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INSIGHTS

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EDITORS' NOTE

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

- **Removing the Cloak: the Corporate Transparency Act of 2021 — New U.S. Legislation Targeting Global Corruption.** Over the years, a consensus developed overseas that the U.S. does not adhere to international beneficial ownership reporting standards. The U.S. is a member of the Financial Action Task Force, but did little to adopt the Task Force's recommendations. Beginning in 2016, steps have been taken in the U.S. to change the view overseas. First, FinCEN adopted regulations requiring U.S. financial institutions to determine the natural persons who are the beneficial owners of accounts. This was followed by the adoption of the Corporate Transparency Act of 2021 ("C.T.A.") in 2021. The purpose of the C.T.A. is to create a national database of information regarding individuals who directly or indirectly hold substantial control over, or own a substantial interest in, certain domestic or foreign legal entities. Recently, final regulations were published that implement the reporting obligations of the C.T.A. In her article, Bari Zahn, the founding partner of Zahn Law Group, L.L.P. in New York City, provides a detailed explanation of who must report, whose information must be reported, and when the reporting will begin.

- **Tax 101: Is Crypto Growing Up?** Crypto assets are rarely out of the news these days, and the last months have been no exception. The well-publicized troubles of the FTX exchange have made crypto headline news again. Depending on one's point of view. The FTX bankruptcy will underscore everything that some people think about the subject matter. Some will say the FTX bankruptcy is exactly what was to be expected and confirms the view that crypto assets are some sort of Ponzi scheme. Others will say this serves to justify the need for much greater regulation. And still others will point to the rise in the power of the exchanges, bemoaning that crypto was created to avoid powerful monopolies. Nonetheless, crypto and its technology are here to stay in the financial world. In his Tax 101 article, Gary Ashford, a Tax Partner (non-lawyer) of attorneys Harbottle & Lewis LLP, London, explains that (i) regulation of exchanges and service providers and (ii) taxation on a global basis are in the works. Will they effectively bring normalcy to a "wild west" asset? Readers should stay tuned.

- **Major International Tax Reform in Israel – Proposal Takes Aim at Tax Residence Rules.** In November 2021, the Israel Tax Authority Committee for International Tax Reform published a report proposing substantial reform to international tax rules in Israel. Regarding rules for determining tax residence in Israel, the purported goal was to simplify the rules for determining an individual's tax residence. To that end, it introduces a day-count rule as a supplement to the existing center-of-vital-interest rule. Boaz Feinberg, a Partner of Arnon, Tadmor-Levy Law Firm in Tel Aviv and Rosa Peled, an associate at the law firm of Arnon, Tadmor-Levy Law Firm in Tel Aviv, explain that for most taxpayers, the center-of-vital-interest rule will continue to apply. However, because assessing officers will no longer address cases at the fringes, where the day-count rule is applied, more assessing offices can free-up to examine the remaining cases based on the center-of-vital interest rule.

- **Swiss Lump Sum Tax Regime – Based on Annual Expenditures.** Switzerland can be an attractive country of residence for foreign nationals not pursuing an economic activity in Switzerland. Besides the ordinary income and wealth tax regime, Switzerland provides advantageous tax regimes for expatriates and for high-net-worth individuals. Lump sum tax regimes are based on rulings obtained from Cantonal tax authorities, and the tax base and tax rates vary among the Cantons. Aliasghar Kanani, a Partner of LE/AX Law Firm, Geneva, explains the rules that apply to income, wealth, and inheritance taxes and the advance planning that can prove helpful.

