial precedents even though most are treated as passthrough entities in the U.S. that do not pay U.S. tax and are not tax resident in their own right. This implies that, for treaty benefits to be granted, the owner of an L.L.C. must (i) be a

corporation[2] other than an S-corporation,[3] (ii) be formed under the laws of a state of the U.S., (iii) actually pay tax in the U.S. on global income,[4] and (iv) meet the conditions of the India-U.S. Income Tax Treaty, including the L.O.B. clause. If those facts exist, a *pro rata* portion of the dividend may qualify for the reduced rate of withholding tax. Even then, a challenge from the Indian tax authorities may arise and G.A.A.R. can still be invoked to deny tax treaty benefits.

The U.K. or Singapore

Under the India-U.K. Income Tax Treaty, the rate of withholding tax that is imposed on dividend payments from an Indian company generally is 10%, although it may be 15% certain limited circumstances.

Under the India-Singapore Income Tax Treaty, the rate of tax on dividend payments from an Indian company is 10%, if the beneficial owner is a Singapore company that owns at least 25% of the shares of the Indian company paying the dividends. In all other cases, the rate is 15%.

Entitlement to the reduced tax rate is subject to potential challenge under Indian domestic G.A.A.R. In addition, the M.L.I. has been adopted in both income tax treaties and the treaty P.P.T. must be met as well. Consequently, the benefit of reduced withholding tax rates under each income tax treaty may be lost if the Indian tax authorities conclude that, having regard to all relevant facts and circumstances, it is reasonable to conclude that obtaining that benefit was one of the principal purposes of arranging an investment in India through a Singapore or U.K. corporation, provided that the reduced rate of withholding may be allowed if considered to be in accordance with the object and purpose of the treaty.

"Prudence suggests that the commercial and economic substance of the U.K. or Singapore shareholder should be tested before claiming the treaty benefit of a reduced dividend withholding tax in India."

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The Netherlands

Under the India-Netherlands Income Tax Treaty, the rate of withholding tax on a dividend from an Indian company is 10%. However, a possibility exists to invoke the M.F.N. clause under the income tax treaty in order obtain the benefit of a 5% rate, as was discussed before the Delhi High Court in the case of a Netherlands taxpayer.

In the *Concentrix Services Netherlands B.V.* case,[5] the Indian tax authorities were unsuccessful in defending their action of denying application of the M.F.N. benefit. The taxpayer was a tax resident of Netherlands and a shareholder of an Indian company which was making payment of a dividend at a time when the D.D.T. was no longer in effect. The taxpayer made an application to the Indian tax authorities

[2] If the shareholder in the U.S. is not a corporation that would qualify for the 15% rate of withholding tax, the withholding tax rate under Indian domestic law is lower than the treaty rate.

[3] An S-corporation is a corporation that generally is owned only by U.S. citizens and resident individuals. It elects flow through treatment under Subchapter S of the Internal Revenue Code.

[4] In principle, the dividend may qualify for the dividends received deduction that is provided under Section 245A of the Internal Revenue Code.

[5] W.P.(C) 9051/2020.

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seeking the benefit of the M.F.N. under the India-Netherlands Income Tax Treaty signed in 1989. The taxpayer contended that the lower tax rate of 5% for dividend income under the India-Slovenia Income Tax Treaty signed in 2003 was available to it. Further, the 5% withholding tax rate provided for in the India-Lithuania Income Tax Treaty signed in 2011 and the India-Colombia Income Tax Treaty signed in 2011 would be imported into the India-Netherlands tax treaty under the M.F.N. clause, as each of those countries were O.E.C.D. members as of the date the taxpayer sought to apply the M.F.N. clause. Nonetheless, the Indian tax authorities denied the application because none of those countries was a member of the O.E.C.D. when its income tax treaty with India was signed. The tax authorities argued that no intention existed to extend the rate of withholding tax in those income tax treaties to existing treaties with other countries once those other countries became members of the O.E.C.D.

The Delhi High Court disagreed with the position of the Indian tax authorities and held that the benefit of the lower tax rate of 5% for dividend income under the three income tax treaties was available to Concentrix because it was a Dutch resident corporation entitled to treaty benefits and all of the countries were O.E.C.D. members at the time the M.F.N. clause in the treaty applicable to Concentrix was sought to be invoked.

The Delhi High Court also placed reliance on the Decree issued by the Netherlands authorities which stated that the lower tax rate of 5% for dividend income under the India-Slovenia tax treaty would apply to the India-Netherlands tax treaty. Hence, it was held that India could not adopt an inconsistent position in light of applicable treaty interpretation principles.

Nonetheless, the Indian tax authorities have not relinquished the position raised in the *Concentrix* case. A similar Delhi High Court judgment is currently before the Supreme Court.[6] The issue will be settled once the Supreme Court rules. In the interim, the position of the tax authorities is troublesome. A tax circular has been issued disagreeing with the rationale of the Delhi High Court. It contends that the M.F.N. clause cannot be applied automatically irrespective of its language unless an explicit notification is made by India. The circular is not binding on taxpayers. However, it will be followed by the tax authorities. Until the matter is finally settled, only taxpayers that have received a favorable order from any court in India can follow the holding in the *Concentrix* case without risk of assessment. Note that a subsequent decision of the Income Tax Appellate Tribunal ("I.T.A.T.") has held that the Circular may not be in line with the law.

In these circumstances, a corporation that is resident of a country having an income tax treaty with India that includes an M.F.N. provision may wish to explore the option of invoking the Mutual Agreement Procedure ("M.A.P.") of that treaty. Even then, the impact of the Indian G.A.A.R. and the P.P.T. under the India-Netherlands Income Tax Treaty would need to be analyzed. Also, the effect of differences among the three treaties providing a 5% withholding tax rate on direct investment dividends requires analysis. The 5% tax rate under India-Slovenia Income Tax Treaty and India-Lithuania Income Tax Treaty is available only if the beneficial owner directly holds at least 10% of the capital of the Indian company paying the dividends. No similar requirement exists in the India-Netherlands Income Tax Treaty. It is not clear whether the 10% ownership requirement of other treaties must be imported under other treaties along with the 5% withholding tax rate.

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[6] The Nestle SA case is discussed below in the text at note 7.

Finally, the conditions under the India-Slovenia Income Tax Treaty to qualify for the 5% withholding tax rate have been modified by Article 8 of the M.L.I., which requires the 10% shareholding to be met throughout a 365-day period that ends on the date of payment of the dividend. Article 8 of the M.L.I. does not apply to the India-Netherlands Income Tax Treaty. In the context of a parent company owning all the shares of an Indian subsidiary, this is not a problem. But it may be a problem for a Dutch company owning less than 10% of an Indian company when invoking the M.F.N. clause under the India-Netherlands Income Tax Treaty.

"The M.L.I. does not apply to the India-Switzerland Income Tax Treaty."

Switzerland

Under the India-Switzerland Income Tax Treaty, the rate of dividend withholding tax is 10% and a possibility exists to invoke an M.F.N. provision in the treaty to claim a reduction in withholding tax to 5%.

As mentioned above, after the judgment in the *Concentrix* case, the Delhi High Court gave similar access to the lower dividend withholding tax rate of 5% for dividend income in the *Nestle SA* case,[7] involving the M.F.N. provision under the India-Switzerland Income Tax Treaty. There, the Delhi High Court referred to the withholding tax rate for dividends under the India-Lithuania Income Tax Treaty and the India-Colombia Income Tax Treaty. Subsequently, the Swiss tax authorities officially notified Swiss taxpayers that the withholding tax rate of 5% is applicable on receipt of dividend income from Indian companies. As a result, the foreign tax credit in Switzerland is capped at 5%. Reciprocity from the Indian tax authorities in this matter is expected by Switzerland.[8] As mentioned previously, the Indian tax authorities do not share this view.

The M.L.I. does not apply to the India-Switzerland Income Tax Treaty. Consequently, the P.P.T. and Article 8 of the M.L.I. have no impact on dividends paid to a Swiss corporation.

Cayman Islands and British Virgin Islands ("B.V.I.")

Income tax treaties are not in effect between India and the Cayman Islands or B.V.I. Accordingly, dividends paid to residents of these jurisdictions are subject to full Indian withholding tax of 20%, plus applicable surcharge and cess. Currently, there is much discussion about a potential redomicile of Cayman Islands and B.V.I. corporations to Mauritius. Mauritius is a business-friendly jurisdiction that has a favored tax regime for corporation and an income tax treaty in effect with India. Ideally, the redomicile of a corporation to Mauritius should not be considered a taxable event for a corporation holding shares of an Indian company. Nonetheless, a question arises whether the redomiciliation will adversely impact the redomiciled company's entitlement to income tax treaty benefits in India based on claims of treaty shopping or avoidance under a P.P.T. standard.

Recently, the Mumbai bench of the I.T.A.T. addressed the issue in the *Asia Today Limited* case.[9] In reaching its decision in a case involving redomiciliation, it acknowledged that various dynamic and constantly evolving business reasons and

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7 W.P. (C) 3243/2021.

8 Announcement of the Swiss Federal Department of Finance on August 13, 2021.

9 TS – 620-ITAT-2021 (Mum).

justifications may exist for redomiciliation, especially if the existing place of domicile inhibits future business or prospects in some way. In this regard, it reflected a view in the U.S. that entering a transaction for good and valid business purposes will not be tainted under a P.P.T. standard if the good and valid business purpose is merely enhanced by a resulting tax saving.[10]

CONCLUSION

The D.D.T. system was enacted to allow India to collect tax on dividend distributions at the rate it determined without regard to limitations under its network of income tax treaties. Now that the D.D.T. has been repealed, India once again faces limitations on its ability to fully tax dividend distributions to nonresidents. It has taken a position that M.F.N. provisions have only limited application. Whether that position can be maintained at a time of international cooperation is an open question. Interesting times.

[10] See for example Code §7701(o), codifying the economic substance doctrine of U.S. tax law. The provision does not alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice, are respected. Among these basic decisions are (i) the choice between capitalizing a business enterprise with debt or equity, (ii) the choice between foreign corporations and domestic corporations, (ii) the treatment of a transaction or series of transactions as a tax-free corporate organization or reorganization, and (iv) the ability to respect a transaction between related parties provided that the arm's length standard of Code §482 is satisfied.

PERENCO V. ECUADOR AND *ACHMEA B.V. V. THE SLOVAK REPUBLIC*: PRACTICAL LIMITATIONS WHEN SEEKING RELIEF UNDER A B.I.T.

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INTRODUCTION

The immediate reaction of tax advisers in seeking relief for a client faced with a cross-border tax dispute is to seek Competent Authority relief under the Mutual Agreement Procedure of an applicable income tax treaty. As explained in Paul Kraan's article elsewhere in this edition of *Insights*, a Bilateral Investment Treaty ("B.I.T.") can also protect against certain abuses by foreign tax authorities. A B.I.T. is designed to promote foreign investment between two nations. One of the main points of the treaty is to assure an investor from one state that its investment in the other state will be treated fairly. Typically, this means that the foreign investor or its local subsidiary will not be the target of unfair sovereign acts, but it also protects against unfair or confiscatory tax assessments. Approximately 3,000 B.I.T.'s are currently in effect.

Compared to an income tax treaty, which aims to avoid double taxation by allocating taxing rights between its parties and provides a dispute resolution process to be followed by the Competent Authorities of its parties' tax administrations, a B.I.T.is structured to ensure that the foreign investor and its local subsidiary will receive the same treatment as domestic companies, including fair and equitable treatment and protection from expropriation. In addition, the dispute resolution provision under a B.I.T. grants a foreign investor the right to bring an action before an international arbitration panel that is enforceable as a judgment in the event obligations imposed on a party to a B.I.T. are violated. However, the wheels of justice grind slowly, as will be seen below.

An example of a company seeking relief from confiscatory tax assessments under a B.I.T. involves a French oil and gas company, Perenco Ecuador Limited ("Perenco"), which in 2008 filed a petition requesting arbitration by the International Centre for Settlement of Investment Disputes ("I.C.S.I.D.") against the government of Ecuador ("Ecuador").[1] This petition was filed following the enactment of a law in Ecuador that increased the participation of the Ecuadorian government at the expense of Perenco. Five similar petitions were filed with the I.C.S.I.D. in response to these measures.

A B.I.T. between two Member States no longer has a role to play in resolving disputes that arise entirely within the European Union in light of the *Achmea* decision in 2018, which dismissed the competency of the B.I.T. as an avenue for a resident of one Member State to obtain relief against another Member State based on European Union ("E.U.") law.

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[1] *Perenco Ecuador Ltd. v. Republic of Ecuador and Empresa Estatal Petróleos del Ecuador (Petroecuador),* I.C.S.I.D. case No. ARB/08/6.

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This article will explore two cases where arbitration under a B.I.T. provided ephemeral benefits. They are *Perenco v. Ecuador* and *Achmea v. The Slovak Republic*.[2]

PERENCO V. ECUADOR

Context of the Dispute

Ecuador's Amazonian Region is known for its important oil resources. Perenco is one of several foreign oil companies that have been granted permission to exploit the area's oil reserves.

In 1993, Ecuador put in place Law 44. This law permitted oil contractors to operate through participation contracts. Under those contracts, the private company assumed all the risks and costs of exploration and exploitation in return for the grant of a right to receive a share of the revenue generated from the production of oil.

In 2002, Perenco became a party to two participation contracts related to oil exploration and production activities in Blocks 7 and 21, situated in the Ecuadorian Amazonian Region. Four years later, Perenco and an unrelated company, Burlington, formed a joint venture regarding production in those blocks, with Perenco having the majority interests.

In 2005, international oil prices began to rise. In 2002, the price of Ecuadorian crude oil was approximately U.S.$15 per barrel. By 2005, prices reached U.S.$50 per barrel and generated extraordinary profits for oil companies. As a result, the Ecuadorian government announced that it would renegotiate the participation contracts in order to provide a greater share of the revenue to itself.

In 2006, Law 42 was adopted in Ecuador. It allocated 50% of "extraordinary income" derived from production of oil to the Ecuadorian government. Extraordinary income was defined as any revenue earned per barrel that exceeded a specified reference price. The reference price was set at U.S.$25 per barrel for the Block 7 participation contract and U.S.$15 per barrel for the Block 21 participation. Thus, for example, if in 2006 the reference price was U.S.$25 and the prevailing price of oil was U.S.$45 per barrel, the Ecuadorian government would be entitled to U.S.$10 per barrel ((U.S.$45 - U.S.$25) x 50% = U.S.$10 per barrel).

A second decree issued in October 2007 increased the Ecuadorian government's share of revenue from sales above the reference price from 50% to 99%, effectively freezing Perenco's profits at slightly more than the reference price.

Perenco's Request for Arbitration at the I.C.S.I.D.

The governments of France and Ecuador entered into a B.I.T. (the "F-E B.I.T.") on September 7, 1994. Article 4 of the F-E B.I.T. provides as follows:

> Each Contracting Party shall ensure fair and equitable treatment in accordance with the principles of international law, to investments of nationals and companies of the other Contracting Party and to ensure the enjoyment of the right thus recognized is hampered in either law or in fact.

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[2] Case C-284/16.

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In particular, though not exclusively, shall be regarded as barriers of fact or law in fair and equitable treatment, any restriction to purchase and transport of raw materials and auxiliary materials, energy and fuel and means of production or operation of any kind, interference with the sale and transport of goods within the country and abroad, as well as any other measures having a similar effect.

Investments made by nationals or companies of either Contracting Party shall enjoy full protection and security by the other Contracting Party.

Neither of the Contracting Parties shall impair the management, maintenance, use, enjoyment or disposal of investments of nationals or companies of the other Contracting Party.

Article 6 of the F-E B.I.T. provides as follows:

1. The Contracting Parties shall not take any measures of expropriation or nationalization or any other measures the effect of which is, directly or indirectly dispossessing nationals and companies of the other party (hereinafter referred to as "expropriation") of their investments, except for a public purpose and provided that such measures are not discriminatory nor contrary to a specific commitment undertaken pursuant to the laws of the Contracting Party between those nationals or companies and the host State. The legality will be verifiable by judicial proceedings.

   The expropriation of measures that could be taken shall be subject to the payment of fair and adequate compensation amounting to the real value of the investment and the concerned is assessed in relation to a normal economic situation and prior to any threat of dispossession.

   Such compensation, its amount and has no later than the date of expropriation. The compensation shall be paid without delay, and effectively realisable freely transferable. It produces until the date of payment, shall include interest at the market rate of interest.

2. Nationals or companies of one Contracting Party whose investments have suffered losses due to a war or any other armed conflict, revolution, state of emergency or national revolt in the other Contracting Party benefit, on the part of this latter, from a treatment no less favourable than that accorded to its own investors or to those of the most favoured nation.

   In the event of a declaration of a national state of emergency, these companies or nationals receive fair and adequate compensation for the loss allegedly suffered as a result of the events referred to above.

Article 9 of the F-E B.I.T. provides for relief ultimately through arbitration, as follows:

> 1. The Contracting Parties shall not take any measures of expropriation or nationalization or any other measures the effect of which is, directly or indirectly dispossessing nationals and companies of the other party (hereinafter referred to as "expropriation") of their investments, except for a public purpose and provided that such measures are not discriminatory nor contrary to a specific commitment undertaken pursuant to the laws of the Contracting Party between those nationals or companies and the host State. The legality will be verifiable by judicial proceedings.
>
> The expropriation of measures that could be taken shall be subject to the payment of fair and adequate compensation amounting to the real value of the investment and the concerned is assessed in relation to a normal economic situation and prior to any threat of dispossession.
>
> Such compensation, its amount and has no later than the date of expropriation. The compensation shall be paid without delay, and effectively realisable freely transferable. It produces until the date of payment, shall include interest at the market rate of interest.
>
> 2. Nationals or companies of one Contracting Party whose investments have suffered losses due to a war or any other armed conflict, revolution, state of emergency or national revolt in the other Contracting Party benefit, on the part of this latter, from a treatment no less favourable than that accorded to its own investors or to those of the most favoured nation.
>
> In the event of a declaration of a national state of emergency, these companies or nationals receive fair and adequate compensation for the loss allegedly suffered as a result of the events referred to above.

On April 30, 2008, Perenco petitioned the I.C.S.I.D. to begin arbitration proceedings, contending that its rights under Articles 4 and 6 were violated by the Ecuadorian government.

Perenco submitted that Ecuador breached Article 4 of the of the F-E B.I.T. because it failed to accord Perenco's investment in Blocks 7 and 21 fair and equitable treatment. The participation contracts were written so that Perenco's participation was tied exclusively to the volume of the production and not according to the oil price fluctuations. By enacting the Law 42, Ecuador undermined this expectation.

When the arbitration process under the F-E B.I.T. began, Perenco ceased making payments under Law 42. In response, the Ecuadorian government seized all crude production from Blocks 7 and 21. In response, Perenco submitted that the enactment of the Law 42, the seizure of Perenco's crude production from the Blocks 7 and 21, and the cancellation of the contracts breached Article 6 of the B.I.T. which prohibited expropriation. In total, Perenco claimed damages of U.S.$1.572 billion.

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In 2009, the I.C.S.I.D. arbitration panel issued a decision recommending provisional measures restraining Ecuador from demanding Perenco pay any amount.

The Answers From Ecuador

Ecuador challenged the authority of the I.C.S.I.D. arbitration panel to adjudicate the dispute. Ecuador contended that Perenco was not a French company within the meaning of the F-E B.I.T. and that the I.C.S.I.D. arbitration panel lacked jurisdiction over Perenco's Blocks 7 and 21 contract claims because the dispute was not a technical and/or economic dispute.

As to the substantive issue, Ecuador responded that Article 4 of the F-E B.I.T. was not breached because Law 42 did not modify the participation contracts as the contracts did not guarantee Perenco a right to a given revenue stream. In addition, Ecuador argued that Article 6 of the B.I.T. was not breached as the measures taken were all legitimate exercises of Ecuador's police powers and that they were legitimate responses to Perenco's illegal conduct. Finally, Ecuador argued that there was no expropriation as Perenco was not deprived of the contract's benefits.

"In sum, the I.C.S.I.D. arbitration panel considered that the enactment of Law 42 imposing the sharing ratio of 99% for the Ecuadorian government and 1% for Perenco with regard to amounts in excess of the reference price was in breach of fair and equitable treatment under Article 4 of the F-E B.I.T., but did not constitute an expropriation prohibited by Article 6 of the F-E B.I.T."

Decisions of the I.C.S.I.D. Arbitration Panel in 2011 as to Jurisdiction and in 2014 as to Liability

In 2011, the I.C.S.I.D. arbitration panel determined that it had jurisdiction over Perenco's contract claims because Perenco was indirectly owned by French citizens.

In 2014, the I.C.S.I.D. arbitration panel concluded that Ecuador was liable for breaches of the participation contracts and for acting in violation of the fair and equitable treatment standard of Article 4 of the F-E B.I.T. The I.C.S.I.D. arbitration panel went on to conclude that the cancellation of the contract constituted a breach of Article 6 of the B.I.T.

In sum, the I.C.S.I.D. arbitration panel considered that the enactment of Law 42 imposing the sharing ratio of 99% for the Ecuadorian government and 1% for Perenco with regard to amounts in excess of the reference price was in breach of fair and equitable treatment under Article 4 of the F-E B.I.T., but did not constitute an expropriation prohibited by Article 6 of the F-E B.I.T.

Environmental Counterclaim by Ecuador

In 2015, Ecuador presented an environmental counterclaim on the basis of an environmental catastrophe in the two oil blocks situated in the country's Amazonian rainforest that had been worked by the consortium headed by Perenco.

In August 2015, the I.C.S.I.D. arbitration panel issued an interim decision on the environmental counterclaim and recommended that the parties seek to negotiate a resolution. If the parties could not arrive at a settlement, the I.C.S.I.D arbitration panel advised that it would proceed to appoint an independent expert. In the end, no agreement was found, and an independent expert was chosen.

Applications of Perenco to Apply the Conclusions in the Dispute Between Burlington and Ecuador

At the same time that Ecuador was pursuing a counterclaim against Perenco based on environmental damages, it pursued a claim against Burlington, the other

company that joined Perenco in exploiting the oil reserves in Block 7 and Block 21. The claim against Burlington raised all the same issues that had been raised against Perenco. On February 7, 2017, the Burlington I.C.S.I.D. arbitration panel rendered its decision on the counterclaims of Ecuador, finding Burlington liable for environmental damages.

On April 18, 2017, Perenco filed a dismissal application based on concepts of *res judicata*. It argued that Ecuador brought the same dispute against Perenco and Burlington in two separate proceedings and that Ecuador's counterclaims concern the same subject matter and are premised on the same legal basis. It pointed out that Ecuador did not dispute that it sought identical overlapping compensation with regard to the same alleged damage in both proceedings. As all factual and legal issues forming the basis of Ecuador's counterclaims against Perenco have been determined, there was nothing more for the arbitration panel to decide.

In response, Ecuador asserted, among other things, that Perenco's motion was not timely made as the parties in both disputes were arbitrating counterclaims for more than five years. If Perenco wished to prevent parallel litigation of the counterclaims, it should have filed a *lis pendens* application as early as December 2011. In Ecuador's view, Perenco waited until it knew the result of the Burlington arbitration and sought to take advantage once the decision in the Burlington arbitration was reached.