- **Code Section 245A – Sometimes, Things are More Than They Appear.** Code §245A effectively exempts U.S. corporation from U.S. Federal income tax on dividends received from certain foreign subsidiaries. It allows a deduction equal to the amount of the dividend received. Code §245A applies only with respect to dividends received "by a domestic corporation which is a United States shareholder." Nevertheless, Code §245A can also apply to dividends received by a controlled foreign corporation from a qualifying participation in a lower-tier foreign corporation. The question presented in that fact pattern relates to how Code §245A will be applied. Is the controlled foreign corporation entitled to claim the deduction as dividends are received? Or is a U.S. corporation that is a U.S. Shareholder with regard to the foreign corporation entitled to claim the deduction at the time Subpart F income is reported in its U.S. tax return? Significantly different results may apply depending on the answer. Interestingly, the differences affect U.S. taxpayers other than the corporation that is a U.S. Shareholder. Stanley C. Ruchelman and Daniela Shani explain the different results that may apply.

- **Is the N.I.I.T. an Income Tax, a Social Security Tax, or Neither? Double Taxation of Income Hangs in the Balance.** The Net Investment Income Tax ("N.I.I.T.") applies to U.S. individuals, estates, and trusts. U.S. citizens who reside abroad are subject to N.I.I.T. in addition to U.S. income tax. They also may be subject to income tax and social security tax in their respective countries of residence. U.S. tax law provides no statutory relief from N.I.I.T. for such taxpayers. N.I.I.T. is due and the position of the I.R.S. is that the N.I.I.T. cannot be reduced by a foreign tax credit and cannot be eliminated by an applicable Social Security Totalization Agreement. How did Congress pass legislation that allows the I.R.S. to reach that result? Nina Krauthamer and Wooyoung Lee tell all, including recent taxpayer experience.

- **Anti-Abuse Developments: A New Normal in the Netherlands.** "*Doe normaal*" is practical advice in the Netherlands encouraging one to act normal. In the past, that phrase would describe commonly used plans to reduce tax. Today, if the old normal is followed by a multinational group effecting an acquisition, the group could end up facing unintended tax consequences. Legislators and tax authorities are increasingly examining traditionally "normal" acquisition structures and financing arrangements in a quest to combat deemed abusive tax arrangements. Like its fellow E.U. Member States, the Netherlands has shifted its tax policy agenda in recent years in line with international and E.U. initiatives to target perceived abuse. In a similar way, the U.S. has targeted abusive arrangements for several decades via common law doctrines and codified anti-abuse rules, including the economic substance doctrine and conduit financing regulations. Michael Bennett, a

U.S. attorney, recounts recent developments in the Netherlands based on a two-year assignment as a U.S. tax adviser in the Amsterdam Office of a major international law firm. He also addresses "economic substance" rules followed for close to a century in the U.S. This is Mr. Bennett's first article for *Insights* as an associate of Ruchelman P.L.L.C.

We hope you enjoy this issue.

- The Editors

REMOVING THE CLOAK: THE CORPORATE TRANSPARENCY ACT OF 2021 – NEW U.S. LEGISLATION TARGETING GLOBAL CORRUPTION

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INTRODUCTION[1]

In the last decade, the United States lagged behind the rest of the world in requiring business entities to report identifying information on their owners as a measure to attack tax evasion, terrorist financing, and money laundering. While a U.S. corporation or a foreign corporation reporting effectively connected income must report the ultimate 25% beneficial owner on Form 5472 (*Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*) when it engages in certain transactions with a related party, Congress was concerned that bad actors overseas could hide behind U.S. entities when engaging in illicit activity.

Over the years, a consensus developed overseas that the U.S. did not adhere to international beneficial ownership reporting standards. The U.S. is a member of the Financial Action Task Force but did little to adopt the Task Force's recommendations. In part, this changed in 2016 when the Financial Crimes Enforcement Network ("FinCEN")[2] instituted a regulation requiring U.S. financial institutions to determine the natural persons who are the beneficial owners of entities.[3]

Because the U.S. has been slow to implement rules and regulations put into place by other countries, some have regarded the U.S. as a tax haven. This perception has been based on the lack of transparency that has historically existed around the actual control of entities in the U.S. A 2011 study by the World Bank found that the U.S. performed worst among all countries reviewed in collecting beneficial ownership information.[4] That information can be used by U.S. law enforcement agencies in identifying entities established for illegal purposes, such as corruption, human smuggling, drug and arms trafficking, and terrorist financing.