The arbitration panel ruled in favor of Ecuador. According to the decision, Ecuador's counterclaims in the two proceedings progressed in parallel, although the counterclaims were presented in the Burlington matter more than ten months earlier. The parties were fully aware of this fact. While parallel proceedings are generally avoided, neither panel had the power on its own motion to order the consolidation of the parts relating to counterclaims. Moreover, Perenco never challenged the jurisdiction of the arbitration panel to hear Ecuador's counterclaims nor their admissibility.

Perenco filed a second dismissal application on January 30, 2018, contending that that Burlington's payment in full satisfied Perenco's obligations on the counterclaims. This application was dismissed.

Award of Damages on the Perenco Claim and the Ecuadorian Counterclaim

On September 27, 2019, the I.C.S.I.D. arbitration panel issued the final award in the arbitration proceedings. It ruled that Perenco was entitled to damages in the amount of U.S.$448,820,400. This was balanced by an award in favor of Ecuador in the amount of U.S.$54,439,517 for environmental damages to Block 7 and Block 21 and for remedying the damages to infrastructure.

Perenco acted quickly in taking steps to enforce the award. In October 2019, it asked the U.S. Federal Court of the District of Columbia to enter a judgment against Ecuador in the net amount set forth in the Award. According to the I.C.S.I.D. rules, the place of arbitration controls the process for enforcing the award. Here the arbitration was held in the U.S. Under Section1391(f)(4) the Foreign Sovereign Immunities Act ("F.S.I.A.").

At about the same time, Ecuador petitioned the I.C.S.I.D. for an order annulling the award. The circumstances in which annulment is granted are limited. An *ad hoc* committee of three members was appointed to address Ecuador's petition.

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In May 2021, the *ad hoc* committee issued a decision concluding the annulment proceeding and largely confirming the award. The committee reduced the damages awarded from U.S.$448.82 million to around U.S.$412 million, finding that there was a lack of reasoning in the original award. Although Ecuador was ordered to pay the reduced award by July 27th, 2021, Ecuador refused to do so. Instead, it petitioned the U.S. District Court for the District Court of Columbia to rule that Perenco *owed* unpaid income tax in the amount of U.S.$40,845,760.13, as finally determined by the courts in Ecuador. In broad terms, a determination is final and binding when no further appeal is available or the time for filing an appeal has run. The District Court was asked to allow a set-off of that amount against the award of the *ad hoc* committee.

On September 20, 2021, Perenco filed its response with the U.S. District Court. Claiming that Ecuador's request for a tax set-off fails under a common law rule known as the "revenue rule." The common law revenue rule is a judicial doctrine that prevents courts in one country from being used by a foreign government as a tool to collect lost tax revenue of any kind. The leading authority in the U.S. is *Moore v. Mitchell*, 30 F.2d 600 (2d Cir. 1929).[3]

Ecuador's reliance on the final determination against Perenco for taxes owed proved to be faulty. On November 8, 2021, the Tax Chamber of the Ecuadorian National Court of Justice issued a decision remanded one of the seven tax judgments for which Ecuador claimed set-off to a lower court for further consideration on the merits. This did not stop the Ecuadorian government from pursuing its claim for a set-off. On February 16, 2022, Ecuador submitted a response brief arguing that the six other judgments should be decided on their own merits and that the remanding of a single judgment should not bar Ecuador from seeking setoff for the six other judgments. On February 22, 2022, Perenco responded, arguing that even if Ecuador could prove that the tax claims are enforceable, those claims still could not be set off against the award because a final determination of the amount due does not yet exist.

No decision has been reached by the U.S. District Court as of the date of publication of this article.

Takeaway

The long history of arbitration and litigation between Perenco and Ecuador brings to mind the Supreme Court case of *Marbury v. Madison*, 5 U.S. 137 (1803). That case involved an individual, William Marbury, who was nominated to a Federal office by John Adams, then President of the U.S., and whose nomination was approved by the Senate. Nonetheless, James Madison, the Secretary of State, refused to issue a commission to Mr. Marbury confirming appointment to the office. A writ of mandamus was sought from the Supreme Court, which refused to order Mr. Madison to issue the commission. The Supreme Court held that Mr. Marbury had a right to the commission but no remedy against the Secretary of State, Mr. Madison, to issue the commission.

[3] See also *Attorney General of Canada v. R.J. Reynolds Tobacco Holdings Inc.,* 268 F.3d 103 (2d Cir. 2001); *European Community v. RJR Nabisco Inc.,* 355 F.3d 123 (2d Cir. 2004). For a full discussion of the revenue rule, see Doobay and Ruchelman, "Adventures in Cross-Border Tax Collection: Revenue Rule vs. Cum-Ex Litigation," Volume 175, Number 3 *Tax Notes Federal* 359, April 18, 2022.

In *Perenco v. Ecuador*, Perenco was found to have been damaged by the acts of the Ecuadorian government which violated the F-E B.I.T. Perenco even had a remedy authorized by the F-E B.I.T. An arbitration procedure before the I.C.S.I.D. was available and access to the U.S. Federal District Court for the District of Columbia to enforce a decision of the I.C.S.I.D. Notwithstanding the right and the remedy, the matter has not been finally resolved after 14 years of litigation before the I.C.S.I.D. and the U.S. Federal District Court for the District of Columbia. Like Mr. Marbury more than 200 years ago, Perenco seems to have a right, but no effective remedy for the violation of that right by the Ecuadorian government. That may change one day when a judgment is issued and assets seized in satisfaction of the judgment, but the cost in terms of legal expense and time-value of money is appalling.

ACHMEA B.V. V. THE SLOVAK REPUBLIC: THE END OF B.I.T.S AT THE INTRA-E.U. LEVEL

Context of the Dispute

Following a reform on its health system in 2004, the Slovak Republic opened its market to foreign private insurance companies. It is in this context that Achmea, member of a group of insurance companies based in the Netherlands, formed a subsidiary in the Slovak Republic to provide sickness insurance.

In 2006 and 2007, the Slovak Republic partly reversed the liberalization of the private health insurance market by enacting a law prohibiting the distribution of profits generated by private health insurance companies operating in the Slovak Republic. Ultimately, the Constitutional Court of the Slovak Republic determined that the prohibition was contrary to the Slovak constitution. Consequently, the Slovak Republic allowed the distribution of profits by a law enacted in 2011.

In 2008, Achmea brought an arbitration proceeding against the Slovak Republic according to the arbitration clause that appears in Article 8 of the B.I.T. between the Netherlands and the Slovak Republic ("the N-S B.I.T."). The arbitration took place in Germany.

The N-S B.I.T. was concluded in 1991 and entered into force on January 1, 1992. In accordance with Article 3(1) of the N-S B.I.T."), the two countries undertook to ensure fair and equitable treatment of the investments of investors from the other country and not to impair by unreasonable or discriminatory measures the operation, management, maintenance, use, enjoyment, or disposal of those investments. In accordance with Article 4 of the N-S B.I.T., each country guaranteed the free transfer of profits in a freely convertible currency without undue restriction or delay of payments relating to an investment, such as profits, interest, and dividends.

Achmea contended that the relevant law enacted by the Slovak Republic was contrary to the Article 4 of the N-S B.I.T. and initiated arbitration proceedings in Germany.

Article 8 of the N-S B.I.T., provides a dispute mechanism to resolve claims under the N-S B.I.T. It provides as follows:

> 1. All disputes between one Contracting Party and an investor of the other Contracting Party concerning an investment of the latter shall if, possible, be settled amicably.

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2. Each Contracting Party hereby consents to submit a dispute referred to in paragraph 1 of this Article to an arbitral tribunal, if the dispute has not been settled amicably within a period of six months from the date on which either party to the dispute requested amicable settlement.

3. The arbitral tribunal referred to in paragraph 2 of this Article will be constituted for each individual case in the following way: each party to the dispute appoints one member of the tribunal and the two members thus appointed shall select a national of a third State as Chairman of the tribunal. Each party to the dispute shall appoint its member of the tribunal within two months, and the Chairman shall be appointed within three months from the date on which the investor has notified the other Contracting Party of his decision to submit the dispute to the arbitral tribunal.

4. If the appointments have not been made in the abovementioned periods, either party to the dispute may invite the President of the Arbitration Institute of the Chamber of Commerce of Stockholm to make the necessary appointments. If the President is a national of either Contracting Party or if he is otherwise prevented from discharging the said function, the Vice-President shall be invited to make the necessary appointments. If the Vice-President is a national of either Contracting Party or if he too is prevented from discharging the said function, the most senior member of the Arbitration Institute who is not a national of either Contracting Party shall be invited to make the necessary appointments.

5. The arbitration tribunal shall determine its own procedure applying the United Nations Commission on International Trade Law (UNCITRAL) arbitration rules.

6. The arbitral tribunal shall decide on the basis of the law, taking into account in particular though not exclusively:

   ○ the law in force of the Contracting Party concerned;

   ○ the provisions of this Agreement, and other relevant agreements between the Contracting Parties;

   ○ the provisions of special agreements relating to the investment;

   ○ the general principles of international law.

7. The tribunal takes its decision by majority of votes; such decision shall be final and binding upon the parties to the dispute.

"During the arbitration, the Slovak Republic raised an objection to the jurisdiction of the arbitration panel based on European Union law. The arbitration panel dismissed the objection and damages in the principal amount of €22.1 million."

During the arbitration, the Slovak Republic raised an objection to the jurisdiction of the arbitration panel based on European Union law. The arbitration panel dismissed the objection and damages in the principal amount of €22.1 million. The Slovak Republic brought an action before the Higher Regional Court in Frankfurt, Germany to

set aside the award. The Higher Regional Court dismissed the action. The Slovak Republic appealed the dismissal to the German Federal Court of Justice, contending that Article 8 of the N-S B.I.T. was incompatible with Articles 267 and 344 of the Treaty on the Functioning of the European Union ("T.F.E.U.").[4]

Article 344 provides as follows:

> Member States undertake not to submit a dispute concerning the interpretation or application of the Treaties to any method of settlement other than those provided for therein.

Article 267 provides as follows:

> The Court of Justice of the European Union shall have jurisdiction to give preliminary rulings concerning:
>
> a. the interpretation of the Treaties;
>
> b. the validity and interpretation of acts of the institutions, bodies, offices or agencies of the Union;
>
> Where such a question is raised before any court or tribunal of a Member State, that court or tribunal may, if it considers that a decision on the question is necessary to enable it to give judgment, request the Court to give a ruling thereon.
>
> Where any such question is raised in a case pending before a court or tribunal of a Member State against whose decisions there is no judicial remedy under national law, that court or tribunal shall bring the matter before the Court.
>
> If such a question is raised in a case pending before a court or tribunal of a Member State with regard to a person in custody, the Court of Justice of the European Union shall act with the minimum of delay.

The matter was referred to the Court of Justice of the European Union because it had not yet ruled on the question and the matter was of considerable importance to the numerous bilateral investment treaties in force between Member States of the E.U. containing similar arbitration clauses. The C.J.E.U. ruled that the dispute resolution provision of the N-S B.I.T. was incompatible with Articles 267 and 344 of the T.F.E.U.

According to the C.J.E.U., an international agreement cannot affect the allocation of powers fixed by the foundation treaties governing the operations of the E.U. and the autonomy of the E.U. legal system. That principle is enshrined in Article 344 of the T.F.E.U., which provides that Member States cannot submit a dispute concerning the interpretation or application of the foundation treaties to any method of settlement other than those provided for in those treaties. The essential characteristic of E.U. law is that it stems from an independent source of law – the foundation treaties – and reflects the primacy of E.U. law over the laws of the Member States.

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[4] The T.F.E.U. is one of two treaties forming the constitutional basis of the European Union, the other being the Treaty on European Union.

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In order to ensure that the specific characteristics and the autonomy of the E.U. legal order are preserved, the foundation treaties established a judicial system intended to ensure consistency and uniformity in the interpretation of E.U. law. The keystone of the legal system is Article 267 of the T.F.E.U., which, sets up a dialogue between one court and another, specifically between the Court of Justice and the courts and tribunals of the Member States. In this way, a system is established securing uniform interpretation of E.U. law.

Applying these principles to the dispute resolution provisions of the N-S B.I.T., a resolution of the dispute between Achmea and the Slovak Republic will involve the application of E.U. law which can only be resolved by the courts of E.U. Member States and the C.J.E.U. The arbitration panel that is used to resolve a dispute under the N-S B.I.T. is not a court established by a Member State and its decision is not reviewable by the C.J.E.U. By entering into the N-S B.I.T., the Slovak Republic established a mechanism for settling disputes between an investor and a Member State which could prevent the disputes from being resolved in a manner that ensures the full effectiveness of E.U. law, even though they might concern the interpretation or application of that law.

As a final point, the C.J.E.U. differentiated use of a dispute resolution system in commercial arbitration from reliance on an arbitration panel to resolve a claim against a Member State of the E.U. The former involves a dispute between private parties. The latter involves a dispute involving a private party and a Member State of the E.U., which can be resolved only by a court of a Member State.

Consequently, Articles 267 and 344 of the T.F.E.U. must be interpreted as precluding a provision in an international agreement concluded between Member States, such as Article 8 of the N-S B.I.T. under which an investor from one of those Member States may, in the event of a dispute concerning investments in the other Member State, bring proceedings against the latter Member State before an arbitral tribunal whose jurisdiction that Member State has undertaken to accept.

Consequences of the *Achmea* Decision

In January 2019, 28 Member States of the E.U., including the U.K., adopted a political declaration calling for the termination of all intra-E.U. B.I.T.'s. Included in the declaration were the following three points:

- All arbitration proceedings based on intra-EU B.I.T.'s are incompatible with E.U. law, are invalid from the very beginning, and pending disputes must be terminated.
- Courts are to be notified that intra-E.U. B.I.T. awards cannot be recognized or enforced.
- State-owned companies must withdraw from arbitration proceedings under intra-E.U. B.I.T.'s.

In October 2019, the European Commission announced the agreement of Member States to the termination of approximately 190 intra-E.U. B.I.T.'s. Awards in arbitration proceedings concluded before March 6, 2018, the date of the judgment in the *Achmea* case, will remain in effect.

“While the decision by the C.J.E.U. can be understood at various levels, several commentators view the decision in the Achmea case as a huge step backward in rights of investors.”

In May 2020, 23 Member States signed an agreement to collectively terminate all intra-E.U. B.I.T.’s. Sunset clauses that promised continued coverage by a B.I.T. for a period of time after its termination no longer had effect. Finland, Sweden, Austria, and Ireland abstained from signing the agreement, as did the U.K.

Internal investments by persons resident in the E.U. continue to benefit from the protections conferred by the fundamental freedoms of the single market, the freedom of establishment, and the right to free movement of capital. They also enjoy rights guaranteed by the Charter of Fundamental Rights and the general principles of E.U. law. However, these rights can be enforced only by the courts of Member States, guaranteed by Article 19 of the Treaty of the European Union, under the control of the Court of Justice of the European Union.

In July 2018, the European Commission published a communication on the protection of intra-European investments, and in May 2020, it launched a public consultation on the protection of investments within the European Union, in order to promote investment all over the European Union.

Takeaway

While the decision by the C.J.E.U. can be understood at various levels, several commentators view the decision in the *Achmea* case as a huge step backward in rights of investors. One article summarizes the *Achmea* case and the follow-up steps by the E.U. as extremely troubling:

> We demonstrate that the CJEU’s *Achmea* judgment has resulted in significantly more damage beyond the termination of intra-EU BITs. It made the application of EU law difficult, if not impossible. Indeed, it has opened the floodgate to deficient judicial protection in the face of structural backsliding of the rule of law in some EU Member States. While the motives of the CJEU and by extension the European Commission to safeguard their ultimate control over the internal market by exclusively relying on the preliminary ruling system of integrated European judiciary may be understandable, they cannot serve as a credible justification for the long-term consequences of disempowering investors in the name of an ideological stance regarding EU judiciary, which cannot work in the backsliding Member States, where the ‘integration of the EU’s judiciary’ could stand for the absence of independent adjudication. Consequently, the Achmea judgment and post-*Achmea* developments such as the recently signed Termination Agreement to terminate the intra-EU BITs have been leading to significant—possibly irreparable in the short- to medium-term—lowering of the procedural and substantive protection standards for European investors in times when they are in need of more rather than less protection.[5]

[5] Kochenov, D.V., and Lavranos, N., *Achmea versus the Rule of Law: CJEU’s Dogmatic Dismissal of Investors’ Rights in Backsliding Member States of the European Union*, Hague J Rule Law (2021), available here.

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BILATERAL INVESTMENT TREATIES: A POTENTIAL LEGAL REMEDY IN INTERNATIONAL TAX DISPUTES

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INTRODUCTION

Traditionally, international tax disputes tend to focus on provisions in treaties for the avoidance of double taxation, including a reduction in tax on various types of investment income, an increased threshold for imposing tax on business profits, as well as procedures to claim relief in the event of double taxation or the imposition of tax that is not in accordance with the terms of the relevant treaty. However, such double taxation agreements ("income tax treaties") may not be the only legal remedy available in an international tax dispute, as countries also conclude bilateral investment treaties ("B.I.T.'s") with the aim to protect and stimulate cross-border investment. Disputes under B.I.T.'s generally are settled by an arbitration panel. This article sets out under which circumstances an international tax dispute may fall within scope of an investment treaty.

SHORTCOMINGS IN LEGAL PROTECTION UNDER TAX TREATIES

Traditionally, income tax treaties are considered the appropriate means of redress for avoiding double taxation arising from a cross-border transaction. The allocation of taxing rights between states under such treaties is generally based on internationally accepted principles and methods. These are laid down in the model treaty (and related commentary) which is established under the auspices of the Organisation for Economic Cooperation and Development ("O.E.C.D.")[1] and in the United Nations ("U.N.") Model Convention.[2]

O.E.C.D. Member States are predominantly prosperous countries with a high income per capita. However, in recent decades, the economic emergence of certain countries that are not O.E.C.D. Member States has resulted in the increased importance of investment in those countries and (economic) self-awareness, as well.

As regards foreign investment in such emerging economies, taxing rights are allocated in ways that strongly emphasize the position of the source state. This may concern source taxes in ways that are not entirely customary in international relations,

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1 O.E.C.D. Income and Capital Model Convention ("the O.E.C.D. Model Treaty") and Commentary, Paris, November 21, 2017.

2 U.N. Model Double Taxation Convention Between Developed and Developing Countries ("the U.N. Model Treaty"), as updated on May 19, 2017. This model treaty distinguishes itself from the O.E.C.D. Model Treaty by a stronger emphasis on the position of the source state.

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such as the indirect levy of tax on capital gains (through a withholding tax that is imposed on the purchase price). Also, the interpretation of recognized international tax concepts differs in many cases from the common international standards, such as those that define a permanent establishment and explain when it may exist.

Initially, a foreign company that is confronted with such unique application of tax concepts will attempt to obtain relief by using legal remedies available in the relevant country. However, local judiciary authorities may not always be completely independent and, even when independent, may endorse the divergent views taken by the local tax administration.

In such circumstances, multinational companies may attempt to obtain relief through remedies outside the local legal system. An applicable income tax treaty may provide relief through a mutual agreement procedure ("M.A.P.") between the competent authorities of the contracting states concerned. However, the M.A.P. in most income tax treaties only requires the contracting states to make an effort to resolve the issue and may not eliminate double taxation where the competent authorities maintain differing views on a particular provision of the income tax treaty In many instances, pursuing this route does not lead to a satisfactory outcome for the taxpayer because, in part, the taxpayer is not even a party to the M.A.P. between the relevant states.

For this reason, an arbitration provision has been developed within the context of the O.E.C.D. Model Convention which makes it possible to proceed to compulsory binding arbitration if the competent authorities do not reach an agreement.[3] The aim is to include binding arbitration in as many income tax treaties as possible. Indeed, the Base Erosion and Profit Shifting ("B.E.P.S.") Action Plan developed by the O.E.C.D. earlier this decade includes Action 14, which calls for effective dispute resolution mechanisms. Meanwhile, within the E.U. this has led to the adoption of a directive which offers a uniform mechanism to address tax treaty disputes among E.U. Member States in accordance with the B.E.P.S. Action 14 minimum standard.[4] Nonetheless, there is little experience with arbitration under a bilateral income tax treaty.

However, international tax disputes are not governed solely by procedures of income tax treaties. With regard to cross-border investment, often states conclude a B.I.T. that is intended to protect those investments from improper state action in the host country. If any disputes should result, the International Centre for the Settlement of Investment Disputes ("I.C.S.I.D.") of the World Bank can be requested to appoint an arbitration panel to resolve the dispute, absolutely. That request can be made directly by the investor concerned. This article examines the extent to which international tax disputes may be resolved under the terms of a B.I.T.

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[3] See Paragraph 5 of Article 25 of the O.E.C.D. Model Convention.

[4] E.U. Council Directive on Tax Dispute Resolution Mechanisms in the European Union on October 10, 2017.

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INVESTMENT PROTECTION AGREEMENTS

Nature and Content

The first B.I.T.[5] was concluded in 1959 between Germany and Pakistan.[6] The current investment protection agreement network includes thousands of B.I.T.'s, as well as a large number of multilateral investment protection agreements. The network of investment treaties, therefore, provides broad coverage. Often, a B.I.T. is concluded prior to consideration of an income tax treaty.

"While income tax treaties are mostly based on the O.E.C.D. Model, there is no generally accepted model B.I.T."

While income tax treaties are mostly based on the O.E.C.D. Model, there is no generally accepted model B.I.T. However, numerous countries have developed unique unofficial model agreements from which a B.I.T. is negotiated. These unofficial model agreements may form the basis of a multilateral agreement. As such, the legal form of investment protection agreements can differ.[7] Despite any differences, investment protection agreements often adopt a similar structure, pursuant to which investments are stimulated and protected by means of guarantees.[8]

This can be explained by the fact that the letter and spirit of every investment protection agreement is ultimately the same: the creation of a favorable investment climate by protecting and stimulating investments.[9] The provisions of nearly all investment protection agreements provide for the protection of investments against expropriation and unreasonable treatment, liberalization through the abolition of legal prohibitions on investment, and the creation of a level playing field in the form of equal treatment.[10]

In general, the letter and spirit of an investment protection agreement is realized through a number of substantive rights:[11]

- Expropriation is prohibited unless the expropriation is nondiscriminatory and in the general interest. In that event, the affected investor is entitled to adequate compensation. (This is the most important substantive right).
- Investments are entitled to be treated in a fair and equitable manner and to complete protection and security.

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5. In the following, the term "investment protection agreement" refers to a B.I.T. and a multilateral investment agreement offering similar investment protection.
6. J.W. Salacuse, *BIT by BIT: The Growth of Bilateral Investment Treaties and Their Impact on Foreign Investment in Developing Countries*, 24 Int'l L. pp. 655-675 (1990).
7. *E.g.*, A. Newcombe & L. Paradell, *Law and Practice of Investment Treaties* (Kluwer Law International 2009).
8. *Id.*
9. See S. Franck, *Foreign Direct Investment, Investment Treaty Arbitration, and the Rule of Law*, McGeorge Global Bus. and Dev. L. Journal 19, p. 337 (2007).
10. K.J. Vandevelde, *Bilateral Investment Treaties: History, Policy, and Interpretation* (Oxford University Press 2010).
11. See S. Franck, *The Legitimacy Crisis in Investment Treaty Arbitration: Privatizing Public International Law through Inconsistent Decisions*, 73 Fordham L. Rev. 4, pp. 152-165 (March 2005).

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- Investors are entitled to equal treatment and the right against discrimination based on nationality. (A most-favored-nation ("M.F.N.") clause is often included.)
- Repatriation of income earned from the relevant investments cannot be prevented.
- Provisions of international law that are more favorable than the investment protection agreement are given preference over the provisions in the investment protection agreement, provided a reference to international law is part of the agreement.`
- An umbrella clause may be included in the investment protection agreement under which the contracting states are obligated to fulfil all the undertakings given in respect of an investment.[12] (By means of these substantive rights, contracting states can guarantee investors that their investments will be free of specified sovereign risk.)[13]

Legal Protection

In addition to substantive rights, investment protection treaties contain procedural rights that make the realization of substantive rights possible.[14] The legal structure of the investment protection agreement allows the aggrieved party to enforce its rights directly by means of an arbitration panel specifically appointed for that purpose, without the need to obtain government approval in the host state. This differs considerably from the situation under income tax treaties, where disputes must generally be resolved through a M.A.P., where the taxpayer has little or no influence. Instead, an investment protection agreement allows the taxpayer to maintain control over all facets of the procedure, from commencement of the action to the hearing itself.[15] This can be particularly advantageous if the host country cannot provide fair and balanced legal protection due to corruption, the absence of an independent judiciary, or stonewalling by the taxation agency.[16] In this way, an investment protection agreement guarantees permanent and adequate legal protection.

The investment protection agreement designates the body, or bodies, that are competent to decide investment disputes under the applicable agreement. In most cases, the body will be an arbitration panel appointed by the International Centre for Settlement of Investment Disputes ("I.C.S.I.D."), which is part of the World Bank. More than 140 countries recognize the I.C.S.I.D.[17] As these agreements can differ, case law under other agreements is not controlling. Nonetheless, case law provides guidance for the interpretation of agreements. Investment protection agreements

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[12] R. Dolzer & M. Stevens, *Bilateral Investment Treaties*, pp. 81-82 (Kluwer Law International 1995).

[13] See also Franck, *supra* note 11.

[14] *Id.*

[15] H.L. Buxbaum, *The Private Attorney General in a Global Age: Public Interests in Private International Antitrust Litigation*, 26 Yale Intl. L. J. pp. 219-263 (2001).

[16] See also Vandevelde, *supra* note 10.

[17] Franck, *supra* note 11.

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have similar purposes and provide similar protection in many ways. As a result, decisions under other comparable agreements may be taken into account according to the Vienna Convention on the Law of Treaties.[18]

Accessibility

Three facts must exist to successfully invoke protection offered by an investment protection agreement:

- A qualifying investment is made in the territory of one of the contracting state.
- The qualifying investment is made by a qualified investor from the other contracting state.
- As to the investment and the investor, an obligation contained in the investment protection agreement purportedly has been violated.

Almost all investment treaties define the term "investment."[19] The definition generally is broad, such as "every kind of asset invested in accordance with the national laws and regulations of the Contracting Party in the territory of which the investment is made" or "every kind of asset" – followed by a non-exhaustive list of qualifying investments.[20]

It is not surprising that the broad definition of "investment" has led to broad interpretations in the case law.[21] Arbitration panels are prepared to give broad interpretations to the term "investments" to ensure the scope of protection is extensive.[22]

Investor activities must be assessed on an aggregate basis. Consequently, if the activities consist of separate elements that can only be considered an investment when viewed as a whole, protection under an investment protection agreement is possible even if host country obligations to only one of those elements has been breached.[23]

A territorial factor must also be present for an investment to qualify for protection. The investment must relate to one of the contracting states for an investment protection agreement to be applicable. Hence, there must be a sufficient nexus with the host country. Courts have applied a relatively low threshold when determining whether nexus exists.[24] This is evidenced by the fact that a large number of treaties

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[18] Vienna Convention on the Law of Treaties (May 23, 1969), Treaties IBFD. See Franck, *supra* note 11.

[19] Dolzer & Stevens, *supra* note 12, p. 26.

[20] *Id.*, p. 27.

[21] AR: I.C.S.I.D., January 14, 2004, Case No. ARB/01/3, *Enron v. Argentina*, par. 44, and Vandevelde, *supra* note 10, p. 13.

[22] M. Sornarajah, *The International Law on Foreign Investment*, p. 9 (Cambridge University Press 2004).

[23] EC: I.C.S.I.D., August 18, 2008, Case No. ARB/04/19, *Duke Energy v. Ecuador*.

[24] *E.g.*, in AL: I.C.S.I.D., April 26, 1999, Case No ARB/94/2, *Tradex Hellas v. Albania and CZ*: U.N.C.I.T.R.A.L., March 14, 2003, IIC 62 (2003), *CME v. Czech Republic*, where the court stated that "[it is not required that] the assets or funds be imported from abroad or specifically from [territoriality of the other contracting state] or have been contributed by the investor itself." See also Vandevelde, *supra* note 10, p. 148.

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include a provision that makes the agreement applicable to investments that are made through a business resident in a third state.

Once a particular investment has been found to be covered by an investment protection agreement, the next issue is whether the holder of the investment has access to the investment protection agreement. Traditionally, the definition of "investor" included in most investment protection agreements applies to natural persons, legal entities, and partnerships.[25] Natural persons qualify as an investor if they hold the nationality of one of the contracting states. This must be determined according to the domestic law of the investor state.[26] Different criteria are used to determine if a legal entity or partnership qualifies as an investor. Included are the place of incorporation and the place where control is exercised. Other criteria may be used where the facts are unique.

E.U. Situations

Specifically with regard to B.I.T.'s concluded by and between E.U. Member States, the *Achmea* case of the European Court of Justice ("E.C.J.") found an arbitration clause in a B.I.T. to be incompatible with community law, as tribunals essentially remove disputes from the jurisdiction of the Member States' courts and consequently from the E.U.'s judicial system.[27] This ruling has significant consequences for arbitration clauses in B.I.T.'s concluded by the Member States.

Under the E.U. treaties, the Member States' courts and the E.C.J. collaborate in resolving disputes involving aspects of community law. Through the preliminary reference mechanism under Article 267 of the Treaty on the Functioning of the European Union ("T.F.E.U."), domestic courts refer questions on community law to the E.C.J. and are required to follow the answers provided by the E.C.J. This system should ensure that community law is applied effectively and uniformly throughout the E.U. and preserves the essential characteristics of the legal order in a uniform way within the E.U. To ensure the effectiveness of community law, courts in Member States must make preliminary references to the E.C.J. To that end, community law must always prevail over other sources of law, whether international or domestic. A more detailed discussion of the Achmea case appears elsewhere in this edition of *Insights* in a companion article co-authored by Stanley C. Ruchelman and Marie de Jorna.

TAXATION IN INVESTMENT PROTECTION AGREEMENTS

General

Having outlined the general contours of a B.I.T., the next issue is whether a B.I.T. can provide protection in regard to tax measures. As previously described, in certain cases, the legal protection provided by an income tax treaty is inadequate. The additional legal protection provided under an investment protection agreement can be of great significance in these circumstances.

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[25] United Nations Conference on Trade and Development (U.N.C.T.A.D.), *Bilateral investment treaties 1995-2006: Trends in investment rule making*, p. 12 (U.N. 2007).

[26] *Id.*, p. 13.

[27] Case 284/16 *Slovak Republic v. Achmea*.

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In most countries, autonomous tax policy is a sensitive subject. This finds expression in B.I.T.'s. In general, states are wary of third-party actions that may impose undesired limitations on taxation. This concern extends to B.I.T.'s and often is manifested in a number of B.I.T.'s through the inclusion of a carve-out provision.[28] The carve-out removes taxation from the scope of the B.I.T. However, other B.I.T.'s include only a partial exclusion for taxation.[29] The protocol to the Germany-Mexico B.I.T. states that tax measures that violate provisions of a B.I.T. can be subject to arbitration, with the exception of those provisions relating to national or M.F.N. treatment.[30]

"... international law recognizes that taxation by sovereign states can amount to indirect expropriation in specific circumstances."

Taxation as a Form of Indirect Expropriation Under B.I.T.'s

The right of a state to impose tax is a fundamental attribute of sovereignty. Consequently, international law provides that taxation constitutes an important exception to the rule that expropriation is not allowed without adequate compensation. By its nature, taxation involves the taking of the taxpayer's money, resulting in a form of expropriation. Nonetheless, tax exclusion clauses in B.I.T.'s generally prevent effective actions against the state imposing tax.

Nonetheless, international law recognizes that taxation by sovereign states can amount to indirect expropriation in specific circumstances. In the case of *Yukos*, the court ruled that the tax measures imposed by the host state on a resident of the investor state could amount to expropriation for purposes of the relevant investment protection treaty "if the ostensible collection of taxes is determined to be part of a set of measures designed to effect a dispossession outside the normative constraints and practices of the taxing authorities."[31]

The definition of "expropriation" in investment protection agreements usually follows the definition found under international law.[32] Expropriation[33] can occur both directly and indirectly.[34] Direct expropriation occurs if the investment is nationalised or otherwise directly confiscated by means of a legal transfer of ownership or a direct physical takeover.[35] Indirect expropriation occurs when a state interferes in the

[28] U.N.C.T.A.D., *supra* note 25, p. 81.

[29] *Id.*, p. 82.

[30] *Id.*, p. 83.

[31] *Quasar de Valores et al v. The Russian Federation*, Award dated July 20, 2012.

[32] A.F. Rodriguez, *International Arbitration Claims against Domestic Tax Measures Deemed Expropriatory or Unfair and Inequitable,* Inter-American Development Bank, Occasional Paper-SITI-11, p. 7 (January 2006).

[33] Weston considers "expropriation" to be ambiguous and unsuitable. He proposes using "wealth deprivation." See B. Weston, *"Constructive taking" under International Law: A Modest Foray into the Problem of "Creeping Expropriation,"* Virginia Journal of Intl. L. 16, pp.103-175 (1975).

[34] *E.g.*, U.N.C.T.A.D., *supra* note 25, p. 44, and O.E.C.D., *Working Papers on International Investment*, No. 2004/4, *Indirect Expropriation and The Right to Regulate, in International Investment Law* p. 3 (O.E.C.D. 2004).

[35] O.E.C.D., *supra* note 34, p. 3.

use of an investment or in the benefits received from that investment, even if the investment has not been physically seized and the legal ownership has not been affected. A governmental measure can also qualify as indirect expropriation if the investment's market value decreased as a result thereof[36] or if the economic benefit that could reasonably be expected was denied.[37] The effect of such government action is equal to that of expropriation. In broad terms, direct expropriations are rarely found, while indirect expropriations are more common.[38]

Taxation represents a partial breach of property rights.[39] As such, most forms of taxation could be contested by invoking an investment protection agreement, although this could not reasonably be expected to be the intention of such an agreement.[40] As a general rule, taxation does not qualify as expropriation under international law.[41] Under international law, a state cannot be held liable for loss of ownership as a result of a *bona fide* tax that is generally accepted as a legal expression of the executive power of a government.[42]

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[36] MX: I.C.S.I.D., November 21, 2007, Case No. ARB(AF)/04/05, *Archer Daniels Midland v. Mexico.*

[37] MX: I.C.S.I.D., August 30, 2000, Case No. ARB(AF)/97/1, *Metalclad Corporation v. Mexico.*

[38] C.H. Schreuer, Part 1 — Report: The concept of expropriation under the ECT and under investment protection treaties, Investment Arbitration and the Energy Charter Treaty, pp. 108-159 (C. Ribeiro ed., 2006); 2 Transnat'l Dispute Mgmt. 3, p. 108 (June 2005).

[39] For practical reasons, the definition of "tax" as applied in investment treaties, is not discussed. In general, it is accepted that a tax measure will include legal provisions, procedures and their legal implementation.

[40] *E.g.*, T. Walde & A. Kolo, Investor-State Disputes: The Interface Between Treaty-Based International Investment Protection and Fiscal Sovereignty, 35 Intertax 8/9, pp. 440-447 (2007).

[41] *E.g.*, in MX: U.N.C.I.T.R.A.L., February 3, 2006, LCIA Case No. UN3481, *EnCana v. Ecuador*, the court stated that, "a tax law is not a taking of property; if it were, a universal state prerogative would be denied by a guarantee against expropriation, which cannot be the case." In MX: I.C.S.I.D., December 16, 2002, Case No. ARB(AF)/99/1), *Feldman v. Mexico*, 7 I.C.S.I.D. Reports 318 (2003) 42 ILM 625, the tribunal argued that, "governments must be free to act in the broader public interest through protection of the environment, new or modified tax regime, the granting or withdrawal of government subsidies, reductions or increases in tariff levels, imposition of zoning restrictions and the like."

[42] Sec. 712, *Restatement of the Law Third, the Foreign Relations of the U.S.A.* (American Law Institute 1987); Feldman, para. 105. See also A. Kolo, *Tax "Veto" as a Special Jurisdictional and Substantive Issue in Investor-State Arbitration: Need for Reassessment?,* Symposium, 2009.

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Exceptional Circumstances

This does not mean that taxation cannot fall under the scope of the definition of expropriation. In certain circumstances, taxation can constitute expropriation under international law[43] as a result of which a tax dispute between a tax authority and an investor can be resolved by arbitration.[44] In *Link Trading v. Moldova* (2002), the arbitration panel ruled that taxation can be considered an expropriation if the nature of the tax involves "abusive taking."

According to the panel, a tax is considered "abusive taking" if it is unreasonable, arbitrary, discriminatory, or contrary to existing agreements.[45] In *Encana v. Ecuador*, where a refusal to refund Ecuadorian V.A.T. was in dispute, the panel concluded that taxation falls under the scope of the definition of expropriation if it can be qualified as "extraordinary, punitive in amount or arbitrary in its incidence."[46]

As a result of the current paucity of case law in regard to tax disputes, it can be concluded that two types of taxation can be identified under an investment protection agreement. Taxation that results in an indirect expropriation must be distinguished from taxation that, while having a substantial negative impact on the market value of the investment, nevertheless must be regarded as legitimate and, therefore, does not qualify as an indirect expropriation under an investment protection agreement.[47]

Assessment Framework

Certain elements can be extracted from case law and the literature that, taken together, can create an assessment framework for distinguishing *bona fide* tax measures from taxation that qualifies as expropriation:

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43 Rodriguez, *supra* note 32, p. 8. See also U.K.: London Court of International Court of Arbitration, July 1, 2004, Administered Case No. UN 3467, *Occidental v. Ecuador*. See also L. B. Sohn & R.R. Baxter, *Draft Convention on the International Responsibility of States for Injuries to Aliens*, 55 A.J.I.L. 545, art. 10(5) (1961) (herein, the Harvard Draft):

> An uncompensated taking of property of an alien or a deprivation of the use or enjoyment of property of an alien which results…from the action of the competent authorities of the State in the maintenance of public order, health, or morality…shall not be considered wrongful, provided…it is not a clear and discriminatory violation of the law of the State concerned,…[and] it is not an unreasonable departure from the principles of justice recognized by the principal legal systems of the world.

44 Rodriguez, *supra* note 32, p. 13; see also CA: N.A.F.T.A./U.N.C.I.T.R.A.L., June 26, 2000, *Pope & Talbot Inc. v. the Government of Canada*, Interim Award in which the tribunal concluded that, "a blanket exception for regulatory measures would create a gaping loophole in international protections against expropriation."

45 MD: U.N.C.I.T.R.A.L., April 18, 2002, *Link v. Moldova*, available here.

46 MX: U.N.C.I.T.R.A.L., February 3, 2006, LCIA Case No. UN3481, *EnCana v. Ecuador.*

47 Wälde & Kolo, *supra* note 40; R.E. Walck, *Tax and Currency Issues in international Arbitration*, 3 World Arb. & Med. Rev. 2, p. 176 (2009).

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- The government measures must lead to a substantial decrease in value.
- The decrease in value interferes with the reasonable expectations underlying the investment.
- The government measure deviates from internationally accepted norms (characteristics test).[48]

This assessment framework was confirmed in *Archer Daniels Midland v. Mexico*, where the panel ruled that factors beyond a substantial decrease in value or paralyzing government interference could be taken into account in determining whether the tax constituted an expropriation:

> * * * including whether the measure was proportionate or necessary for a legitimate purpose; whether it discriminated in law or in practice; whether it was not adopted in accordance with due process of law; or whether it interfered with the investor's legitimate expectations when the investment was made.[49]

In the *Revere Brass and Copper* case, the arbitration panel ruled that mining tax and royalties, imposed in violation of a concluded advance tax ruling, qualified as expropriation.[50] The ruling formed part of a concession given to a subsidiary for the extraction of bauxite in Jamaica. The newly elected government ignored the ruling and increased the tax burden by introducing a new mining tax. Revere considered the negative impact on profitability excessive and ended its subsidiary's activities. The arbitration panel recognized that Revere's subsidiary still had full ownership and could have continued with its activities but regarded the matter as an expropriation under international law nonetheless because Revere could no longer make an economically effective use of the business. The profitability of the investment was severely impaired by the tax.

Substantial Financial Damages

While it is difficult to determine the scope and extent of damage arising from a tax measure for it to qualify as expropriation, general agreement exists that the bar is set very high.[51] The United Nations Conference on Trade and Development ("U.N.C.T.A.D.") concluded that the damage must include "a significant depreciation"

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[48] *E.g.*, *Archer Daniels*; Wälde & Kolo, *supra* note 40, Harvard Draft Convention, *supra* note 43; O.E.C.D., *supra* note 34; Restatement, *supra* note 42, §712, cmt. (g); Iran-US. Claims tribunal, December 29, 1989, Award No. 460-880-2, *Too v. Greater Modesto Insurance Assocs., et al.;* and R. Moloo & J. Jacinto, *Environmental and Health Regulation: Assessing Liability Under B.I.T.s,* 29 Berkeley J. of Intl. L. 2, pp. 1-66 (2011).

[49] *Archer Daniels*, par. 250.

[50] August 24, 1970, *Revere Copper and Brass Inc and Overseas Private Investment Corporation* (1978), 56 ILR 258, discussed by M. Hunter & A.C. Sinclair, *Ammoil Revisited Reflections on a Story of Changing Circumstances*, in Investment Law and Arbitration: Leading Cases From The ICSID, NAFTA, Bilateral Treaties and Customary International Law p. 360 (T. Weiler ed., Cameron May 2005).

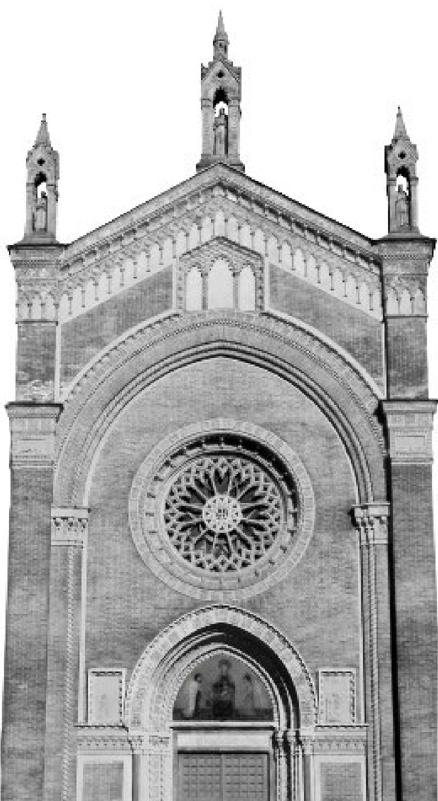
[51] *E.g.*, Kolo, *supra* note 42; *Archer Daniels*; Rodriguez, *supra* note 37; and *Feldman*, para 103.

in value.[52] Moreover, if a measure is extremely discriminatory or absurd, the extent of financial damage need not be the same as for a more common measure.[53] In *Occidental v. Ecuador* the panel dealt with a refusal by the Ecuadorian tax authorities to refund V.A.T., contrary to earlier agreements with the taxpayer.[54] The taxpayer invoked the expropriation clause of the relevant B.I.T. According to the panel, the refusal did not qualify as expropriation since it did not deprive the taxpayer of the economic benefits that were reasonably to be expected or inflict substantial damages on the investment. The right to a V.A.T. refund was not a substantial part of the investment.[55] The previously cited *Archer Daniels* case is one of the few rulings that attempts to define the standard to be applied when measuring damages. The panel concluded that the damage criterion is met if the taxpayer is deprived of all or the majority of the benefits generated by the investment. Not only is the scope of the tax relevant but also the duration of the tax. A permanent loss of value will carry more weight than a temporary loss of value.[56]

OTHER PROVISIONS PROVIDING LEGAL PROTECTION AGAINST TAX MEASURES

Equal National Treatment Under Non-Discriminatory Provisions

The *Archer Daniels* case previously discussed involved a 20% tax imposed by Mexico on soft drinks containing a corn syrup sweetener. The tax did not apply to soft drinks sweetened with sugar cane. The reason for this measure appeared to have been the protection of the Mexican sugar cane market. A.D.M. was a U.S. manufacturer of corn syrup. It saw a sharp decline in the value of its Mexican investments as a result of the measure. A.D.M. challenged the tax under the North American Free Trade Agreement ("N.A.F.T.A."), a multilateral investment protection agreement. One of the grounds for its complaint was that the tax qualified as expropriation.[57]



[52] U.N.C.T.A.D., *Series on Issues in International Investment Agreements: Taking of Property* 4 (2000). See also R. Higgins, *The Taking of Property by the State: Recent Developments in International Law*, 176 *Recueil des Cours*, pp. 259-324 (1982).

[53] Wälde & Kolo, *supra* note 40.

[54] *Occidental v. Ecuador.*

[55] *Occidental v. Ecuador*. See also I.C.S.I.D., September 13, 2006, Case No. ARB/04/15, *Pope & Talbot and Telenor v. Hungary.*

[56] *Archer Daniels*, para. 240:

> The test on which other Tribunals and doctrine have agreed – and on which the "Claimants" rely – is the "effects test". Judicial practice indicates that the severity of the economic impact is the decisive criterion in deciding whether an indirect expropriation or a measure tantamount to expropriation has taken place. An expropriation occurs if the interference is substantial and deprives the investor of all or most of the benefits of the investment. There is a broad consensus in academic writings that the intensity and duration of the economic deprivation is the crucial factor in identifying an indirect expropriation or equivalent measure.

[57] A.D.M. invoked article 1102 of the N.A.F.T.A.

The arbitration panel applied the assessment framework described above and concluded that the impact of the tax on A.D.M.'s investments was not sufficient to constitute expropriation. However, the arbitration panel considered the tax a violation of N.A.F.T.A. because the nondiscrimination provision guarantees the domestic and equal treatment of foreign investments. The arbitration panel ruled that the effect of the tax was such that U.S. manufacturers and distributors of corn syrup in Mexico received less favorable treatment than Mexican manufacturers of sugar cane. As a result, the tax violated the investment protection agreement.