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1 The author acknowledges the assistance of Charli Beam, a Junior Associate at The Zahn Law Group, who provided invaluable contributions to the research and writing of this Article.

2 FinCEN is a bureau of the U.S. Department of the Treasury that collects and analyzes information about financial transactions in order to combat domestic and international money laundering, terrorist financing, and other financial crimes. FinCEN is generally best known for its role in collecting information on FinCEN Form 114 (*Report of Foreign Bank and Financial Accounts (FBAR)*), which must be filed by U.S. persons having a financial interest or signatory authority over a foreign financial account.

3 M. Read Moore & Nancy G. Henderson, "America the Gradual: An Update on How Anti-Money Laundering Initiatives Affect Estate Planners," pg. 10-3 (2023).

4 Emile van der Does de Willebois, Emily M. Halter, Robert A. Harrison, Ji Won Park, and J.C. Sharman, "The Puppet Masters: How the Corrupt Use Legal Structures to Hide Stolen Assets and What to Do About It" (October 24, 2011).

CORORATE TRANSPARENCY ACT OF 2021

The Corporate Transparency Act of 2021 ("C.T.A.") was enacted as part of the National Defense Authorization Act for Fiscal Year 2021. The purpose of the C.T.A. is to create a national database of information regarding individuals who directly or indirectly hold substantial control over, or own a substantial interest in, certain domestic or foreign legal entities.[5]

The Beneficial Ownership Rule (the "B.O. Rule") implements Section 6403 of the C.T.A., and describes who must file a report, what information must be provided, and when a report is due. The proposed Beneficial Ownership Information Reporting Rule was published on December 7, 2021, and the final rule was published on September 30, 2022. The rules are effective January 1, 2024. However, companies created before January 1, 2024, have until January 1, 2025, to file initial reports. Companies created after January 1, 2024, will have 30 days from official notice of creation or registration to file initial reports.

The B.O. Rule is notably different from the Customer Due Diligence Rule ("C.D.D. Rule"), FinCEN's existing due diligence rule. The C.D.D. Rule has four core requirements. It requires covered financial institutions to establish and maintain written policies and procedures that are reasonably designed to

- identify and verify the identity of customers,
- identify and verify the identity of the beneficial owners of companies opening accounts,
- understand the nature and purpose of customer relationships to develop customer risk profiles, and
- conduct ongoing monitoring to identify and report suspicious transactions and, on a risk basis, to maintain and update customer information.

With respect to the requirement to obtain beneficial ownership information, financial institutions will be required to identify and verify the identity of its beneficial owner ("B.O."), which is (i) any individual who owns 25% or more of a legal entity and (ii) any individual who controls the legal entity.

The new B.O. Rule defines a beneficial owner more broadly and requires identification of all individuals who control a company, rather than just a single individual exercising control. Additionally, the B.O. Rule provides more exemptions than the definition of a legal entity customer in the C.D.D. Rule.[6] This means that banks and other financial institutions may currently be collecting beneficial ownership information ("B.O.I.") from entities that will not be required to report this information under the Rule.

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5 FinCEN Beneficial Ownership Information Reporting Requirements, 31 C.F.R. 1010 (2022).

6 FinCEN publishes final rule on beneficial ownership, Davis Polk, October 6, 2022.

DETAILS OF THE B.O. RULE

Scope of Coverage

The final regulations[7] apply to domestic companies and, when engaged in business in the U.S., foreign companies. Also subject to the B.O. Rule are limited liability companies, corporations, and any entity that comes into existence through registration with a secretary of state at the level of any state or the District of Columbia, or a similar office in the U.S. General partnerships, sole proprietorships, and trusts generally are not reporting companies under the C.T.A. because they are not created by filing a document with an applicable agency.