Fair and Equitable Treatment

The *Occidental v. Ecuador* case, in respect of which a decision was given under the U.S.-Ecuador B.I.T. is similar to the *Archer Daniels* case.[58] Initially, the arbitration panel rejected a claim based on the expropriation provision, because revoking a right to a V.A.T. refund did not qualify as expropriation. However, after further consideration, the revocation of the refund was considered to be an unauthorized violation of the investment protection agreement. The arbitration panel considered that the right to fair and equitable treatment had been violated.[59] The right to a V.A.T. refund was part of an agreement with the Ecuadorian tax authorities, which interpreted national legislation (the ruling). The arbitration panel emphasized that a contracting state to a B.I.T. must provide investors from the other contracting state with a stable and predictable legal infrastructure. That obligation is a consequence of the right to fair and equitable treatment that is mandated by the B.I.T. Whether the contracting state acted in bad faith was irrelevant. Based on the underlying facts, the panel concluded that the domestic V.A.T. legislation and the subsequent interpretation in a tax ruling materially contributed to Occidental's decision to invest in Ecuador. The panel concluded that "the tax law was changed without providing any clarity about its meaning and extent, and the practice and regulations were also inconsistent with such changes."[60] As such, the panel ruled that Ecuador failed in its obligation to provide a stable and predictable legal system. The revoked refund resulted in a violation of the existing B.I.T.[61]

Last but not least, the *Vodafone* case offers a more recent and quite spectacular example of the interaction between income tax treaties and B.I.T.'s. In what is commonly regarded as one of the most significant international tax disputes of this era, a Dutch affiliate of the Vodafone Group, Vodafone International Holdings B.V.

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58 *Occidental v. Ecuador.*

59 Art. II(3)(a) of the Treaty between the United States of America and the Republic of Ecuador Concerning the Encouragement and Reciprocal Protection of Investment, with Protocol and a Related Exchange of Letters (August 27, 1993): "Investment shall at all times be accorded fair and equitable treatment, shall enjoy full protection and security and shall in no case be accorded treatment less than that required by international law."

60 *Occidental v. Ecuador*, para 184.

61 It should be noted that the tribunal in *EnCana v. Ecuador*, para. 173 considered that a contractual obligation was indeed more important than an obligation derived from general legislation and, therefore, applied to the underlying issue a more limited interpretation of the right to fair and equitable treatment:

> [I]n the absence of a special commitment from the host state, the foreign investor has neither the right nor any legitimate expectation that the tax regime will not change, perhaps to its disadvantage, during the period of the investment.

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("V.I.H.") sought to rely on the formal route in the B.I.T. signed between India and the Netherlands rather than the mutual agreement procedure provided for in the income tax treaty between the two countries. More specifically, V.I.H. invoked Clause 9 of the B.I.T. to challenge a retrospective amendment of Indian law to tax capital gains, which had been enacted in the aftermath of the following events.

Back in 2007, V.I.H. had acquired a 67% interest in the Indian telecom company Hutchison Essar Limited ("H.E.L.") for an amount of $11 billion. This transaction entailed a share purchase agreement between V.I.H. and the Hutchison Telecommunications International Limited ("H.T.I.L.") involving a Cayman Island-based company C.G.P. Investments Limited ("C.G.P."), which in turn, directly and indirectly, held a 67% interest in H.E.L. Shortly thereafter, the Indian tax authorities issued a notice demanding payment of $2.2 billion as capital gains tax, which Vodafone contended it was not liable to pay as the transaction between H.T.I.L. and V.I.H. did not involve the transfer of any capital asset situated in India.

"The scope of substantive rights laid down in an investment protection agreement in the context of taxation is difficult to define, partly due to the scarcity of guidance in the case law."

Following verdicts by the Bombay high court and the Indian Supreme Court, eventually the case reached the Permanent Court of Arbitration at the Hague. In a unanimous decision, the court held that the retrospective demand was in breach of the guarantee of fair and equitable treatment.[62] Moreover, the court requested India not to pursue any such tax demand any more against Vodafone Group, so as to end the tax dispute between India and the Vodafone Group that had lasted almost a decade.

CONCLUSIONS

The scope of substantive rights laid down in an investment protection agreement in the context of taxation is difficult to define, partly due to the scarcity of guidance in the case law. Nonetheless, it follows from the above that a B.I.T. can provide legal protection against those forms of taxation that may constitute a violation of its provisions. Particularly, the provisions on expropriation, nondiscrimination, and the right to fair and equitable treatment set limits on a contracting state's right to impose taxation.

Where taxation results in a substantial decrease of the value of an investment, it may be a form of expropriation that can be redressed under a B.I.T. if it detrimentally affects the reasonable expectations of the investor that formed the basis for its investment. However, access to a B.I.T. is allowed only if the imposition of the tax deviates from internationally accepted legal standards. The most obvious example of an internationally accepted legal standard is a tax that violates the principle of non-discrimination. The tendency of arbitration panel decisions is that when the violation of a generally accepted legal principles is flagrant, the disputed government action on the investment need not be as great in order for a claim by an affected investor to be upheld.

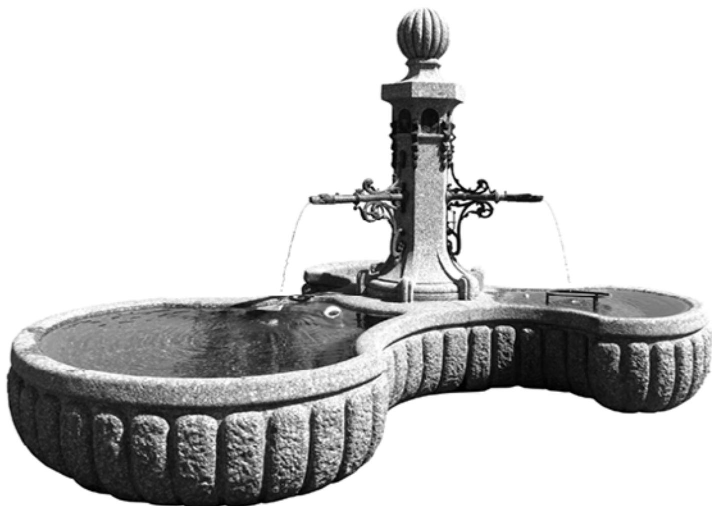
Future cases and arbitration guidance will be required to determine the circumstances in which a violation of specific international tax principles can be considered a deviation from internationally accepted legal standards. In matters relating to taxation, it may be expected that an arbitration panel will apply a high standard before a claim will be upheld under a B.I.T. regarding the imposition of tax. The unanticipated

[62] *Vodafone v. India (I)Vodafone International Holdings BV v. India* (I)(PCA Case No. 2016-35), arbitral award dated September 25, 2020.

imposition of tax by the host country must have a significant impact on the value of the investment and must be at odds with the reasonable expectations of the investor at the time the investment was made. If both these conditions are met, it is conceivable that a panel may conclude that such taxation qualifies as indirect expropriation.

For tax advisers who customarily look for relief under the terms of an income tax treaty, the most interesting aspect of arbitration under a B.I.T. is that the investor is a direct party to the arbitration. Indeed, the investor can instigate arbitration proceedings in addition to participating in the proceedings. The generous legal protection offered by an investment protection agreement stands in stark contrast to arbitration under a tax treaty, but it is still in the formative stages.

Arbitration under a tax treaty or an investment protection agreement does not necessarily have to be mutually exclusive. The competent authority in the state of residence can be requested to start a M.A.P. under the relevant tax treaty, while at the same time commencing proceedings under the existing investment protection agreement. Note that access to a B.I.T. may require that all avenues for domestic legal recourse have been exhausted previously. In this respect, the spectre of arbitration under an investment protection agreement can keep pressure on the mutual consultation procedure under the tax treaty.



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TAX CASES AFFECTING REMOTE WORKERS AND THEIR EMPLOYERS

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Tags
Auxiliary or Preparatory
Digital Nomad Visas
Fixed Place of Business
Home Office
Permanent Establishment
Product Information
Remote Worker

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INTRODUCTION

The legacy of the pandemic has demonstrated that an employee does not need to be in the office in order to work efficiently. Employees have adjusted to working remotely. In North America, remote working may mean a location in the suburbs surrounding the location of a business office, or perhaps a nearby state. In Europe, remote working may mean relocation to a different country. To illustrate, an article appearing in *The Guardian*[1] addresses how individuals have been encouraged to relocate to work remotely by the issuances of "digital nomad visas" offered by countries such as Croatia, Estonia, Iceland, and Greece. These visas typically require the applicant to meet minimum income levels, while others may require a minimum level of cash in the bank, as well.

While these programs focus on visa entitlement for foreign programmers and digital engineers, they do not always address the risk of tax for a foreign employer when the individual works exclusively for one company or one group of companies. An employer needs to be aware of the jurisdiction in which each of its remote employees is situated to ensure that the presence of the employee and the activity conducted in the country does not trigger a permanent establishment ("P.E.") for the employer and resulting income tax exposure.

This article addresses several recent cases in Europe and pronouncements by the Canada Revenue Agency ("C.R.A.") in Canada.

DENMARK

In Denmark, the *Skatterådet*, or Tax Council, of the *Skattestyrelsen*, or the Danish Tax Agency, issues binding rulings on tax matters of general public importance. On April 26, 2022, the *Skatterådet*, ruled that the presence of a remote employee of *Spörger*, a German company, resulted in the establishment of a P.E. in Denmark, thereby subjecting *Spörger* to Danish tax on the profits attributable to the P.E. [2]

The facts in the ruling were as follows. *Spörger* employed a sales employee who resided in Denmark (the "Employee") and who did not wish to move to Germany. The Employee was employed as an area sales manager and tasked to handle certain sales in relation to Africa, Belgium, Germany, the Netherlands, the Baltics and the Nordics. *Spörger* did not obtain any commercial advantage from the Employee

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[1] Burgen, Stephen. "Spain Plans 'Digital Nomad' Visa Scheme to Attract Remote Workers." *The Guardian*. Guardian News and Media, September 25, 2022.

[2] SKM number SKM2022.250.SR. related to case number 21-0722131, reported here.

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performing tasks from Denmark—the Employee's performance of work from Denmark was solely due to personal circumstances.

The Employee reported to *Spörger* management Germany. Denmark had a modest demand for *Spörger* products. To illustrate, the turnover on the Danish market for each of the years in the period 2019-2020, was between 0.05% and 0.16% of *Spørger's* total annual turnover. The Employee's work did not include contact with Danish customers, but only contact with Danish dealers and other business partners. However, where the sale of products took place through individual orders, the Employee could confirm orders from customers where the selling price was within a determined price range.

Regarding the Employee's place of work, § 2(1) of the employment contract stated: "The employee's place of work is with the customers and at his private address (home workplace)." The tasks assigned to the employee involved significant travel outside of Denmark and was estimated to have constituted between 50% to 60% of his total working time for the company. When the Employee was not travelling, the Employee's activities on behalf of *Spörger* was carried out from his residence in Denmark. The Employee's work that related to sales into the Danish market constituted a maximum of 5% of the Employee's total work effort.

The *Skatterådet* looked to the definition of a P.E. in the income tax treaty between Denmark and Germany ("DG Treaty") to rule that a P.E. of *Spörger* existed in Denmark.

Paragraph 1 of Article 5 (Permanent Establishment) defines a P.E. to be "a fixed place of business through which a company's business is wholly or partly carried on." The provision is standard and the *Skatterådet* explained the three conditions for a fixed place of business to exist:

- There must be a place of business, which covers all premises, fittings or installations that are actually used to carry out the company's business.
- The place of business must be fixed, which means that a connection is required between the place of business and a specific geographical location, and must not be of a temporary nature.
- The foreign enterprise must wholly or partially carry on its business through the fixed place of business.

Even if all three conditions are met, a P.E. will not exist if he activity carried out could be characterized as being of a preparatory or auxiliary nature. See paragraph 4(e) of Article 5 of the DG Treaty.

In determining that a P.E. existed, the *Skatterådet* determined that *Spörger* gained an advantage from the work being carried out in Denmark. The activity that was carried on by the employee from his home in Denmark constituted a surrogate for activity that would have been carried in an office in Denmark. It did not matter that the Employee's work related to the Danish market constituted not more than 5% of his annual time at work when 40-50% of his time at work for each year was carried out from Denmark. The important factors were as follows:

- The Employee had access to his own workspace at his place of residence in Denmark, making his residence a place of business.

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- The Employee's employment was not time limited.
- The Employee's work for *Spörger* was continuous and of a long-term nature.

The Employee was tasked with developing and building relationships with dealers in Africa, Belgium, Germany, the Netherlands, the Baltics and the Nordic countries. The Nordic market includes Denmark. Hence, the location of the Employee in Denmark apparently had value for *Spörger*, because Denmark near the Spörger's customers. The work in Denmark is thus not only due to private circumstances.

The tasks the Employee performed from home in Denmark were closely related to the sales activities in connection with customer visits in Denmark and abroad, and was part of the company's core activity. This was also evidenced by the Employee's title as area sales manager. This indicated that the employee's work was of a significant nature, and included more than tasks of a preparatory or auxiliary nature.

FINLAND

On December 3, 2021, the Finnish Supreme Administrative Court held that the activities of three employees of a Swedish company who carried on product promotion activity in Finland did not constitute a P.E. under the income tax treaty in effect among the Nordic countries.[3]

The Swedish company, C AB (the "Company") was part of an Australian group, which researched, manufactured, marketed and sold biopharmaceutical products. The Company was responsible, among other things, for product sales and marketing in the Nordic countries and maintained three employees in Finland (the "Finland Employees"). The Finland Employees were tasked with presenting the company's products to doctors and other medical experts in Finland. The Finland Employees did not have the right to take legal action on behalf of the company, receive orders, or negotiate the sales price specified for the company's products or other contract terms. The company did not have offices in Finland. Rather, the Finland Employees worked from their homes.

The *Verohallinto*, the Finnish Tax Administration, contended that the activity of the three employees in Finland constituted a P.E. of the Company. In the view of the *Verohallinto*, the activity of the three employees in Finland was tied to the sales activity carried on in Sweden. A deficiency it tax was asserted, and the deficiency was affirmed by a lower-level administrative court. That determination was reversed by the Supreme Administrative Court.

The Supreme Administrative Court established that, to evaluate whether an activity is auxiliary or preparatory in nature, attention should be focused on the kind of activity that is practiced in Finland. Activities that are part of the Company's core business cannot be considered auxiliary or preparatory. Core business activities are considered to be activities that form a significant and determining part of the Company's business. In the facts presented, the three employees were not involved in sales. Consequently, the Company cannot be considered to have a fixed place of business in Finland. The activity of visiting doctors and other medical experts to build product awareness are preparatory in nature. The Company's core business is not product presentation and the facts do not show that the product presentation

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[3] ECLI identifier: ECLI:FI:KHO:2021:171. Reported unofficially here.

accrued income directly in Finland. The Company's activities in Finland support the operations of the main facility in Sweden.

SPAIN

In January of 2022, the Spanish Tax Authorities ("STA") held that the presence of an employee of a U.K.-based company was insufficient to establish a permanent establishment for the company and that the employee was not a dependent agent of the employee.

The consultant (the "Employer") resided in the U.K. and employed an English national (the "Employee"). Prior to COVID-19, the Employee was based in London, where he materially participated in activity that generated profits for the business and participated in top management. The Employee was not granted the authority to sign contracts in the name of the Employer or on behalf of the employer. Nor did he ever sign contracts even in the absence of authority.

The Employee owned a house in Spain, where he spent weekends and holidays. The Employee was in Spain in March 2020 when the COVID-19 lockdown in place was announced. When travel restrictions eased, the Employee remained in Spain for personal reasons. Because he was physically present in Spain for more than 183 days during 2020, he became a Spanish resident.

During 2020, he continued to work for the Employer while living in Spain. The Employer did not bear any additional expenses in relation to accommodation nor did the Employer grant any remuneration for carrying out his work in Spain. By the end of 2020, the Employee requested a formal assignment to Spain, which was turned down. The Employee resigned in February 2021.

A ruling was requested by the Employer from the Spanish Tax Authority ("S.T.A.") the Employer did not maintain a P.E. in Spain in 2020 by reason of the presence or the activities of the Employee.

The S.T.A. considered two possibilities under which the Employer might have established a permanent establishment in Spain. One related to the existence of a fixed place of business in Spain from which business activity was carried out. The other related to the existence of a dependent agent in Spain having the power to bind the Employer. The S.T.A. ruled that no P.E. existed.[4]

Fixed Place of Business

The S.T.A. turned to the O.E.C.D. Secretariat Report, "Updated guidance on tax treaties and the impact of the COVID-19 pandemic,"[5] in particular to paragraphs 14 to 19 related to employees working in home offices.

> **Home office**
>
> 14. Whilst noting that the issue of whether a PE exists is a test based on facts and circumstances, in general, a place must have a certain

[4] The ruling is Consultation number V00gg-22 issued by the State Secretary of Finance, General Directorate of Taxes, and is dated January 18, 2022. It appears here.

[5] Available here.

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degree of permanency and be at the disposal of an enterprise in order for that place to be considered a fixed place of business through which the business of that enterprise is wholly or partly carried on.

15. Paragraph 18 of the Commentary on Article 5 of the OECD Model explains that even though part of the business of an enterprise may be carried on at a location such as an individual's home office, that should not lead to the conclusion that that location is at the disposal of that enterprise simply because that location is used by an individual (*e.g.* an employee) who works for the enterprise. The carrying on of intermittent business activities at the home of an employee does not make that home a place at the disposal of the enterprise. A home office may be a PE for an enterprise if it is used on a continuous basis for carrying on business of that enterprise and the enterprise generally has required the individual to use that location to carry on the enterprise's business.

16. During the COVID-19 pandemic, individuals who stay at home to work remotely are typically doing so as a result of public health measures: it is an extraordinary event not an enterprise's requirement. Therefore, considering the extraordinary nature of the COVID-19 pandemic, teleworking from home (*i.e.* the home office) because of an extraordinary event or public health measures imposed or recommended by government would not create a PE for the business/employer, either because such activity lacks a sufficient degree of permanency or continuity or because the home office is not at the disposal of the enterprise. In addition, it still provides an office which in the absence of public health measures is available to the relevant employee. This applies whether the temporary work location is the individual's home or a temporary dwelling in a jurisdiction that is not their primary place of residence.

17. If an individual continues to work from home after the cessation of the public health measures imposed or recommended by government, the home office may be considered to have certain degree of permanence. However, that change alone will not necessarily result in the home office giving rise to a fixed place of business PE. A further examination of the facts and circumstances will be required to determine whether the home office is now at the disposal of the enterprise following this permanent change to the individual's working arrangements.

18. Paragraphs 18 and 19 of the Commentary on Article 5 of the OECD Model indicate that whether the individual is required by the enterprise to work from home or not is an important factor in this determination. Paragraph 18 explains that where a home office is used on a continuous basis for carrying on business activities for an enterprise and it is clear from the facts and circumstances that the enterprise has required the individual to use that location (*e.g.* by not providing an office to an employee in circumstances where the nature of the employment clearly requires an office), the home office may be considered to be at the disposal of the enterprise. As an

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> example, paragraph 19 notes that where a cross-border worker performs most of their work from their home situated in one jurisdiction rather than from the office made available to them in the other jurisdiction, one should not consider that the home is at the disposal of the enterprise because the enterprise did not require that the home be used for its business activities.
>
> 19. In conclusion, individuals teleworking from home (*i.e.* the home office) as a public health measure imposed or recommended by at least one of the governments of the jurisdictions involved to prevent the spread of the COVID-19 virus would not create a fixed place of business PE for the business/employer.

On the basis of the above, the S.T.A. determined that in 2019, no P.E. existed. However, the Employee remained in Spain throughout 2020. Consequently, the S.T.A. examined whether the Employee's home became available to the Employer for the conduct of its business. Ultimately, the S.T.A. ruled that the Employee's residence was not made available to the Employer as a place of business, based on the following facts:

- The Employee decided unilaterally to continue in Spain.
- The Employer maintained a place available to the Employee in the U.K. where the Employee could carry his work on a face-to-face basis with colleagues in the U.K.
- The Employer did not bear any expenses of the premises in Spain, nor did the Employee receive special pay to carry out work from in Spain; in other words, the Employee never received customary expat stipends.

"Ultimately, the S.T.A. ruled that the Employee's residence was not made available to the Employer as a place of business. . ."

Dependent Agent

The S.T.A. concluded that during the months that the public health measure lasted, factors listed in paragraphs 20 and 21 of the O.E.C.D. updated guidance suggested that the Employee did not "habitually" conclude contracts on behalf of the Employer.

> 21. An employee's or agent's activity in a jurisdiction is unlikely to be regarded as habitual if they are only working at home in that jurisdiction because of an extraordinary event or public health measures imposed or recommended by government. Paragraph 6 of the 2014 Commentary on Article 5 explains that a PE should be considered to exist only where the relevant activities have a certain degree of permanency and are not purely temporary or transitory. Paragraph 33.1 of the Commentary on Article 5 of the 2014 OECD Model provides that the requirement that an agent must "habitually" exercise an authority to conclude contracts means that the presence which an enterprise maintains in a jurisdiction should be more than merely transitory if the enterprise is to be regarded as maintaining a PE, and thus a taxable presence, in that jurisdiction. Similarly, paragraph 98 of the 2017 OECD Commentary on Article 5 explains that the presence which an enterprise maintains in a jurisdiction should be more than merely transitory if the enterprise is to be regarded as maintaining a PE in that jurisdiction under Article 5(5).

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> 22. A different approach may be appropriate, however, if the employee was habitually concluding contracts on behalf of enterprise in their home jurisdiction before the COVID-19 pandemic.

Although the Employee had been in Spain for more than six months in 2020, the data provided was not conclusive on whether the activities carried out by the Employee could be identified as activities of an agent, since it was not indicated that they acted as such. Consequently, the exceptional and temporary change of place where the Employee carried out his employment due to the COVID-19 pandemic did not create a new permanent establishment for the Employer. In reaching its decision, the S.T.A. pointed out that, in last analysis, the existence of a dependent agent who habitually exercises an authority to conclude contracts is a question of fact. If other facts existed, the answer might be different.

CANADA

In Canada, a nonresident is deemed to carry on a Canadian business where the nonresident solicits orders or offers anything for sale in Canada through an agent or servant, whether the contract or transaction is to be completed inside or outside of Canada or partly in or partly outside of Canada.[6] The rule is statutory, and overrides common law decisions reaching an opposite conclusion that no trade or business is carried if no contract is concluded in Canada.

Article 12(1) of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* ("the M.L.I.")[7] adopts the policy of the Canadian statutory rule. It provides as follows:

> ***Article 12 – Artificial Avoidance of Permanent Establishment Status through Commissionnaire Arrangements and Similar Strategies***
>
> 1. Notwithstanding the provisions of a Covered Tax Agreement that define the term "permanent establishment", but subject to paragraph 2, where a person is acting in a Contracting Jurisdiction to a Covered Tax Agreement on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are:
>
>   a. in the name of the enterprise; or
>
>   b. for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use; or
>
>   c. for the provision of services by that enterprise,
>
>   that enterprise shall be deemed to have a permanent establishment in that Contracting Jurisdiction in respect of any activities which that

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6. Subsection 253(b) of the Income Tax Act.
7. Available here.

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person undertakes for the enterprise unless these activities, if they were exercised by the enterprise through a fixed place of business of that enterprise situated in that Contracting Jurisdiction, would not cause that fixed place of business to be deemed to constitute a permanent establishment under the definition of permanent establishment included in the Covered Tax Agreement (as it may be modified by this Convention).

2. Paragraph 1 shall not apply where the person acting in a Contracting Jurisdiction to a Covered Tax Agreement on behalf of an enterprise of the other Contracting Jurisdiction carries on business in the first-mentioned Contracting Jurisdiction as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.

Canada surprisingly has opted out of Article 12 of the M.L.I. entirely and has also opted out entirely of Article 13, which targets commissionaire arrangements, Article 14, which targets the splitting up of contracts, and Article 15, which targets independent agents acting almost exclusively for one or more enterprises to which the agent is closely related.