Exempt Entities

Not all entities are covered. The B.O. Rule excludes twenty-three types of corporate entities from the definition of reporting company:

- Securities issuers
- Other entities registered pursuant to the securities exchange act of 1934 entities
- Financial market utilities
- Domestic governmental authorities
- Registered investment companies and advisers
- Pooled investment vehicles
- Banks
- Venture capital fund advisers
- Tax exempt entities
- Domestic credit unions
- Insurance companies
- Entities assisting tax exempt entities
- Depository institution holding companies
- State licensed insurance producers
- Large operating companies
- Money transmitting businesses
- Entities registered pursuant to the commodity exchange act
- Subsidiaries of certain exempt entities
- Brokers or dealers in securities

[7] 31 C.F.R. § 1010.380.

- Accounting firms
- Inactive businesses
- Securities exchange or clearing agencies
- Public utilities

The reason for exempting the foregoing entities is that they already are required to provide B.O.I. to a governmental authority.[8]

Obligation to Report

Reporting companies that are not excluded must provide an initial report ("B.O. Report") that contains information identifying the company, its B.O.'s, and the company applicant. Corrected or updated reports are required if the beneficial ownership changes or is found to be incorrect. This is discussed in greater detail below.

A foreign individual is a B.O. if he or she (i) exercises substantial control over a reporting company (ii) or owns or controls 25% or more of the ownership interests of a reporting company.

Individuals Exercising Substantial Control

Under the regulations, an individual exercises substantial control over the reporting corporation where the individual

- serves as a senior officer;
- has authority over the appointment or removal of any senior officer or a majority of the board of directors (or similar body);
- directs, determines, or has substantial influence over important decisions made by the reporting company; or
- has any other form of substantial control over the reporting company.

Important Decisions

The following decisions are viewed to be important decisions of a reporting corporation:

- Decisions regarding the nature, scope, and attributes of the business of the reporting company, including the sale, lease, mortgage, or other transfer of any principal assets of the reporting company
- Decisions regarding the reorganization, dissolution, or merger of the reporting company
- Major expenditures or investments, issuances of any equity, incurrence of any significant debt, or approval of the operating budget of the reporting company
- Decisions regarding the selection or termination of business lines or ventures, or geographic focus, of the reporting company
- Decisions regarding compensation schemes and incentive programs for senior officers

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[8] 31 U.S.C. 5336(a)(11)(B)(i)-(xxiii).

- Decisions regarding the entry into or termination, or the fulfillment or non-fulfillment, of significant contracts

- Decisions regarding amendments of any substantial governance documents of the reporting company, including the articles of incorporation or similar formation documents, bylaws, and significant policies or procedures

Substantial Control

An individual, including a trustee of a trust or similar arrangement, may directly or indirectly exercise substantial control over a reporting company through

- board representation;

- ownership or control of a majority of the voting power or voting rights of the reporting company;

- rights associated with any financing arrangement or interest in a company;

- control over one or more intermediary entities that separately or collectively exercise substantial control over a reporting company;

- arrangements or financial or business relationships, whether formal or informal, with other individuals or entities acting as nominees; or

- any other contract, arrangement, understanding, or relationship.

". . . the identity of an individual who owns or controls at least 25% of the ownership interests of a reporting company must be reported to FinCEN."

Ownership Interests

As previously mentioned, the identity of an individual who owns or controls at least 25% of the ownership interests of a reporting company must be reported to FinCEN. For this purpose, the term "ownership interest" means the following:

- Any equity, stock, or similar instrument; preorganization certificate or subscription; or transferable share of, or voting trust certificate or certificate of deposit for, an equity security, interest in a joint venture, or certificate of interest in a business trust in each such case, without regard to whether any such instrument is transferable, is classified as stock or anything similar, or confers voting power or voting rights

- Any capital or profit interest in an entity

- Any instrument convertible, with or without consideration, into any share or instrument described in the two preceding bulleted paragraphs (including any future on the instrument), or any warrant or right to purchase, sell, or subscribe to a share of the ownership interest, even if characterized as debt

- Any put, call, straddle, or other option or privilege of buying or selling any of the interests described in the three preceding bulleted paragraphs without being bound to do so, except to the extent that such option or privilege is created and held by a third party without the knowledge or involvement of the reporting company