Canada's tax treaties are based on the O.E.C.D. Model Tax Convention on Income and on Capital and provide that a permanent establishment will not be created where the activities of an employee are merely preparatory or auxiliary.

In 2006, the Canada Revenue Agency released Ruling 2006-0173601R3.[8] In the ruling, a foreign bank requested a determination on whether it would be deemed to have a permanent establishment in Canada in the following fact pattern:

- It would maintain a staff of three Canadian resident employees.
- The employees would work in a rented office.
- The purpose of the office would be to promote the Foreign Bank's services to selected Canadian industries and potential Canadian customers, to support the Foreign Bank's customers in Canada, and to liaise with the Foreign Bank head office in the Foreign Treaty Country.
- The Canadian resident employees would have no authority to conclude contracts on behalf of the Foreign Bank relating to its core business operations.
- All services offered by the Foreign Bank to Canadian customers such as traditional financings, term loans, participation in syndicated financings and mezzanine financings would be carried on through offices of the Foreign Bank outside of Canada.

The C.R.A. concluded that the Canadian employees did not generate a permanent establishment for the Foreign Bank because the Canadian employees' activities

[8] The ruling appears here.

were considered to be activities of a preparatory or auxiliary character for the purposes of the Treaty.

In *Knights of Columbus v. The Queen*,[9] the Tax Court of Canada held that the field agents' premises in Canada did not constitute a permanent establishment for the Knights of Columbus, a U.S. corporation. The Court rejected the Minister of National Revenue's assertion that even though the agents were present in Canada, their homes constituted a fixed place of business for the Knights of Columbus.[10] The houses were not available at the disposal of the Knights of Columbus.

While the case remains good law as to its facts, a different conclusion might be reached in different facts. The Knights of Columbus might be viewed as having the agents' premises at its disposal, for example, if the Knights of Columbus paid for all expenses in connection with the premises, required that the agents have a room in the house maintained exclusively as a home office containing specific office equipment and sufficient size to meet with clients. In such circumstances the premises might be viewed as being at the disposal of the Knights of Columbus even if it did not hold a key to the home of its field agents.

"While the case remains good law as to its facts, a different conclusion might be reached in different facts."

[9] 2008 TCC 307.

[10] See paragraph 78 of the opinion.

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THE U.K. GROWTH PLAN 2022

Author
Kevin Offer

Tags
Additional Rate of Income Tax
Annual Investment Allowance
Basic Rate of Income Tax
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Tax on Dividend

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INTRODUCTION

A mere three weeks after Liz Truss became Prime Minister of the U.K., the Chancellor of the Exchequer, Kwasi Kwarteng, stood up on the morning of September 23, 2022 to announce the new Government's Growth Plan. Billed as a "Mini Budget," it became a far greater set of announcements than expected, and even caused gasps of shock among the M.P.'s within the Conservative Party. The announcements amount to £45 billion of tax cuts resulting in the biggest such package since 1972, larger than the cuts announced by Nigel Lawson in 1988. These cuts follow on from the announcement for help with energy bills for two years which are budgeted to cost £60 billion in the next six months. All of these cuts and costs are to be financed initially by borrowing and are intended to stimulate economic growth leading to higher tax collections.

With such large tax cuts announced and further reforms promised, it was perhaps surprising that the Chancellor announced that he will close the Office of Tax Simplification ("O.T.S."). The O.T.S. is an independent adviser to the government and answerable to the Treasury. It was created to provide the Chancellor with advice on tax reforms that principally would assist individuals and small businesses. However, Kwasi Kwarteng said he wanted to "mainstream" the O.T.S.'s work across the Treasury and H.M.R.C. He went on to say

> [F]or the tax system to favour growth, it needs to be much simpler * * * instead of a single arm's-length body which is separate from the Treasury and H.M.R.C., we need to embed tax simplification into the heart of government.

Some may argue that an independent adviser would assist the Chancellor, but it seems that, with the abolition of the O.T.S. and the announcements made without any report from the Office for Budget Responsibility, outside influence is not something Liz Truss and her cabinet will be seeking.

The various tax changes are summarized below.

U.K. CORPORATION TAX

The main rate of corporation tax will not increase to 25% in April 2023 as originally planned and will remain at 19%. This reverses one of the announcements made by the previous Chancellor, Rishi Sunak, in 2021. The tax rate that will apply to profits caught under the diverted profits tax legislation will remain at 25%, maintaining the 6% differential with the main corporation tax rate. The previously announced increase in the diverted profits tax rate to 31% is also, therefore, cancelled.

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The corporation tax surcharge that is applied to banking profits will also remain unchanged at 8%. This will mean a combined rate of tax on profits paid by banks and building societies of 27%. However, the level at which the bank surcharge takes effect will be increased to £100 million.

As the next Finance Bill Is likely to be in July 2023, the changes are expected to be introduced provisionally through the Provisional Collection of Taxes Act 1968.

ALLOWANCES FOR BUSINESSES

The Annual Investment Allowance ("A.I.A.") provides a 100% deduction in relation to qualifying expenditure on plant and machinery. This was temporarily increased to £1 million and was planned to be reduced to £200,000 from April 1, 2023. The temporary increase in the limit will now be permanent.

Making the A.I.A. increase permanent will allow businesses to plan expenditure more efficiently by preventing the rate of A.I.A. from affecting the timing of investment. The permanent increase will also assist those businesses investing heavily over a number of years.

Due to the elimination of the planned increase in Corporation Tax that was scheduled to be effective from April 1, 2023, the government announced that some amendments will be made to the enhanced allowances available to businesses, commonly known as the "super-deduction." The amendments will ensure that enhanced relief will operate as originally intended. No details have been provided on these amendments, but announcements worded in this way usually lead to the introduction of anti-avoidance provisions to counteract perceived abuse.

INVESTMENT ZONES

The Chancellor announced that investment zones would be created as quickly as possible. Businesses within investment zones will be able to benefit for a period of ten years from tax and other reliefs including

- 100% first year enhanced capital allowance relief for plant and machinery used within designated areas;
- accelerated Enhanced Structures and Buildings Allowance relief of 20% per year;
- 100% relief from business rates on newly occupied business premises and some existing businesses expanding into an Investment Zone;
- no stamp duty land tax on newly occupied commercial land and buildings and for land or buildings for new residential development;
- a zero rate for Employer National Insurance contributions for new employees working in the zone for at least 60% of their time, restricted to earnings up to £50,270 per year; and
- reduced regulation over planning applications.

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ENTERPRISE INCENTIVES

A number of measures will be brought with effect from April 6, 2023, to help businesses raise investment capital and attract talent.

C.S.O.P.

A Company Share Option Plan ("C.S.O.P.") allows companies to grant options to employees in a tax efficient way. Companies can currently grant qualifying C.S.O.P. options over shares worth up to £30,000 to each eligible employee. This limit will be doubled to £60,000 from April 2023. As the limit has not been increased since the introduction of C.S.O.P.'s in 1995 this increase has been long-overdue and should help companies looking to incentivise employees.

In addition to the increase in the limit, the government has announced that some conditions that attach to the options will be removed from April 6, 2023.

S.E.I.S.

Seed Enterprise Investment Schemes ("S.E.I.S.") allow companies to raise up to £150,000 by way of an issue of shares that provide income tax relief to investors of up to 30% of the amount invested and the possibility to roll over capital gains up to the amount of the investment. This limit will be increased to £250,000 to allow qualifying companies to increase the amount that can be raised. There is also an annual limit on how much an individual can invest in S.E.I.S. shares. This limit has also been doubled to £200,000.

Currently, only companies with gross assets below £200,000 at the date of investment can raise funds under S.E.I.S. This limit will be increased to £350,000.

The two-year qualifying rule limiting the benefit to companies that have been trading for not more than two years will be increased to three years.

PERSONAL TAX CUTS

The Chancellor announced a number of cuts to personal tax rates:

- **Basic Rate of Income Tax.** The basic rate of income tax that applies to taxable income from £12,571 to £50,270 will be reduced from 20% to 19% with effect from April 6, 2023. This brings forward by one year the announcement made by the previous Chancellor. To avoid an impact on charities who benefit from the Gift Aid tax rebates, the reduction of the basic rate to 19% will be phased in over a four-year period to support charities.
- **Additional Rate of Income Tax.** The additional rate of income tax – meaning the top rate – currently applies to income of more than £150,000 per year. This top rate of tax would be abolished with effect from April 6, 2023. In addition, an allowance against savings income of £500 with be extended to top rate taxpayers.
- **Tax on Dividends.** The 1.25% increase in tax rates applying to dividend income that came into effect from April 6, 2022 will also be reversed from April 6, 2023.

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The reversal of the increase in dividend tax rates, together with the abolition of the additional rate, creates an opportunity for tax planning. A dividend received by an individual with total gross income exceeding £150,000 will pay 6.85% less tax if the dividend is received after April 5, 2023. For these individuals, a brief deferral of dividends is beneficial. An individual making a contribution to a U.K. pension fund will receive tax relief at a rate of 45% if the contribution is made not later than April 5, 2023. A contribution after that date will receive tax relief of 40%. An acceleration of pension fund contributions will provide a greater immediate tax benefit.

The full detail of the changes are yet to be known and careful planning will be required to ensure no anti-avoidance measures apply.

NATIONAL INSURANCE

The Chancellor confirmed the reversal of the 1.25% increase in National Insurance (social security) contributions with effect from November 6, 2022 which had been announced a couple of days earlier. This was a temporary measure for the current tax year before it was replaced with the Health & Social Care Levy from April 6, 2023, which also has been reversed.

This is the third change in National Insurance this year and will present another challenge for payroll processors as employees look to see the reduction in their pay packets.

Individuals who are self-employed pay National Insurance with their income tax payments so will see a change in the rates they pay for the current tax year to 9.73% and 2.73%.

Employers will also benefit from the same reduction in employers' contributions. An employer may therefore wish to consider delaying bonuses or pay rises until after November 6 to reduce the cost to the business and increase net pay for employees.

"The obligation for determining whether I.R. 35 will apply will therefore revert back to the individual contractor."

Employers are also liable to pay National Insurance contributions on certain benefits provided to employees. For the current tax year only, a new rate of 14.53% is to be introduced to allow for the change in rates. This new rate will also apply to any Settlement Agreements.

OFF-PAYROLL WORKING

The off-payroll working rules known as "I.R. 35" have been the source of a number of problems for contractors who have been caught by (i) a general lack of understanding of how the rules are applied and (ii) pressure from customers and some advisers. The rules apply where services are provided by an individual through a personal service company ("P.S.C."). In such circumstances, tax and National Insurance apply to the payments to the P.S.C. if the engagement was more in the nature of an employment rather than self-employment. This was a measure to counteract widespread noncompliance, as the responsibility for determining whether I.R. 35 applies was moved to the end-client in almost all cases. The client paying the P.S.C. is required to operate P.A.Y.E. and N.I.C.

The Chancellor announced the I.R. 35 position will be reversed from April 2023. The obligation for determining whether I.R. 35 will apply will therefore revert back to the

individual contractor. While a large number of people are celebrating the abolition of I.R. 35 in the press and social media, I.R. 35 this the benefit of the rules change will extend only to the end-client. The rules remain in place for the P.W.C., and H.M.R.C. can be expected to apply the I.R. 35 rules where appropriate. It is easy to see that H.M.R.C. may challenge any contractor who currently suffers deductions from payments made by their customers, it the contractor fails to collect P.A.Y.E. and N.I.C. from April next year.

Even though responsibility for determining whether I.R. 35 applies will rest with the contractor, the customer should not forget the impact of the Criminal Finances Act 2017. This act introduced a corporate criminal offence for failing to prevent the facilitation of tax evasion by an employee or associate. A contractor providing services for or on behalf of the end customer falls within the definition of an associate. Consequently, it will be important for a business to have procedures in place to ensure that its contractors are complying with their tax obligations. Failure to do so may lead to an unlimited fine and a public record of conviction.

BANKERS' BONUSES

The Chancellor made much of the announcement to abolish E.U. rules that limit bonuses for senior bankers to 100% of their fixed pay, or 200% with shareholder approval. The government are of the view that eliminating the ceiling on bonuses will encourage talent to move to the U.K., by effectively remove the bank's obligation to pay higher base salaries.

STAMP DUTY LAND TAX

Stamp Duty Land Tax ("S.D.L.T.") applies on the purchase of real estate in the U.K. In a bid to encourage home ownership and residential home-building. The S.D.L.T. threshold for purchases of residential property in England and Northern Ireland has been increased to £250,000 for all buyers, and to £425,000 for first-time buyers. The threshold for the value of properties qualifying for the enhanced nil rate band for first-time buyers will be increased to £625,000. These measures came into effect from September 23, 2022. The measures do not apply in Scotland or Wales which have their own land transfer taxes.

The higher rates that apply to purchases of additional properties and purchases by non-residents remain unchanged.

TAX FEE SHOPPING

A V.A.T.-free shopping scheme will be introduced for tourists and other non-U.K. visitors to the U.K. This will allow a V.A.T. refund on goods bought in and then exported from the U.K. in personal baggage. The scheme will, effectively, replace a previous scheme which provided V.A.T. refunds to non-E.U. tourists. That scheme ceased once the U.K. left the European Union.

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ALCOHOL DUTIES

Lastly, the new alcohol duty rules are to be deferred to allow businesses more time to make arrangements. In addition, some of the rules have been simplified. These measures will be welcomed by suppliers and customers.

CONCLUSIONS

It seems clear that the Government are keen to pursue a trickle-down approach with the biggest tax cuts going to large businesses and wealthy individuals. Whether those who benefit most will pass down those benefits through increased spending, investing, and employing, remains to be seen. What is clear, however, is that the markets, public, and analysts have largely responded negatively to the announcements. The prospect has been raised of sterling dropping to parity with the US dollar which may come during the Conservative Party's annual conference.

"It is known that Liz Truss is a great admirer of Margaret Thatcher and sees these policies as a return to Thatcherism."

It is known that Liz Truss is a great admirer of Margaret Thatcher and sees these policies as a return to Thatcherism. However, Margaret Thatcher did raise taxes initially and only made cuts when it was perceived the economy was in good shape. That would not seem the case at present with Liz Truss and her Chancellor funding the announcements through borrowing. With interest rates increasing that may prove to be unsustainable with much of the benefit received by the majority being more than wiped out by rising prices and interest payments. The growth plan would therefore seem to be a gamble and only time will tell whether it was work the risk.

LUXEMBOURG AMENDS LAW ON FINANCIAL COLLATERAL ARRANGEMENTS

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INTRODUCTION

Luxembourg is the second largest investment fund center in the world after the U.S. Assets under management ("A.U.M.") in Luxembourg exceed U.S. $5.0 trillion. Luxembourg's success as a financial center largely is due to its advanced investment fund legislation and the legal framework in respect of financial transactions and collateral arrangements. The relevant legislation is the Collateral Arrangements Law of August 5, 2005 ("the Collateral Arrangements Law"). Earlier this year, it was amended by the law of July 20, 2025 ("the Amendment") intended to update the Collateral Arrangements Law to reflect current developments in market practices. This article explains the changes made by the Amendment.

DIRECTIVE 2002/47/EC

The Collateral Arrangements Law was initially adopted in Luxembourg to transpose Directive 2002/47/EC of the European Parliament and of the Council of June 6, 2002 ("Directive"). The aim of the Directive was to create a harmonized E.U.-wide legal framework for the receipt and enforcement of financial collateral typically provided by a borrower to support a financial transaction, whether the borrowing reflected customary banking and lending or more complex structured products trading).In this way, it would provide additional security to lenders, reduce credit losses, and encourage cross-border business within the E.U. The importance of the Directive can hardly be overestimated in times of financial crises.

The Directive set the framework for cross-border use of financial collateral. It abolished formal requirements to register the collateral, and in their place, provided minimum evidentiary requirements, such as a written pledge. This enabled enforcement of a pledge by sale or appropriation of the pledged collateral outside of insolvency proceedings. This gave the holder of the financial collateral an easier path to ensure satisfaction of the underlying obligation. In addition, the Directive required Member States to recognize close-out netting arrangements. In sum, the Directive provided contractual flexibility and legal certainty to the parties.

In comparison to E.U. Regulations, E.U. Directives do not have a direct binding effect in the E.U. Member States. They are pieces of legislation that set out goals that all E.U. countries must achieve. It is up to the individual Member States to adopt their own laws to reach these goals. The Directive provided Member States with a broad range of options regarding implementation and allowed Member States to adapt the Directive to local legal frameworks.

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THE COLLATERAL ARRANGEMENTS LAW

The Collateral Arrangements Law, as further amended, is a perfect example of how the Luxembourg parliament created a competitive market within the E.U. by transposing a Directive to provide a flexible framework for the enforcement of claims against pledged collateral posted by borrowers. To illustrate, the terms for the provision of a collateral can allow for control arrangements, not only possession. Collateral substitution not prejudicing security interest is also possible.

The main pillars of the legal framework created by the Collateral Arrangements Law are as follows:

- **No registration formalities.** Financial collateral arrangements and netting agreements are recognized commercial transactions not requiring any registration. Evidence of the arrangement in writing or by any other legally equivalent manner is considered sufficient for the collateral to be valid.
- **Control arrangements.** The provision of collateral will be recognized if it is delivered, transferred, held, registered, or otherwise designated to be in the possession or under the control of the collateral taker or of a person acting on its behalf.
- **Security trustee.** The Collateral Arrangements Law expressly recognizes that a security arrangement exists by allowing the provision of the collateral to be in favor of a person acting for the account of the beneficiaries of the collateral, a fiduciary, or a trustee. Usually, it is assumed that the creditor also received the collateral and acts as the pledgee. The Collateral Arrangements Law specifically allows for the collateral to be held by a fiduciary or a security trustee without any need of parallel debt arrangements with the collateral agent.
- **Enforcement of pledge without prior notice.** In the event of a triggering default, the pledgee may enforce the pledge without prior notice, unless otherwise provided.
- **Range of enforcement procedures.** The main procedures are (i) out-of-court appropriation at the price determined by the valuation method agreed between the parties (normally, an independent auditor is appointed for this purpose) and (ii) a private sale to a third party in a commercially reasonable manner. Other methods include public auction under simplified procedures discussed below and court order. Specific rules apply to publicly traded financial instruments and insurance contracts, also discussed below.
- **No effect of insolvency.** Provisions of Luxembourg or foreign law governing reorganization measures, winding-up procedures, attachments, liquidations, or similar procedures do not constitute an obstacle to the enforcement and performance of pledge agreements.

THE AMENDMENT

The Amendment leaves the main provisions remain intact, but several important revisions:

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- It confirms the contractual flexibility of the parties and the possibility to enforce a collateral arrangement, even if the secured obligation has not become due and payable.
- It updates and modernizes enforcement procedures.
- It introduces a new public auction regime for the enforcement of the financial collateral arrangement.

These amendments aim to strengthen Luxembourg as a creditor-friendly jurisdiction that provides flexibility for structuring financial transactions.

ENFORCEMENT EVENT

"These amendments aim to strengthen Luxembourg as a creditor-friendly jurisdiction that provides flexibility for structuring financial transactions."

The definition of the "enforcement event" in the Collateral Arrangements Law did not clearly address whether a financial collateral arrangement could be enforced only when the secured obligation becomes due. The Amendment clarifies the definition of an enforcement event by providing that it is an event of default or any other event whatsoever as agreed between the parties that triggers an enforcement action. This affirms the concept of contractual freedom between the parties. They may agree that an enforcement event may occur even if the secured obligation has not become due and payable. Consequently, an enforcement event includes a breach of a financial covenant, warranty, or representation. Where the relevant financial obligations are not due at the time creditor action is taken, the proceeds will be applied to satisfy the relevant financial obligations, unless otherwise agreed.

INTRODUCTION OF CURRENT MARKET CONCEPTS

The Amendment replaces outdated references to a stock exchange with the term "trading venue," including any regulated market, Multilateral Trading Facility ("M.T.F."), or Organized Trading Facility ("O.T.F.").

The Amendment provides that if an enforcement event occurs and the collateral consists of financial instruments admitted to trading, the pledgee may, without prior notice (i) assign or cause the pledged collateral to be assigned on a trading venue to which it is admitted to trading or (ii) appropriate the pledged financial instruments or have them appropriated by a third party, at market price (if such instruments are admitted to trading on a trading venue), unless otherwise provided for in the pledge. These enforcement methods complement other methods provided for in the Collateral Arrangements Law.

The definition of a "financial sector professional" as a recipient of title to collateral transferred on a fiduciary basis now includes any payment institution or any electronic money institution.

The introduction of modern concepts is a good example of how the legal framework has adapted to the fast-evolving market in order to follow current practices and I.T. development.

EXPANDED SCOPE OF COVERED COLLATERAL OVER UNITS AND SHARES OF (U.C.I.'S) AND INSURANCE CONTRACTS

The enforcement procedure has been modernized to reflect current practices. The Amendment confirms that an enforcement action may be taken units and shares of undertakings for collective investments ("U.C.I.'s") and insurance contracts serving as collateral.

The pledgee may appropriate the units or shares of a U.C.I. at the market price where such units and shares are admitted to trading or at the price of the last published net asset value ("N.A.V."), provided that the last publication of the N.A.V. does not exceed one year. Previously, an appropriation was possible only in cases where N.A.V. was published on a regular basis.

Also, the pledgee is now able to request the redemption of the pledged units or shares of a U.C.I. at the redemption price in accordance with the constituent documents of the U.C.I.

Finally, the Amendment expressly confirms the possibility for the pledgee to exercise all rights arising under the pledged insurance contract. Consequently, in the case of a life insurance contract or a capital redemption operation, the pledgee may exercise the right to surrender or request the insurance undertaking to pay any sums due pursuant to the insurance contract.

PUBLIC AUCTIONS

Under the Collateral Arrangements Law, public auctions were carried out at the Luxembourg Stock Exchange. The procedure was slow and inflexible. Now, a creditor may choose and appoint an auctioneer among bailiffs (*huissiers*) or notaries sworn in under the law of the Grand Duchy of Luxembourg. The auctioneer will determine the modalities and criteria of the auction procedure. This new regime is in line with the standard auction procedures in Luxembourg.

CONCLUSION

With the Amendment in place the Collateral Arrangements Law has been modernized to meet trading platforms of the 21st Century, adding to the attraction of Luxembourg as a preferred location for investment funds.

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ITALIAN SUPREME COURT ISSUES A LANDMARK DECISION ON THE ENTITLEMENT TO THE FOREIGN TAX CREDIT

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Tags
Foreign Dividend
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INTRODUCTION

In a recent case regarding distributions from the U.S., the Italian Supreme Court stated a general principle recognizing that, on the basis of double tax treaty provisions, Italian resident individuals are entitled to the foreign tax credit in respect of foreign taxes imposed on non-Italian source dividends.[1]

The decision is particularly relevant because it resolved a conflict between the Italian domestic rule and double tax treaty provisions. The Italian domestic rule denies the application of the foreign tax credit in a fact pattern involving foreign dividends that are subject to a reduced separate taxation in Italy, reasoning that the foreign tax credit applies solely to ordinary income subject to individual income taxes at the standard progressive rates. In comparison, the relevant tax treaty provision grants double tax relief in the form of a foreign tax credit that may be claimed by Italian resident individuals. The Italian Supreme Court ruled in favor of the clear meaning of the treaty provision.