- Any other instrument, contract, arrangement, understanding, relationship, or mechanism used to establish ownership

An individual may directly or indirectly own or control an ownership interest of a reporting company through any contract, arrangement, or otherwise. Included ownership arrangements are the following:

- Joint ownership with one or more other persons of an undivided interest in such ownership interest
- Ownership through another individual acting as a nominee, intermediary, custodian, or agent
- With regard to a trust or similar arrangement that holds such ownership interest, ownership as (i) a trustee of the trust or other individual (if any) with the authority to dispose of trust assets; (ii) a beneficiary who is the sole permissible recipient of income and principal from the trust, or has the right to demand a distribution of or withdraw substantially all of the assets from the trust; or (iii) a grantor or settlor who has the right to revoke the trust or otherwise withdraw the assets of the trust
- Through ownership or control of one or more intermediary entities, or ownership or control of the ownership interests of any such entities, that separately or collectively own or control ownership interests of the reporting company

Calculation of Total Ownership Interest

In determining whether an individual owns or controls 25% or more of the ownership interests of a reporting company, the total ownership interests that an individual owns or controls, directly or indirectly, is calculated as a percentage of the total outstanding ownership interests of the reporting company in the following way:

- Ownership interests of the individual shall be calculated at the present time, and any options or similar interests held by the individual are treated as exercised.
- For reporting companies that issue capital or profit interests, including entities treated as partnerships for U.S. Federal income tax purposes, the individual's ownership interests are the individual's capital and profit interests in the entity, calculated as a percentage of the total outstanding capital and profit interests of the entity.
- For corporations, entities treated as corporations for U.S. Federal income tax purposes, and other reporting companies that issue shares of stock, the applicable percentage is the greater of (i) the total combined voting power of all classes of ownership interests of the individual as a percentage of total outstanding voting power of all classes of ownership interests entitled to vote and (ii) the total combined value of the ownership interests of the individual as a percentage of the total outstanding value of all classes of ownership interests.
- If the facts and circumstances are such that the calculations described in either of the two preceding bulleted paragraphs cannot be performed with reasonable certainty, any individual who owns or controls 25% or more of any class or type of ownership interest shall be deemed to own or control 25% or more of the ownership interests of the reporting company.

Exceptions to Beneficial Owner Status

Certain exceptions exist so that no person described below is treated as to the term beneficial owner:

- A minor child, as defined under the law of the State or Indian tribe territory in which a domestic reporting company is created or a foreign reporting company is first registered, where the reporting company reports the required information of a parent or legal guardian of the minor child
- An individual acting as a nominee, intermediary, custodian, or agent on behalf of another individual
- An employee of a reporting company other than a senior officer, acting solely as an employee, whose substantial control, power, or economic benefits are derived solely from the employment status of the individual employee
- An individual whose only interest in a reporting company is a future interest through a right of inheritance
- An individual who is solely a creditor of a reporting company, meaning his or her interest in the reporting company is based solely on the anticipated payment of a predetermined sum of money, such as a debt incurred by the reporting company or a loan covenant intended to secure the right to receive payment

"The due date for initial reports is modified in the final regulations."

REPORTS

Timing

The due date for initial reports is modified in the final regulations. The statute provides that initial reports must be filed in a timely manner, but not later than two years after the effective date of final regulations. The proposed regulations adopted an initial due date of one year after the effective date of final regulations, looking at the two-year period as discretionary but not mandatory. Newly formed entities were required to file reports within 14 days of creation or registration.

The final regulations adopt the following rules:

- The effective date of the regulations is January 1, 2024.
- Reporting companies created or registered before January 1, 2024, will have one year until January 1, 2025 to file their initial reports, while reporting companies created or registered after January 1, 2024, will have 30 days after receiving notice of their creation or registration to file their initial reports.
- Reporting companies have 30 days to report changes to the information in their previously filed reports and must correct inaccurate information in previously filed reports within 30 days of when the reporting company becomes aware or has reason to know of the inaccuracy of information in earlier reports.