Significant practical implications derive from this court decision as it provides grounds to Italian resident individuals to claim the refund of the income taxes paid in Italy without computing the foreign tax credit.

This article provides an overview of (i) the application of the foreign tax credit in respect of foreign source dividends received by Italian resident individuals and (ii) the main consequences that may result from the decision of the Italian Supreme Court.

TAXATION OF FOREIGN SOURCE DIVIDENDS

Under Italian domestic rules, dividends received by Italian resident individuals are not included in the ordinary income subject to individual income tax at progressive rates (up to 43%) and are instead subjected to "separate" taxation at the rate of 26%.[2]

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1 Decision of the Italian Supreme Court of Cassation No. 25698 of 1 September 2022.

2 Until December 31, 2017, a different tax treatment applied on dividends depending on whether the shareholding qualified as substantial (more than 2% of the voting rights or 5% of the equity in listed companies, or more than 20% of the voting rights or 25% of the equity in non-listed companies) or non-substantial. Dividends from substantial participations were subject to ordinary income taxation on 58.14% (49.72% until 2016) of the dividend payment. The remaining 41.86% (50.28% until 2016) was exempt. Dividends from non-substantial participations were subject to separate taxation at the reduced rate of 26% by way of final withholding tax or substitutive tax. The tax rate was originally equal to 12.5% until 2011. It was increased to 20% in the period from 2012 to June 30, 2014, and to 26% starting from July 1, 2014. As of 2018, the distinction between substantial and non-substantial participation eliminated. All dividends are subject to separate taxation at the rate

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In those cases, the recipient does not have the option to include the dividends in the ordinary income and separate taxation applies on a mandatory basis.[3]

The 26% taxation is applied either by way of withholding tax levied by an authorized financial intermediary[4] or through a substitutive tax to be paid by the recipient, if there is no financial intermediary intervening in the payment. Under the official interpretation of the Italian Revenue Agency,[5] different tax consequences result from an Italian perspective depending on whether separate taxation of foreign-sourced dividends is applied by way of withholding tax or substitutive tax.

If an authorized financial intermediary intervenes in the payment, the 26% withholding tax is applied on the amount of the dividends received net of the foreign taxes applied on those dividends. Example 1 illustrates the application of Italian tax collected by withholding.

Example 1 – Italian Withholding Tax		
A	Gross Dividend	100
B	Foreign Tax (15%)	15
C	Amount Subject to Italian W.H.T. (A – B)	85
D	Italian W.H.T. (C x 26%)	22.1
E	Foreign Tax Credit	0
F	Net Dividend (A – B – D)	62.9
G	Effective Tax Rate	37.1%

of 26%. Grandfathering rules apply in respect of dividends on substantial participations paid out of profits realized by a company up to December 31, 2017, and paid between January 1, 2018, and December 31, 2022. In particular, the taxable amount of the dividends to be included in the ordinary income subject to individual income tax is as follows: (i) 40% for dividends paid out of profits realized before 2008; (ii) 49.72% for dividends paid out of profits realized in the period from 2008 to 2016; and (iii) 58.14% for dividends paid out of profits realized in years 2016 and 2017.

3 It should be specified that the foregoing tax treatment does not apply to dividends directly or indirectly distributed by a company resident in a State with a privileged tax system. Those dividends are fully taxable in the hands of Italian resident individuals, unless previously taxed in the hands of the individuals under Italian domestic Controlled Foreign Corporation rules.

4 The category of authorized financial intermediaries includes Italian resident banks (including permanent establishments of non-Italian resident banks), Italian securities investment firms, Italian trust companies, Poste Italiane S.p.A., Italian stockbrokers and asset management companies authorized to provide individual asset management services.

5 Ruling No. 111/2020 of the Italian Revenue Agency.

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If no authorized financial intermediary intervenes in the payment because, for example, the dividends are directly received by the Italian resident individual, the recipient must declare the dividends received in the individual income tax return and pay a substitutive tax at the rate of 26% on the amount of the dividends gross of foreign taxes. Example 2 illustrates the application of the Italian substitutive tax.

Example 2 – Italian Subsititutive Tax		
A	Gross Dividend	100
B	Foreign Tax (20%)	15
C	Amount Subject to Italian Substitutive Tax (= A)	100
D	Italian Substitutive Tax (C x 26%)	26
E	Foreign Tax Credit	0
F	Net Dividend (A – B – D)	59
G	Effective Tax Rate	41.0%

As shown in Example 2, when foreign dividends are subject to Italian substitutive tax, overall taxation is heavier than when Italian withholding tax is imposed on foreign dividends because the latter is collected after deduction of foreign taxes. No rational explanation exists for the difference; the two cases are identical, but for method of tax collection, and should lead to the same result. In neither case is a foreign tax credit allowed in Italy.

FOREIGN TAX CREDIT APPLIES TO ORDINARY INCOME, ONLY

According to Italian domestic rules, the foreign tax credit is granted, subject to certain conditions, exclusively with respect to foreign source income included in the taxpayer's ordinary income and is limited to the lower of the foreign tax paid or the Italian tax that relates to the foreign income. If the foreign source income is not included in the ordinary income subject to Italian individual income tax at progressive rates, the recipient is not entitled to benefit from any foreign tax credit.[6] That is the case of foreign source dividends received by individuals which, as described above, are subject to separate taxation and are not included in the ordinary income.

[6] As confirmed by the Italian Revenue Agency in Circular Letter No. 9/E of 2015, the rationale is that separate taxation is typically lower than ordinary taxation. Consequently, there is limited need for the application of methods to avoid double taxation, because the final result leads to a level taxation considered to be bearable. However, what was true when the rate for Italian taxation of dividends and certain other income of financial nature was 12.5%, is not necessarily valid when the rate of Italian tax is 26% with no relief for foreign tax.

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In certain cases, the recipient may elect to treat certain financial income as ordinary income instead, which precludes application of the separate tax regime. In such a case, the recipient would be entitled to the foreign tax credit. However, this option is not applicable for foreign source dividends. Such dividends are never allowed to be included in ordinary income subject to individual income tax at progressive rates.

In light of the framework described, foreign dividends suffer double taxation as they are taxed twice: first, at source, in the residence State of the foreign company and then, separately, in Italy in the hands of the recipients. The effect of double taxation is even heavier when the foreign dividends are not received through an authorized financial intermediary. As illustrated in Example 2, when the Italian substitutive tax is applied, the tax base is the amount of the gross foreign dividend computed without any reduction for foreign withholding taxes.

"The domestic foreign tax credit provision conflicts with the double tax relief provisions of the income tax treaties entered into by Italy, which generally provide double tax relief by means of a foreign tax credit."

DOUBLE TAX RELIEF UNDER ITALIAN INCOME TAX TREATIES

The domestic foreign tax credit provision conflicts with the double tax relief provisions of the income tax treaties entered into by Italy, which generally provide double tax relief by means of a foreign tax credit.

In general, the method chosen by Italy to provide double tax relief is the ordinary credit method based on Article 23 B of the O.E.C.D. Model Tax Convention on Income and on Capital. Under the credit method, where an Italian tax resident derives income which may be taxed in the other contracting State in accordance with the provisions of the double tax treaty, Italy is obligated to allow a deduction from the tax – *viz.*, a credit – in an amount equal to the income tax paid in that other State. The credit is subject to a limitation, preventing it from exceeding the portion of Italian income tax that is attributable to the income arising in the other State. In broad terms, the Italian tax is multiplied by a fraction in which the numerator is the income that is derived from sources in the other state and the denominator is the total income of the Italian company.

Most double tax treaties entered into by Italy (87 out of 103) contain a clause allowing Italy to deny the foreign tax credit in the event that a particular item of foreign source income is taxed in Italy separately by way of a final withholding tax applied at the request of the Italian resident recipient. Examples appear in the income tax treaties with the U.S., France, Germany, Luxembourg, the Netherlands, Spain, and the U.K.[7] Consequently, if an item of foreign income is subject to separate taxation by way of withholding tax or substitutive tax on a mandatory basis rather than upon request of the Italian resident recipient, Italy should be required to allow the foreign tax credit.

In the most recent tax treaties, Italy introduced a different clause that denies the foreign tax credit where the final withholding tax is applied "also by request of" the Italian tax resident recipient. (Examples include income tax treaties between Italy and Malta, Cyprus, and Hong Kong. Other tax treaties expressly deny the foreign

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7 See for example Art. 23, paragraph 3, third sentence, of the Italy-U.S. Income Tax Treaty, which provides that "[n]o deduction will be granted if the item of income is subjected in Italy to a final withholding tax by request of the recipient of the said income in accordance with Italian law."

tax credit "whether at the request of the recipient or otherwise" Examples include income tax treaties between Italy and Chile, Jamaica and Colombia). Under the relevant clauses in those treaties, no foreign tax credit would be granted if foreign income is subject to separate taxation in Italy, whether the separate taxation is mandatory by law or upon request by the recipient.

In light of the above, the current Italian tax treatment of foreign source dividends can be summarized as follows:

- Foreign source dividends are subject to separate taxation in Italy either by way of withholding tax or substitutive tax.
- No foreign tax credit is allowed under Italian domestic rules because it only applies to items of income included in the ordinary income.
- An Italian resident individual who receives a dividend does not have the option to treat the dividends as ordinary income.
- Under most income tax treaties entered into by Italy, the foreign tax credit can be denied in Italy solely if the income is subject to separate taxation at the request of the recipient.
- The Italian Revenue Agency has traditionally taken the position that the Italian tax system does not allow any foreign tax credit in relation to income subjected to separate taxation.

DECISION NO. 25698/2022 OF THE ITALIAN SUPREME COURT

The recent decision of the Italian Supreme Court addressed this matter. The facts were straightforward. An Italian tax resident individual directly received distributions from a US partnership without the involvement of any authorized financial intermediary. Under Italian domestic rules, foreign entities (including partnerships) are regarded as tax opaque (*i.e.*, non-transparent) entities, regardless of the actual tax treatment in their country of residence or establishment. Consequently, from an Italian perspective, distributions from foreign entities are treated as dividends provided that certain conditions are met.[8]

In the case, the Italian recipient reported in his individual income tax return the distributions from the U.S. partnership as dividends subject to substitutive tax and used the foreign tax credit, by deducting the U.S. taxes from the Italian taxes on the U.S. income. The Italian Revenue Agency claimed that the individual omitted to pay the substitutive tax on the dividends from the U.S. partnership, arguing that no foreign tax credit was available with respect to the dividends as they were subject to "separate" taxation.

The Italian resident individual filed an appeal before the tax court of first instance, claiming that he was entitled to the foreign tax credit according to Paragraph 3 of

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[8] Distributions from shares and equity-like financial instruments issued by non-Italian entities are treated as dividend income for Italian income tax purposes provided that such remuneration: (i) is fully participating; and (ii) is not deductible from the taxable income of the issuer in its State of residence.

Article 23 (Relief from Double Taxation) of the Italy-U.S. Income Tax Treaty. Those dividends were not subject to separate taxation at his request but were applied on a mandatory basis by operation of law.

The tax court of first instance and the tax court of second instance ruled in favor of the Italian resident individual. The Italian Revenue Agency filed an appeal before the Italian Supreme Court.

The Italian Supreme Court rejected the appeal of the Italian Revenue Agency on several grounds. First, it acknowledged that Paragraph 3 of Article 23 of the Italy-U.S. Income Tax Treaty prevails over any Italian domestic tax rules. As a result, Italy can deny the foreign tax credit only if "if the item of income is subjected in Italy to a final withholding tax by request of the recipient of the said income in accordance with Italian law." Second, it argued that the article must be construed according to its plain meaning. Consequently, when an item of foreign income, such as foreign dividends, are received by Italian resident individuals other than within the course of a business, and for that reason are subject to separate taxation on a mandatory basis the treaty limitation that prevents the individual from claiming foreign tax credits does not apply. The U.S. taxes may be claimed as a credit against the Italian income taxes due on the U.S. source income.

As support for its interpretation, the Italian Supreme Court pointed to the different wording adopted in other income tax treaties entered into by Italy. Under those treaties, Italy can deny the foreign tax credit the request of the recipient or otherwise, meaning under a provision of Italian domestic law.

Based on the above, the Italian Supreme Court ruled that the Italian resident individual was entitled to the benefit of a foreign tax credit on U.S. source dividends based on a straightforward reading of Paragraph 3 of Article 23 (Relief from Double Taxation) of the Italy-U.S. Income Tax Treaty. It clearly states that Italy can deny the foreign tax credit only if the item of income is subjected in Italy to a final withholding tax by request of the recipient in accordance with Italian law.

The principle stated by the Italian Supreme Court should apply not only to foreign dividends taxed by way of a substitutive tax paid by the individual, but also when such dividends are received through an authorized financial intermediary which applies final withholding tax.

PATH FORWARD

In light of decision No. 25698/2022 of the Italian Supreme Court, recipients of foreign source dividends should be able to claim foreign tax credit in respect of the foreign taxes applied on the dividends provided that (i) a tax treaty between Italy and the country of the company paying the dividends is applicable and (ii) according to such treaty Italy can deny the foreign tax credit solely with respect to items of income subject to withholding tax upon request of the recipient.

In moving forward, several additional considerations should be taken into account.

Italian domestic rules provide for conditions and limitations that are not envisaged in the tax treaties and the question arises as to whether those conditions and limitations apply when the foreign tax credit is granted on the basis of an applicable tax treaty.

Moreover, from a practical perspective it is not clear what remedies are available in order to claim the foreign tax credit.

In relation to past years, for which the Italian taxes have already been paid, the only available instrument is to file a refund request with the Italian Revenue Agency, claiming a refund of the Italian taxes that would have not been paid had the foreign tax credit been applied. Under the Italian statute of limitations, refund requests must be filed within 48 months from the date of payment. In case the Italian Revenue Agency denies the refund outright or because the failure to answer a refund claim within 90 days is deemed to be a denial, it would then be necessary to appeal the denial before a tax court.

As far as dividends subject to Italian withholding tax are concerned, given that the dividends are not reported in the tax return of the recipient, it is technically not possible to claim the foreign tax credit in the tax return. Perhaps the withholding tax agent could consider adjusting the Italian withholding tax so that it is net of the foreign tax credit. However, lacking a specific rule, the withholding tax agent would likely be exposed to penalties.

If there is no authorized financial intermediary intervening in the payment, the dividends must be reported in the tax return by the Italian resident recipient and be subjected to substitutive tax. However, the tax return does not plainly allow to use the foreign tax credit against the substitutive tax on dividends.

On a go-forward basis in the absence of legislation, a prudent solution taking into account the risk of penalties is to pay the Italian taxes by way of withholding tax or substitutive tax without using the foreign tax credit and then to file a refund request to recover the higher taxes that have been paid.

The principle stated by the Italian Supreme Court is not limited to foreign source dividends. It should apply to any other items of income that are subject to separate taxation with no option covering inclusion in ordinary income. In particular, it applies to capital gains on shares in non-Italian resident companies realized by Italian resident individuals, to the extent that the applicable tax treaty allows the source country to tax the capital gain.

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ITALY: NEW CLARIFICATIONS CONCERNING THE TAXATION OF TRUSTS AND BENEFICIARIES

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Tags
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Trust Beneficiaries
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INTRODUCTION

A trust is an instrument having extreme flexibility and adaptability. For those reasons, it is becoming more and more common in the field of estate and succession planning as a simple and effective solution to protect an individual's assets from uncertain events. It is customarily used in generational transfers of family assets and businesses, the achievement of charitable purposes, and the protection of vulnerable individuals.

Italy does not have proper civil rules regulating trusts, but the use of trusts has been recognized in Italy through the ratification of the Hague Convention of July 1, 1985 (enforced with the Law n. 364/89 and came into force since January 1, 1992). Nonetheless, the increasing use of trusts in Italy has raised several questions about tax treatment for trusts, settlors, and beneficiaries.

In this context, the Italian tax authorities released Circular Letter No. 34/E on October 20, 2022, providing guidance on several key issues surrounding trusts. It provides many important clarifications making trusts even more attractive for individuals resident in Italy and international families having one or more beneficiaries resident in Italy or wishing to relocate to Italy. By way of example, capital distributions involving assets located outside of Italy can be totally exempt from taxation in Italy when made by an irrevocable, discretionary trust established by a settlor resident abroad.

This article examines the principal provisions of Circular Letter No. 34/E and provides a comprehensive view of the tax treatment of trusts in Italy. Several practical examples are discussed.[1]

TAX TREATMENT OF TRUSTS, SETTLORS, AND BENEFICIARIES

The tax treatment of trusts, settlors, and beneficiaries varies depending on (i) the type of trust from an Italian tax perspective (*i.e.* opaque, transparent, or disregarded), (ii) the nature of the trust based on actual activity carried out (*i.e.* commercial or non-commercial trust), and (iii) the residence of the trust for tax purposes.

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[1] The examples provided are based on the interpretation of recent clarifications provided by the Italian tax authorities. Because some points remain unclarified, the examples may need to be revised in the event additional clarifications are issued by the Italian tax authorities.

Type of Trusts

- **Disregarded Trust.** To be treated as a disregarded trust, a trust must be (i) a revocable trust or (ii) a trust where the settlor or the beneficiaries have a power or *de facto* control or influence to manage the trust assets or dispose of either the assets held in trust or the income from such assets.

  With Circular Letter 61/E/2010, the Italian tax authority listed some cases in which a trust should be considered a disregarded entity for tax purposes:

  - Trusts where the settlor or the beneficiaries can terminate the trust at will.
  - Trusts where the settlor can, at any time appoint himself or herself as beneficiary.
  - Trusts where the trustee cannot administer the trust without the prior consent of the settlor or of the beneficiaries.
  - Trusts where the settlor has the power to revoke the trust assigning trust assets to himself or herself or to other beneficiaries.
  - Trusts where the beneficiaries have the right to receive an anticipated attribution of the trust assets during the life of the trust.
  - Trusts where the trustee must follow the directions provided by the settlor with reference to the management of the trust assets and the trust income.
  - Trusts where the settlor has the power to modify the list of beneficiaries during the life of the trust.
  - Trusts where the settlor can appoint income or assets, or provide loans, to persons appointed by the settlor.
  - Trusts where the administrative and dispositive powers of the trustee are limited, or can be affected, by the settlor or by the beneficiaries

- **Transparent Trust.** To be treated as a transparent trust, a trust must be a fixed-interest trust or another trust where the beneficiaries are identified. According to the interpretation of the tax authorities, a beneficiary is identified when he is not only named as a beneficiary, but also has an enforceable right to the payment of his share of the trust's income.

- **Opaque Trust.** To be treated as on opaque trust, a trust must be irrevocable and discretionary, meaning that the trustee has a discretionary power to appoint income and capital to beneficiaries.

Nature of Trusts

- **Commercial Trust.** To be treated as a commercial trust, the exclusive or principal object of the trust must have a commercial nature, meaning that the activity performed results in the generation of business income pursuant to Art. 55 Italian Income Tax Code, ("I.T.C.").

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- **Noncommercial Trust.** This category is a residual category. To be treated as a noncommercial trust, a trust must not be a commercial trust.

Tax Residence of Trusts

- **Resident Trust.** To be treated as a resident trust, the place of administration of the trust must be located in Italy or its principal business must be carried out in Italy.

  The Italian tax legislation provides two anti-tax avoidance presumptions for a trust to be considered fiscal resident in Italy, even if none of the listed conditions are met.

  - The first provides that a trust is presumed to be resident in Italy if (i) a trust is established in a jurisdiction not included in the white list of countries that allow exchanges of information with Italy and (ii) at least one of its settlors and one of its beneficiaries is an Italian resident person. Circular 48/E/2007 clarifies that, for the purposes of this rule, the tax residency of the settlor is tested at the time of establishment of the trust. Therefore, if at the time of formation of the trust any settlor was an Italian resident person, the anti-abuse rule applies, even though the settlor becomes nonresident at a later stage. For beneficiaries, tax residence is tested in each taxable period during the life of the trust. The taxpayer can rebut the presumption by providing evidence that the trust is considered to be nonresident in Italy according to the general rules. This means that the trust's place of effective management or place of business is located outside Italy.
  - The second addresses the addition of Italian situs real property by a resident person to a trust settled in a State that is not a white-list State. In that fact pattern, the trust is considered to be resident in Italy when, after its formation, an Italian resident person transfers to the trust full or limited ownership rights to Italian real property. Also in this case, the taxpayer can rebut the presumption by providing evidence that the trust is considered to be nonresident in Italy under general rules.

- **Nonresident Trust.** To be treated as a nonresident trust, the place of administration of the trust must be located outside of Italy and its principal business must not be carried on in Italy.

"According to Italian tax law, resident opaque trusts are treated as taxable persons for corporate income tax purposes."

DIRECT TAX PROVISIONS

Italian Resident Opaque Trusts

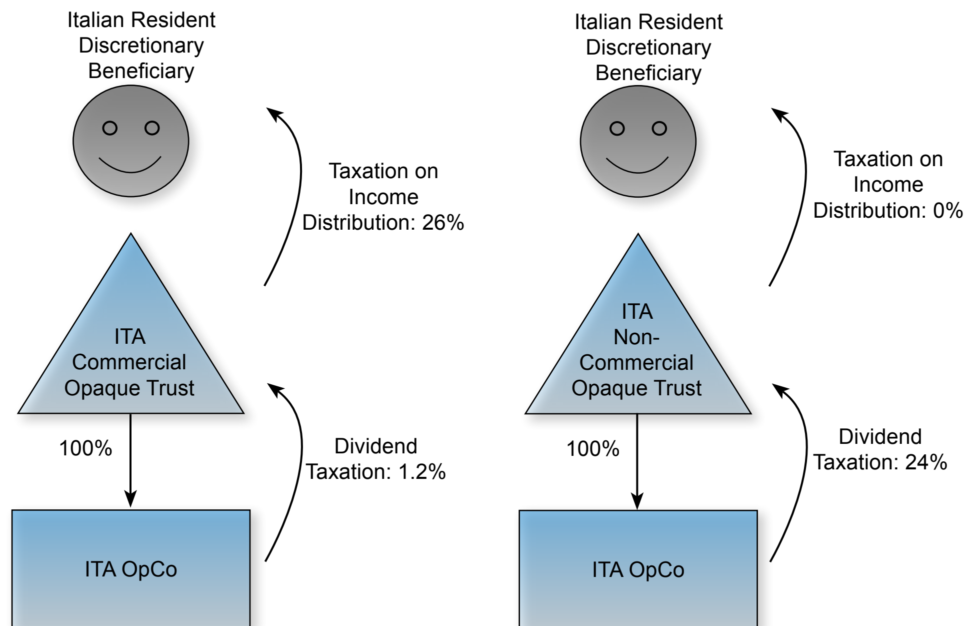
According to Italian tax law, resident opaque trusts are treated as taxable persons for corporate income tax purposes. Taxation of worldwide income occurs at the trust level.

Within the category of opaque trusts, a distinction must be made between opaque commercial trusts and opaque noncommercial trusts.

- For a commercial trust, income must be determined under the rules applicable to business income,[2] including the rules exempting capital gains[3] and dividends from tax.[4] Income is subject to corporate income tax (I.R.E.S.), levied at a rate of 24%. A subsequent income distribution to a discretionary beneficiary is subject to a withholding tax imposed at a rate of 26%. In addition, profits reserves of the commercial trust are considered to be distributed to beneficiaries before capital reserves,[5] regardless of the nature of the reserve to which the trustee has allocated the amounts distributed to the beneficiaries.

- For a noncommercial trust, income must be determined by applying the same rules which apply to individuals. By way of example, capital gains that are derived from the sale of a property held for over five years is not subject to taxation. Once income is determined, it generally is subject to I.R.E.S., levied at a rate of 24%, except for certain financial income[6] that is subject to the substitute tax, levied at a rate of 26%. Subsequent income distributions to a discretionary beneficiary are not subject to additional taxation.

The following diagram illustrates the differences in taxation of dividend income paid by an Italian operating company to an Italian resident commercial opaque trust and an Italian resident noncommercial opaque trust and distributed by the trust to a beneficiary that is an Italian resident individual.



[2] Article 81 and following provisions of the I.T.C.

[3] Article 87, regulating the participation exemption regime.

[4] Article 89, I.T.C. which provides for an exclusion from taxable base of 95% of the gross dividend.

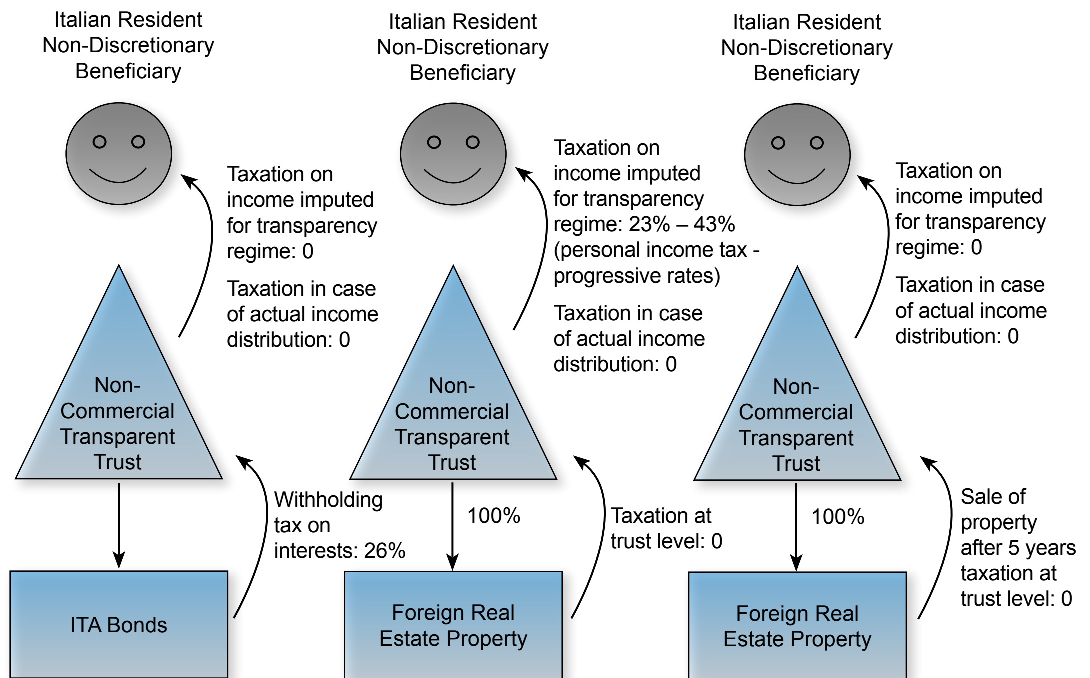
[5] Article 47 (1), I.T.C.

[6] Dividends are not subject to 26% withholding/substitute tax but at 24% corporate income tax.

Transparent Trusts

Whether resident or nonresident, a transparent trust is not considered to be a taxable entity. As a result, the worldwide income of the trust is subject to taxation on an accrual basis at the level of Italian resident beneficiary. Where the beneficiary is an individual, the income imputed to him is added to his taxable income, and taxed at progressive tax rates that range from 23% up to 43%. Where the trust income has already been subjected to a final withholding tax or a substitute tax in Italy, no further tax is due at the level of the beneficiary. Either way, no further tax is due at the time of an actual distribution to an Italian resident beneficiary.

The following diagram illustrates taxation in three different fact patterns involving income received by a noncommercial transparent trust. In one fact pattern, the trust receives interest income derived from Italian bonds held with an Italian financial institution. In the second fact pattern, the trust receives rental income from real estate located outside of Italy. In the third fact pattern, the trust realizes a capital gain from real estate held for more than five years.



Foreign Opaque Trusts

As a general rule, foreign trusts are treated as taxable persons for corporate income tax purposes and subject to taxation in Italy in respect of income produced in Italy only. Where a trust is a foreign opaque trust, the taxation of an Italian resident beneficiary on eventual income distributions will vary depending on whether the trust is established in a low-tax jurisdiction described in Article 47-bis I.T.C.

Income distributions from a foreign opaque trust established in a low-tax jurisdiction are treated as taxable income for an Italian resident beneficiary. If the beneficiary is an individual, progressive tax rates apply, ranging from 23% to 43% on the amount received. Where the trust receives Italian source income on which Italian tax has

been paid at the trust level, no additional Italian tax is imposed on an Italian resident beneficiary when that Italian source income is distributed.

In the case of a foreign opaque trust established in a low-tax jurisdiction, where it is not feasible to differentiate contributed capital from income generated by the trust, the entire amount distributed to a Italian resident beneficiary resident is presumed to be income for Italian tax purposes. This all-or-nothing characterization may be rebutted by accurate and complete accounting records prepared by the trustee or other documentation such as bank and financial account statements. In all instances, Italian tax rules will be applied in identifying income and capital. An accounting method applied by a trustee according to the rules of its country of residence or the country of residence of the trust will not be determinative for Italian tax purposes.

In order to understand if income distributions from a foreign opaque trust is established in a low-tax jurisdiction several factors must be evaluated. The first is the nominal rate of tax imposed on the trust. An opaque trust is deemed to be established in a low tax jurisdiction where the nominal level of tax in its country of residence is less than 12%, which amounts to 50% of the Italian corporate income tax of 24%. If the trust exclusively generates income of a financial nature, the nominal rate of tax must be less than 13%, which amounts to 50% of the Italian substitute tax on financial income, currently 26%. For this comparison, special tax regimes that directly affect tax rates or that provide exemptions or reductions in the tax base affect the nominal rate in the foreign country. The comparison between the foreign nominal level of taxation and the Italian one must be made at the time the income is generated by the trust.

The second is the place of establishment. A trust is established in a low-tax jurisdiction by reference to its place of tax residence at the moment of the distribution of income to an Italian resident beneficiary (provided that the income distributed was subject to taxation, at the time of its generation, in compliance with the minimum level of taxation provided for by the aforementioned Article 47-bis of the ITC). Where a trust has more than one trustee and can be viewed to have residence in more than one jurisdiction, the state of residence is the state where the trust is actually taxed. In the event that the trust is not considered to be tax resident in any state based on relevant local criteria so that no tax is imposed on the trust or its Italian resident beneficiary, a trust is considered to be established in the state where the trust's administration activity is predominantly carried out.[7] Finally, a trust established in an E.U. or E.E.A. Member State may be considered as established in a low tax jurisdiction if it benefits from a tax exemption regime provided for offshore trusts.

If a foreign opaque trust is considered to be established in a jurisdiction other than a low tax jurisdiction, Italy will impose tax only on income generated in Italy. Distributions of income to a discretionary beneficiary residing in Italy are not taxed.

Disregarded Trusts

If a trust is a disregarded trust, its income is imputed directly to the settlor or a beneficiary based which party has de jure power or *de facto* power to (i) control or influence the management of trust assets or (ii) dispose of trust assets or income. In other words, the trust is deemed not to exist for Italian tax purposes.

[7] These trusts are referred to as resident but not domiciled trusts.

INDIRECT TAX PROVISIONS

Time of Payment of Inheritance and Gift Tax

Prior to the release of Circular Letter 34/E, the position of the Italian tax authorities was that a settlor's transfer of assets to a trust ("*atto dispositivo*") constituted an immediate gratuitous transfer subject to inheritance and gift tax ("I.H.G.T."). The Italian Supreme Court expressed a different view in several recent cases. It adopted a clear rule that the transfer of assets in favor of a trustee is a temporary transfer. The effective transfer by the settlor occurs at a later stage, at the time of distribution of assets to beneficiaries.

The Italian tax authorities have now aligned their position to the approach of the case law. The addition of assets into trusts represents a non-taxable event for I.H.G.T. purposes. Consequently, I.H.G.T. will be applied only upon the enrichment of the beneficiary which occurs (a) upon distribution of the capital to the beneficiaries or earlier (b) in case of beneficiaries acquiring a vested interest over the trust's assets.

Distributions of income are not instead subject to I.H.G.T. but rather to income tax, in the manner described above.

"Distributions of income are not instead subject to I.H.G.T. but rather to income tax . . ."

In applying its new position, the Italian tax authorities have adopted a grandfather rule. For settlements effected in earlier years where I.H.G.T. was paid at the time of contribution of assets to a trust, Circular 34/E provides that that no additional I.H.G.T. will be due upon capital distribution to the beneficiaries. The grandfather rule applies only where assets that have been transferred to the trust and the beneficiaries have not changed. Where the final transfer of assets is made to a different beneficiary or relates to assets or rights other than those transferred and taxed at the moment of the contribution of assets to the trust, I.H.G.T. previously paid at the time of contribution can be credited against the I.H.G.T. due when assets are transferred to beneficiaries. Alternatively, taxpayers may claim a refund of I.H.G.T. provided that the three-year statute of limitations from the date of payment has not elapsed.

Tax Rates and Tax Base

I.H.G.T. is levied on the worldwide assets transferred by an Italian resident transferor. It is also imposed on the transfer of Italian-situs assets transferred by a nonresident transferor. I.H.G.T. tax rates range from 4% to 8% subject to exemptions of up to €1.0 million depending on the degree of kinship between the transferor and the transferee. The degree of kinship, the computation of the tax base, and the rate of I.H.G.T. applicable to a transfer is determined at the moment of the transfer of assets to a beneficiary. The resident or nonresident status of the settlor is determined at the time assets are contributed to the trust. Finally, assets held in a disregarded trust are subject to I.H.G.T. at the time of the death of the settlor.

Examples of Application

The following examples illustrate the way I.H.G.T. will now be applied.

Example 1

A trust was established by a nonresident with regard to Italy many years ago by means of a contribution of foreign financial assets into a foreign resident trust. The

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trust is not a disregarded from an Italian tax perspective. Mr. X is a beneficiary. At the time the trust was funded, Mr. X was a tax resident in a country other than Italy. At some point thereafter, Mr. became a tax resident of Italy. He is subject to the ordinary regime for residents. After his relocation to Italy, Mr. X receives a capital distribution from the trust.

The capital distribution is not subject to Italian I.H.G.T., and as a capital distribution, it is not subject to any income tax. The residency of the trust in a white list jurisdiction or a low tax jurisdiction has no effect on Mr. X's Italian tax position with regard to the capital distribution, with one possible exception. If the trust is an opaque trust resident in a low tax jurisdiction the trustee's accounting records, supported by bank account statements and financial account statements must clearly document that the distribution is a capital distribution legally and in substance. That determination is made according to Italian tax rules applicable to trusts.

Example 2

Ms. Y is a tax resident of a country other than Italy. She establishes a revocable trust to which she contributes Italian real property. After five years, Ms. Y meets an untimely death. At the conclusion of her life, Ms. Y continued to be a tax resident of the same country.

No I.H.G.T. is due at the moment of contribution of the Italian real property to the revocable trust. However, at the conclusion of her life, the Italian real estate property is subject to Italian I.H.G.T.

TAX REPORTING OBLIGATIONS AND WEALTH TAXES

The Italian tax authorities clarified that the current legislation concerning tax reporting obligations applies to individuals who qualify as "beneficial owners" of assets held in trust. It does not matter that the legislation makes no explicit reference to trusts. The reporting obligations may be summarized as follows:

- Italian tax reporting obligations that are typically made on Form RW of the Italian tax return are not extended to the trustee or the protector. In addition, the obligation is not extended to the settlor, provided the trust is not deemed to be disregarded for Italian tax purposes.
- Regarding Italian resident noncommercial opaque trusts, the Italian tax reporting obligations fall upon the trust, itself.
- Italian tax resident beneficiaries of nondiscretionary trusts are required to fulfil the Italian tax reporting obligations disclosing the value of the foreign investments and financial assets held by the trust, as well as their share in the trust's assets.
- Regarding foreign opaque trusts, resident beneficiaries are required to comply with Italian tax reporting obligations, provided that (i) the beneficiaries are identified, or can be easily identified, pursuant to the trust deed and to the related documentation and (ii) such beneficiaries have available information; for example, where the trustee communicates a trust decision to attribute the income or capital of the trust fund to a resident beneficiary.

- No tax reporting obligations arise for second degree beneficiaries, meaning individuals who only have a right to income or assets of the trust after the primary beneficiaries ceases to hold such interest; note that a different conclusion is possible if the relevant provisions of the trust provides that a purported second degree beneficiary has at least a potential right to receive a distribution from the trust during the lifetime of the primary beneficiaries.

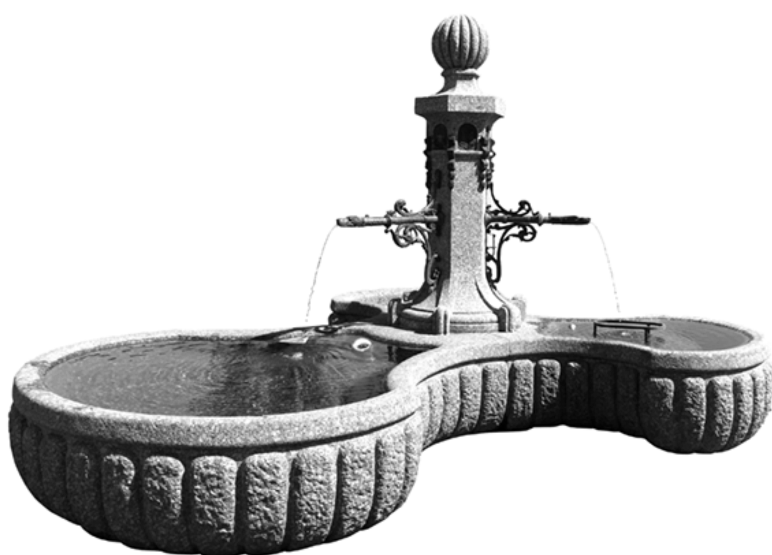
WEALTH TAX

Beginning with the 2020 tax period, noncommercial trusts that are resident in Italy are subject to wealth taxes on real property and financial assets held abroad (respectively, "I.V.I.E." and "I.V.A.F.E.").

In very general terms, wealth taxes apply to noncommercial trusts at the following rates:

- Financial assets held abroad are subject to an annual tax at the rate of 0.2%.[8] The tax is capped at €14,000. The tax base is the fair market value for listed assets and nominal value for unlisted assets.
- Real estate located abroad are subject to an annual tax at the rate of 0.76%. The tax base is the original purchase price, except for real estate located in an E.U. or E.E.A. Member State. If exchange of information programs are in place with an E.U. or E.E.A. Member State, the tax base is the value resulting from foreign cadastral registers or other deemed value relevant to foreign income, wealth or transfer taxes.

Lastly, Italian tax resident beneficiaries of a trust that is not a disregarded trust are not subject to Italian wealth taxes.



[8] For bank accounts, I.V.A.F.E. applies at a fixed amount of €100.

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KEY FEATURES OF THE NEW-FANGLED BELGIUM-FRANCE INCOME TAX TREATY

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INTRODUCTION

After nearly two decades of negotiations, Belgium and France signed a new Income Tax Treaty on November 9, 2021 (the "New Treaty"). The New Treaty is in line with the latest O.E.C.D. standards, incorporates the applicable provisions of the Multilateral Instrument (the "M.L.I."), and addresses salient tax issues for taxpayers engaging in cross border transactions involving Belgium and France.

The New Treaty will enter into force when both Belgium and France complete the ratification procedure. In Belgium, the consent of the Federal Parliament and five Regional Parliaments is required. In practice, the New Treaty should not enter into force before January 2023. Until then, the Belgium-France Income Tax Treaty of March 10, 1964 (the "Current Treaty") will remain applicable.

TAXES COVERED

In contrast with the Current Treaty that only applies to income taxes, the New Treaty will cover wealth taxes in addition to income taxes. This larger scope will impact application of (i) the French real estate wealth tax, (ii) the Belgian "Cayman Tax," which imposes Belgian income tax on profits derived through certain low-tax offshore structures, and (iii) the Belgian securities accounts tax, which imposes a tax of 0.15% on securities accounts having an average value in excess of €1.0 million.

RESIDENT STATUS

Under the Current Treaty, a legal entity qualifies as "resident" depending on the location of its effective place of management, without any requirement to be subject-to-tax in Belgium or France. This changes under the New Treaty, which is in line with the latest O.E.C.D. standards. Now, a resident is defined as "any person who, under the laws of [Belgium or France], is liable to tax therein by reason of the person's domicile, residence, place of management or any other criterion of a similar nature." Consequently, a juridical or natural person who is not subject-to-tax in Belgium or France is no longer eligible for Treaty protection.

The new subject-to-tax requirement should exclude most, but not all, investment funds:

- Collective investment undertakings and pension funds may claim benefits under Article 10 (Dividends) and Article 11 (Interest) of the New Treaty even if not "resident" under the standard definition.

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- French translucent entities, such as *sociétés civiles immobilières* (“S.C.I.’s”),[1] will be eligible for Treaty protection provided certain conditions are met. The New Treaty treats partnerships, group of persons, or similar entities as “residents” where the entity (a) has its effective place of management in France, (b) is subject to tax in France, and (c) all of its shareholders, partners, or members are personally subject to tax based on their respective shares in the profits of the entity.

PERMANENT ESTABLISHMENTS

Article 5 of the New Treaty adopts the M.L.I. definition of the term “Permanent Establishment” (“P.E.”), thereby enabling French and Belgian tax authorities to challenge artificial arrangements designed to avoid the existence of a P.E. status.

First, the New Treaty broadens the circumstances in which a dependent agent will constitute a P.E. In addition to the existing rule where a dependent agent “acts and habitually concludes contracts on behalf of an enterprise,” a P.E. will exist where a person “habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise.”

Second, the New Treaty narrows the circumstances in which an agent will be viewed to be an independent agent. Any person who “acts almost exclusively on behalf of one or more enterprises to which that person is closely related” will be deemed not to be an independent agent as to those enterprises. A person is deemed to be “closely related” to an enterprise if one controls the other or both are under the control of the same persons or enterprises. The determination is made based on all the relevant facts and circumstances. Control will typically exist where one of the parties holds a direct or indirect beneficial ownership interest in the other in excess of 50%.

Third, the New Treaty includes an anti-fragmentation rule that applies when determining whether an activity has a “preparatory or auxiliary character” and, for that reason, is not considered to be a P.E. Activity that ordinarily would not constitute a P.E. under Paragraph 4 may be considered to be a P.E. under new Paragraph 4.1 which provides the following limitation:

> Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and
>
> a. that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or
>
> b. the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,

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[1] S.C.I.’s are corporations that have legal personality under French corporate law, but can elect to be treated as flow-through entities for French corporate tax purposes.

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> provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.

In a deviation from the M.L.I., which provides that a building site or a construction and/or installation project must exist for 12 months in order to be treated as a P.E., the New Treaty provides that a P.E. will exist if the site or project exists for nine months. Under the Current Treaty, the period is six months.

REAL ESTATE INCOME

Under the Current Treaty, income derived from immovable property is taxed only in the country where the property is located. This rule is consistent with the traditional O.E.C.D. approach and remains unchanged in the New Treaty.

What is changed by the New Treaty is the treatment of real estate income derived by a Belgian corporation that invests in an S.C.I. or other entity that has legal personality but is treated as tax transparent in France.

"Given the tax transparency of S.C.I.'s, French tax authorities take the position that an S.C.I.'s real estate income should be treated as real estate income derived by shareholders."

Given the tax transparency of S.C.I.'s, French tax authorities take the position that an S.C.I.'s real estate income should be treated as real estate income derived by shareholders. Under this view, the income should be taxable in France under Article 6 (Immovable Property) of the Current Treaty because France is the State where the property is located. In contrast, Belgian tax authorities take the position that, because an S.C.I. has legal personality, income derived by individual shareholders should be characterized as dividends and taxed in Belgium. Not surprisingly, the disparity in views has given rise to tax disputes between the tax authorities of the two States.

The New Treaty addresses the dispute in Article 6 (Immovable Property) and Article 22 (Elimination of Double Taxation). The New Treaty provides that any income distributed by an S.C.I. will be characterized in accordance with Belgian domestic law.

Where the shareholder of an S.C.I. is a Belgian corporation, the income will be taxed in Belgium. The New Treaty allows the Participation Exemption to apply. This is a major development as Belgian tax authorities have argued that the Participation Exemption is not automatically applied.

Generally, corporations with legal personality but that are transparent for corporate tax purposes do not satisfy the qualitative (or subject-to-tax) test. The New Treaty confirms that the subject-to-tax test will not be applied at the level of the S.C.I., provided the Belgian corporate shareholder is taxed in France on the profits of the S.C.I. in proportion to the rights it holds. Other conditions for the Belgian Participation Exemptions remain applicable. In other words, the Belgian corporation must have a minimum shareholding of 10% or a minimum investment of €2.5 million and the shares must be held for an uninterrupted period of at least one year at the time dividends are received. In addition, the Participation Exemption is subject to the condition that the Belgian corporation is taxed in France on the profits of the S.C.I. in proportion to the rights it holds.

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In a nutshell, Belgian corporations receiving dividends from French S.C.I.'s will be eligible for the Belgian Participation Exemption under the New Treaty, without assessing the "subject-to-tax" test at the level of the S.C.I.

DIVIDEND WITHHOLDING TAXES

Article 10 (Dividends) of the Current Treaty limits dividend withholding tax on dividends to a rate of 10% provided the beneficiary is a qualifying parent corporation and meets a minimum ownership percentage or a minimum value for the requisite period of time. If those conditions are not met, the withholding tax is imposed at the rate of 15%.

This will change in the New Treaty. Paragraph 2 of Article 10 of the New Treaty provides a full exemption from dividend withholding tax where the following conditions are met:

- The shareholder holds a direct participation of at least 10% in the share capital of the corporation issuing the dividend throughout a period of 365 days that ends on the day of payment of the dividend.
- The recipient is the beneficial owner of the dividends. Any change of ownership directly resulting from a corporate reorganization of the shareholder or the subsidiary, such as a merger or division, does not affect the calculation of the 365 days holding period.

In all other cases, the New Treaty reduces the dividend withholding taxes to 12.8%, provided the recipient is the beneficial owner of the dividend.

The beneficial owner concept is not defined in Belgian law or in treaties concluded by Belgium. The Commentary to Article 10 of the 2017 O.E.C.D. Model Convention defines a beneficial owner as "the person who has the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person."

Paragraph 6 of Article 10 of the New Treaty grants withholding tax relief for dividends paid out of income or gains derived from immovable property by an investment vehicle that (a) distributes most of this income annually, and (b) whose income or gains from such immovable property are exempt from tax. The reduction in withholding tax to 12.8% applies if the beneficial owner of the dividends directly or indirectly holds an interest representing less than 10% of the capital of the investment vehicle. Where the beneficial owner of the dividends directly or indirectly holds an interest of 10% or more of the investment vehicle, the dividends may be taxed at the domestic withholding tax rate of the source country.

In the absence of an applicable treaty, dividends paid by a Belgian resident corporation to a nonresident shareholder are subject to a 30% withholding tax. The tax is eliminated if the nonresident shareholder is entitled to the benefits of the Parent-Subsidiary Directive or is resident in a jurisdiction with which Belgium has an income tax treaty in force. Other exemptions and reduced rates are available under Belgian domestic law.

INTEREST WITHHOLDING TAXES

Article 11 (Interest) of the Current Treaty reduces withholding taxes on interest payments to 15%. Article 11 of the New Treaty provides for a full exemption. The exemption applies only when the recipient is the beneficial owner of the interest income.

In the absence of treaty relief, interest paid by a Belgian resident corporation or P.E. to a nonresident lender not entitled to the benefits of the Interest and Royalties Directive ("I.R.D.") is subject to a 30% withholding tax. The tax is eliminated if the I.R.D. is applicable to the interest payment.

Under Belgium's implementation of the I.R.D., and provided certain formalities are fulfilled, interest paid to an E.U. resident corporation is exempt from withholding tax where the recipient is (i) a corporation that holds directly or indirectly at least 25% of the capital of the borrower or (ii) is an associated corporation in relation to the borrower. For these purposes, two corporations are associated if at least 25% of the capital of each of the two corporations is owned directly or indirectly by the same E.U. resident corporation. The formalities are that corporations must have a legal form listed in the annex to the I.R.D. and be subject to corporate income tax.

CAPITAL GAINS TAXATION

Capital Gains on Substantial Holdings by French Individuals

At the present time, Belgium does not have any wealth tax and only exceptionally applies capital gains tax on the sale of shares, which makes it attractive as a place for wealthy investors to reside. For example, the French actor Gérard Depardieu caused a media storm in 2012 after stating that he would move his residence to a small municipality in Belgium, close to the French border, shortly after a so-called "super-tax" on earnings above €1.0 million was introduced in 2012 when François Hollande became President of the French Republic. Even if the French "super-tax" was short-lived as it was repealed in 2015 by François Hollande under public pressure, Belgium became an attractive location for French nationals having sizeable investment portfolios.

For at least two reasons, the attraction of Belgium may come to an end if capital gains tax is the driver for relocation. First, the Belgian Finance Minister has recently announced the intention of the Government to tax capital gain on shares realized by Belgian individuals at a rate of 15%.[2] Second, Paragraphs 2 and 3 of the New Treaty allows France to tax the gains of Belgian residents if the following conditions are met:

- The Belgian resident was previously a French resident for at least six years during the ten-year period preceding the establishment of tax residence in Belgium.
- The capital gain relates to the disposition of shares representing more than 25% of a French corporation.

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[2] For further details about the reform, click here for the French text and here for the Dutch text.

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- The tax is imposed only on shares owned on the date the individual establishes Belgian residence.
- The gain is realized within the first seven years after the departure from France.

If an individual who would otherwise be subject to the capital gains tax contributes shares in a French corporation to a Belgian holding corporation, French tax can be imposed on the Belgian holding corporation.

Capital Gains on the Shares of a French Real Estate Corporation

Under the Current Treaty, Belgian residents realizing a capital gain from the sale of shares in a French real estate corporation are exempt from taxation in France and Belgium. The Current Treaty allocates the taxing rights to Belgium, but in most instances, capital gains realized on the shares of a French real estate corporation are exempt from Belgian tax under domestic law.

French tax authorities challenged the double no-tax result, and in 2020, the French Council of State affirmed the position of the tax authorities. The New Treaty adopts the views of the French tax authorities. Paragraph 2 of Article 13 of the New Treaty provides as follows:

> Gains from the alienation of shares or other rights in a company, trust or comparable institution, the assets of which derive more than 50% of their value directly or indirectly from immovable property referred to in Article 6 and situated in a Contracting State, not being property used by such company for the conduct of its business activities, or of rights relating to such property, may be taxed in that State if, under the laws of that State, such gains are subject to the same tax regime as gains from the alienation of immovable property. For the purposes of this provision, no account shall be taken of gains derived from the alienation of shares quoted on a regulated stock exchange in the European Economic Area.

Consequently, when the New Treaty is effective, a Belgian resident individual realizing a capital gain upon the sale of the shares or parts of a French S.C.I. will be subject to a 19% nonresident personal income tax in France and the 7.5% French solidarity tax. If the Belgian resident is a corporation, the 25% French nonresident corporate income tax will be imposed.

FOREIGN TAX CREDIT ON FRENCH-SOURCE DIVIDENDS

Belgian Corporate Shareholders

As previously mentioned, Paragraph 2(c) of Article 22 of the New Treaty confirms that French-source dividends will be exempt from Belgian corporate income tax under the conditions and within the limits provided for in Belgian domestic law.

If the Belgian corporate shareholder is not eligible for the Belgian Participation Exemption, the French tax levied on the dividend income may be claimed as a credit against the Belgian tax liability, which is quite unique in the history of Belgian income tax treaties.

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Belgian Individual Shareholders

In principle, French-source dividends paid to Belgian individuals are subject to a 12.8% dividend withholding tax in France and a 30% income tax in Belgium. To avoid double taxation, the Current Treaty requires Belgium to grant a foreign tax credit equal to at least 15% of the net dividend, after deduction of the French withholding tax. However, in 1988, Belgium abolished the foreign tax credit under its domestic law, subject to certain exceptions. As a result, the Belgian tax authorities refused to allow the foreign tax credit. This position was challenged in court and the Belgian Court of Cassation ruled in favor of taxpayers in three separate cases decided in 2017, 2020 and 2021. Each time, the court explained that international law trumps national law. Consequently, the absence of a national tax rule cannot be used to deny the application of a treaty provision.

After years of litigation, the Belgian tax authorities issued their Circular Letter of May 28, 2021 (the "Circular Letter"), allowing a foreign tax credit on French-source dividends, as mentioned in the Treaty. While Belgian individuals have enthusiastically welcomed the Circular Letter, it will be reversed by reason of Paragraph 2(e) of the New Treaty, which makes the foreign tax credit allowed in the New Treaty to be subject to the provisions of Belgian law, stating as follows:

> Subject to the provisions of Belgian law regarding the deduction from Belgian tax of taxes paid abroad, where a resident of Belgium derives items of his aggregate income for Belgian tax purposes which are interest or royalties, the French tax charged on that income shall be allowed as a credit against Belgian tax relating to such income.

As a result, the total tax burden on Belgian individuals receiving French-source dividends will be increased from 25.88% to 38.96% as indicated in the following table.

NUMERICAL EXAMPLE UNDER THE CURRENT TREATY

Gross Distributed Dividend	€100
– French Dividend W.H.T. of 12.8%	*– €12.8*
Net Dividend Taxable in Belgium	€87.2
– Belgian Dividend W.H.T. of 30%	*– €26.16*
Net Intermediary Dividend	€61.04
+ Belgian Foreign Tax Credit of 15%	*+ €13.08*
Net Dividend	**€74.12**
Total Tax Burden	**25.88%**

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NUMERICAL EXAMPLE UNDER THE NEW TREATY

Gross Distributed Dividend	€100
– French Dividend W.H.T. of 12.8%	*– €12.8*
Net Dividend Taxable in Belgium	€87.2
– Belgian Dividend W.H.T. of 30%	*– €26.16*
Net Dividend	**€61.04**
Total Tax Burden	**38.96%**

This suggests that Belgian resident individuals may wish to accelerate the distribution of dividends from French companies to a date that is prior to the effective date of the New Treaty, wherever possible.

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GREEK TAX INCENTIVE REGIMES FOR NEWLY ARRIVED RESIDENTS AND FAMILY OFFICES

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Tags
Family Office
Greece
High Income Earners
Non-Domiciled Taxation
Pensioners

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INTRODUCTION

The segment of European countries that have enacted favorable tax regimes designed to attract the wealthy are well known. Switzerland has its *forfait* regime, the U.K. has its Nondom Tax Regime, Portugal and Italy have new resident regimes, and Malta and Cyprus have favorable regimes designed to attract new residents. To that list of countries, Greece is a new arrival, having introduced several tax incentive regimes designed to create a favorable tax environment for nonresident individuals transferring tax residence to Greece and the establishment and operation of family offices in Greece. This article provides an overview of the most important Greek incentive provisions, which are (i) the 5A Nondom Tax Regime, (ii) the 5B Pensioners Regime, (iii) the 5C Employee and Self-Employed Regime, and (iv) the Family Office regime.

THE 5A NONDOM TAX REGIME

Tax Benefits

The Nondom Tax Regime provides an alternative taxation method for foreign source income generated by individuals who transfer their tax residence to Greece. The main features of the regime include the following benefits:

- A flat tax of €100,000 per year which satisfies total tax liability for foreign source income, including capital gains, regardless of the amount or classification of such income.
- The elimination of any requirement to declare foreign source income in Greece. Instead, a tax assessment reflecting a liability of a flat amount is issued by the tax authorities as of the last working day of June.
- The flat tax must be paid in one installment, typically on or before the last working day of July. A special rule applies for the first year of residence. Under that rule, the individual must pay the flat tax within 30 days from the date of notice that the individual qualifies for taxation under the Nondom Tax Regime. Should an applicant fail to pay the flat tax by the last day of the tax year, coverage in the Nondom Tax Regime is cancelled with immediate effect.
- The Nondom Tax Regime covers a maximum of 15 tax years, beginning with the year of application.
- The Nondom Tax Regime may be extended to close relatives, such as a spouse, ancestors, and descendants. The tax for each of those individuals who is covered by the regime is €20,000 per year, with the exception of

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underage children. The Greek inheritance and gift tax rules do not apply for relatives covered by the regime.

- An exemption from Greek inheritance or gift tax is granted covering all property located abroad.
- Because the Nondom Tax Regime is viewed to favorable, no foreign tax credit is available for any foreign tax paid on foreign source income covered by the regime.
- The Nondom Tax Regime does not have an impact on any Greek source income, which must be declared and taxed according to the general tax rules applicable in Greece.
- An individual covered by the Nondom Tax Regime may import funds from abroad without having to justify the source.
- An individual covered by the Nondom Tax Regime is expected to qualify as a Greek tax resident for income tax treaty purposes and qualifies for the issuance of a Tax Residence Certificate upon request.
- If in any year, an individual fails to qualify for the Nondom Tax Regime, the individual is taxed on worldwide income according to the general tax rules applicable in Greece. Failure to qualify could result from the failure to pay the flat tax, withdrawal from the program, or the running of the 15-year period of coverage. It is expected that the individual will move his or her tax residence abroad before becoming at risk to Greek tax on worldwide income.

Qualification for the Nondom Tax Regime

Two main conditions must be met for coverage by the Nondom Tax Regime:

- The applicant must not have been a Greek tax resident for seven out of the eight years prior to the transfer of tax residence to Greece.
- An investment of at least €500,000 in real estate properties or undertakings or transferable securities or shares in legal entities in Greece must be made either by the qualifying individual or through close relatives, such as a spouse, an ancestor, or a descendant, or a majority-owned legal. The investment generally must be completed within three years from the date of application and must be retained for the full duration of the regime. However, it does not apply for an individual who has obtained a specific type of residence permit related to investment activity in Greece.

There is no requirement in the law under which an individual must be present in Greece for a minimum period of time in order to qualify as a Greek tax resident under the Nondom Tax Regime. Given that the undertaking of significant investments in Greece demonstrates the intent of to render Greece as the center of vital interests, a leased or owned main residence in Greece must be declared.

Application Procedure

The procedure for obtaining tax residence under the Nondom Tax Regime involves the following steps:

- Applications with the competent tax authority must be made by March 31 of the respective tax year. Applications filed after that date will be deferred to the following tax year.
- Requests for extension of the application to relatives must be made by the same date.
- Decisions by the applicable authority are made within 60 days.
- Supporting documentation must be provided on a timely basis within the foregoing 60-day deadline.
- Evidence of completion of the investment must be filed within six months following actual completion.

THE 5B FOREIGN PENSIONERS TAX REGIME

The Foreign Pensioners Regime provides for an alternative taxation method for individuals who earn foreign source pension income and transfer their tax residence to Greece.

Tax Benefits

The main features of the Foreign Pensioners Tax Regime include the following benefits:

- Total foreign source income of the individual is subject to a flat tax rate of 7% per year, unless the income is exempt from tax based on an applicable income tax treaty. The reduced tax rate is not limited to pension income.
- The total foreign source income is exempt from the special solidarity contribution.
- Total foreign source income for tax year, together with income from sources in Greece, must be reported on an income tax return that is due non later than June 30 of the following tax year.
- Payment of the tax must be made in one installment, typically on or before the last working day of July of the following year. Should an applicant fail to pay the tax by the last day of the tax year, coverage in the Foreign Pensioner's Tax Regime is cancelled with immediate effect.
- The Foreign Pensioner's Tax Regime covers a maximum of 15 tax years, beginning with the year of application.
- The Foreign Pensioner's Tax Regime does not provide an exemption from Greek inheritance tax or gift tax for any property located abroad.
- A foreign tax credit is available for any foreign income tax paid on foreign source income covered by the Foreign Pensioner's Tax Regime. As mentioned above, if an income tax treaty applies to foreign source income, it must allocate taxing rights to both states.
- Any income that is derived from source in Greece is taxed in Greece under general tax rules.

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- An individual covered by the Foreign Pensioner's Tax Regime is expected to qualify as a Greek tax resident for income tax treaty purposes and qualifies for the issuance of a Tax Residence Certificate upon request.
- There is no option for extending coverage under the Foreign Pensioner's Tax Regime to the close relatives of the qualifying individual. Inclusion of the qualifying individual in the regime does not have an impact on the tax residency status of relatives.
- If in any year, an individual fails to qualify for the Foreign Pensioner's Tax Regime, the individual is taxed on worldwide income according to the general tax rules applicable in Greece.. Failure to qualify could arise from the failure to timely pay the 7% tax, a voluntary withdrawal from the Foreign Pensioner's Tax, or the running of the 15-year period of coverage.

Qualification for the Foreign Pensioner's Tax Regime

Three main conditions must be met for coverage by the Foreign Pensioner's Tax:

- Foreign source pension income must be received. Evidence of pension income is provided by any document certifying that an individual receives a pension that is paid by (i) a foreign social security institution, (ii) a governmental authority, (iii) an occupational pension fund, (iv) an insurance indemnity paid in a lump sum or in annual payments by a private insurance company in the context of a group pension plan.
- The applicant must not have been a Greek tax resident for five out of the six years prior to the transfer of tax residence to Greece.
- Prior to applying for the Foreign Pensioner's Tax Regime, the applicant must have been resident in a State with which Greece has a valid agreement on administrative cooperation in the field of taxation.

"Three main conditions must be met for coverage by the Foreign Pensioner's Tax."

There is no requirement in the law under which an individual must be present in Greece for a minimum period of time in order to qualify as a Greek tax resident under the Foreign Pensioner's Tax Regime. Hence, no undertaking is required as to the intent to spend a set number of days. Nonetheless, if an individual retains contacts with another jurisdiction it is likely prudent to be present in Greece for sufficient time each year and to maintain sufficient contacts in Greece to fend off an assertion of residence in the other State.

Application Procedure

The procedure for obtaining tax residence under the Nondom Tax Regime involves the following steps:

- Applications with the competent tax authority must be made by March 31 of the respective tax year. Applications filed after that date will be deferred to the following tax year.
- Requests for extension of the application to relatives must be made by the same date.
- Decisions by the applicable authority are made within 60 days.

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THE 5C EMPLOYEE AND SELF-EMPLOYED TAX REGIME

The Employee and Self-Employed Regime provides for an alternative taxation method for taxing Greek-sourced income from salaried employment and business activity by individuals who transfer tax residence to Greece.

Tax Benefits

The main features of the Employee and Self-Employed Regime include the following benefits:

- Exemptions from income tax and special solidarity contribution are provided annually for 50% of Greek source income deriving from salaried employment or business activity. The remaining 50% of this income is taxed in accordance with the general tax rules applicable in Greece, together with any other Greek or foreign source income.
- Total foreign source income for tax year, together with income from sources in Greece, must be reported on an income tax return that is due not later than June 30 of the following tax year.
- The Employee and Self-Employed Tax Regime does not provide an exemption from Greek inheritance tax or gift tax for any property located abroad.
- An individual covered by the Employee and Self-Employed Tax Regime is exempt from imputed income calculated based on deemed expenses for maintaining a place of residence, such as a house or an apartment, and a private car.
- The Employee and Self-Employed tax Regime covers a maximum of seven tax years, beginning with the year of application.
- An individual covered by the Employee and Self-Employed Tax Regime is expected to qualify as a Greek tax resident for income tax treaty purposes and qualifies for the issuance of a Tax Residence Certificate upon request.
- An individual that has been included in the Employee and Self-Employed Tax Regime may opt for the parallel inclusion in the Nondom Tax Regime or the Foreign Pensioner's Tax Regime, provided the relevant conditions for the other regimes are met.
- Following revocation of the Employee and Self-Employed Tax Regime an individual who remains a tax resident in Greece is taxed on worldwide income according to the general tax rules applicable in Greece. Revocation could arise from the cessation of the employment relationship or the business activity for more than 12 months, voluntary withdrawal from the regime or the running of a period of seven years.

Qualification for the Employee and Self-Employed Tax Regime

Four main conditions must be met for coverage by the Foreign Pensioner's Tax:

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- The applicant must not have been a Greek tax resident for five out of the six years prior to the transfer of tax residence to Greece.
- The applicant transfers tax residence from an E.U./E.E.A. Member State or from a State with which Greece has a valid agreement on administrative cooperation in the field of taxation.
- The applicant provides services in Greece in the context of a new employment relationship, which includes a position as a member of the board of directors of a Greek legal entity or an executive with a Greek permanent establishment. Alternatively, the applicant is self-employed and carries on business activity from a base in Greece.
- The applicant declares an intention to remain in Greece for at least two years.

Application Procedure

The procedure for obtaining tax residence under the Employee and Self-Employed Tax Regime involves the following steps:

- For employment or business activity taking place up to and including July 2 of each year, the application is filed by the end of that year. Applications filed after that date will be deferred to the following tax year.
- For employment or business activity that taking place after July 2 of each year, the application is filed in relation to the following year.
- Decisions by the applicable authority are made within 60 days.
- Supporting documentation is required to be filed within the 60-day deadline mentioned above. If supporting documents are not timely filed and the application is rejected, a partial cure is provided. Documents submitted by March 31 of the year following the rejection, the rejecting decision can be revoked. As a result, the application can be re-examined and a new decision issued within 60 days from the filing of the supporting documents.

THE FAMILY OFFICE TAX REGIME

Concept of Family Offices

A family office is a special purpose vehicle having as its exclusive purpose the management of assets and investments owned by individuals. The Family Office Tax Regime applies to family offices of Greek tax residents and members of their families. Investments of a Greek tax resident may be made directly or indirectly through legal entities. In addition to overseeing investments, a family office may manage expenses incurred by a wealthy Greek tax resident, or members of his family, relating to living costs, charitable activities, and cultural activities.

A family office may take the legal form of a *Société Anonyme*, a limited liability company, a private capital company, or a personal company or partnership, provided it is not formed for the purposes of carrying on activities of a nonprofit nature. It may be established in Greece or abroad. Similarly, its assets and investments under management may be located in Greece or abroad.

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Qualifying Members of the Family Office

To benefit from the Family Office Tax Regime, the office must be operated for the benefit of (i) a Greek tax resident individual, (ii) close family members of the resident, such as a spouse, parents and grandparents, and unmarried or underage children, and (iii) Greek or foreign legal entities in which the foregoing individuals hold a majority stake. Persons who benefit under the 5A Nondom Tax Regime, the 5B Foreign Pensioners Tax Regime, and the 5C the Employee and Self-Employed Tax Regime qualify as Greek residents for purposes of the Family Office Tax Regime.

Qualifying Conditions

The family office must meet the following conditions to qualify for the Family Office Tax Regime:

- It must employ at least five employees. This condition must be met not later than the 12-month anniversary of its establishment and must continue to be met at all times thereafter. Family members do not count as employees for this purpose.
- It must incur annual expenses in Greece of at least €1.0 million.

Qualifying Services

The following services may be provided by a family office:

- **Services related to the personal and social life of family members.** This category of services includes public relations, security, cooks, housekeepers, teachers, educators, babysitters, drivers, technicians, gardeners, cleaning services, supply of goods, and management of charity work.
- **Administrative support services.** This category of services includes secretarial support, management of human resources on behalf of family members, accounting, payment of expenses, management of bank accounts, technical support for the management and maintenance of real estate and surrounding areas, and organization of business trips.
- **Financial management services.** This category of services includes investment management and management of transfers of wealth.
- **Strategic planning services.** This category of services includes business consulting, real estate planning, succession planning. and educational planning.
- **Other advisory services.** This category of services includes tax services, consulting services, legal services, engineering services, medical services, compliance advice, risk management support, and cyber security services.

The family office cannot provide services or incur expenses that are not related to the fulfillment of its purpose. When providing qualifying services, the family office may employ the individuals performing the services, outsource the services to third parties located within Greece or located elsewhere. However, payments made to individuals or legal persons that are tax residents in noncooperative states or in states with a preferential tax regime will not be deductible by the family office unless they relate clearly to real and customary transactions.

Calculation Of Taxable Income

The gross income of a family office is determined on a cost-plus basis, using a 7% profit mark-up to all expenses maintained in properly kept tax records and paid through disbursements from the family office's bank account. Certain adjustments are made when computing the tax base.

- Depreciation expense is taken into account.
- Book tax expense is not taken income account.
- Where taxable income using the cost-plus method is less than book income, book income is used as the tax base in lieu of cost plus 7%.
- Once taxable income is determined, the general corporate tax rate of 22% is applied.
- Greek corporate income tax returns must be filed.
- Withholding tax must be collected where appropriate.
- Dividends to shareholders appear to be fully taxed, at this time.
- Payments for internal transactions taking place between the family office and its members are considered to be transactions made within one and the same entity and are outside the scope of V.AT.

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Qualification for the Family Office Tax Regime

Documentation is required to support the contention that the Family Office Tax Regime is applicable, meaning that the cost plus 7% income computation applies. The procedure is as follows:

- Tax returns for each year must be filed by a family office not later than July 31 following the close of the tax year.
- Within one month after filing the tax return, a family office must submit supporting documentation regarding all income and expenses taken into account in determining taxable income.
- Within one month following submission of the documentation, the tax authorities must accept the submission or notify the family office that the submission is not complete. The family office has 30 days to respond with additional information.
- The tax authorities may accept the additional information or begin an audit. An audit may also begin if the family office ignores the notification.

CONCLUSION

In comparison to the O.E.C.D., the European Commission, and the European Parliament, the Greek government has adopted well-thought-through provisions designed to attract wealthy families, retirees, executives, and family offices. At least one tax-examination cycle will be required to assure wealthy nonresidents that the plan works in practice as well as in theory.

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Ruchelman P.L.L.C. is a boutique law firm based in New York City. It was founded in 1989 by an alumnus of a legacy firm that is now Deloitte's.

Our firm provides a wide range of tax planning and commercial legal services to clients across the Americas, Asia, Europe, and the Middle East. Clients include global investors, multinational corporations expanding into the U.S., and U.S. businesses with international operations. Our core practice focuses on cross-border transactions.

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