Content

The B.O.I. Report must contain the following four pieces of information about each Beneficial Owner:

- The B.O.'s name
- The B.O.'s birthdate
- The B.O.'s address
- The B.O.'s unique identifying number and issuing jurisdiction from an acceptable identification document (and the image of such document). An example is a passport or residence identity card

In addition, the B.O.I. Report must include the following information regarding the reporting company:

- Its full legal name
- All trade names and "doing-business-as" names used by the reporting company
- The address of the principal place of business of the reporting company
- Its jurisdiction of formation
- Its tax identification number[9]

A domestic reporting company must use its U.S. tax identification number. If the reporting company is foreign, it must use its U.S. tax identification number, if one exists. If a U.S. tax identification number has not been obtained for any reason, it must provide a foreign tax identification number.

Company Applicant

The person who files a B.O. Report is referred to as a "Company Applicant." A Company applicant may be one of two persons:

- The individual who directly files the document that creates the entity, or in the case of a foreign reporting company, the document that first registers the entity to do business in the United States.
- The individual who is primarily responsible for directing or controlling the filing of the relevant document by another.[10]

Comments received by FinCEN identified practical issues in identifying a company applicant who actually filed documents creating a company. In many cases, a company applicant may be an employee of a law firm or business formation service. For example, if an attorney is responsible for the preparation and filing of incorporation documents and a paralegal files these documents directly with the state office, both the attorney and paralegal would be reported as company applicants. Consequently, the final regulations provide that a reporting company existing or registered at the

9 31 C.F.R. §1010.380(b)(1)(i)(A)-(C).

10 31 C.F.R. §1010.380(e).

time of the effective date of the rule has until January 1, 2025, to file the initial report. In addition, reporting companies formed or registered after the effective date of the rule also do not need to update company applicant information.

Reporting companies must report a business address for a company applicant who forms or registers an entity in the normal course of the applicant's business. However, a B.O. Report need not include the address an individual uses for tax residency purposes.[11]

Certifications

The regulations require a reporting company to certify that reports submitted to FinCEN are true, correct, and complete.[12] The certification requirement applies to all reports and applications submitted to FinCEN, not just to a B.O.I. Report.

INDIVIDUAL FINCEN IDENTIFIERS

Reporting companies concerned about furnishing a B.O.I. Report with personal information of a B.O. may report a FinCEN identifier instead of a B.O.I. Report. There may also be an administrative benefit if an individual is likely to be identified as a B.O. of numerous reporting companies.

A FinCEN identifier is a unique identifying number that FinCEN will issue to individuals or entities upon request. To obtain a FinCEN identifier, the same information that would appear in a B.O.I. Report is furnished directly to FinCEN by the individual. An individual who chooses this method is responsible for keeping the B.O.I. updated.

LAWYERS' OBLIGATIONS

Although the F.A.T.F. has published guidance relating to a lawyer's role in anti-money laundering efforts over the last decade, no U.S. Federal or state laws or regulations require lawyers to act as gatekeepers to the financial system. While lawyers in the U.S. clearly may not engage in or aid money laundering in any way, they are not required to conduct due diligence or file suspicious activity reports. While this is not changed under the C.T.A., attorneys, paralegals, or other persons who file documents with an applicable agency to create any kind of legal entity will file a B.O. Report. That reporting obligation provides information not significantly different from information included on line 6 of Part II of I.R.S. Form 5472 (Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business). There, the I.R.S. receives the name, address, U.S. tax identifying number, foreign tax identifying number, name of country where business is conducted principally, country of citizenship, and country of residence of the ultimate 25% shareholder. The driver for providing the information is that the U.S. entity enters into a monetary transaction with a foreign related party determined using the standard of 25% ownership.

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11 31 C.F.R. §1010.380(b)(1)(ii).

12 31 C.F.R. §1010.380(b).

OVERALL IMPACT OF THE B.O. RULE

The overall impact the B.O. Rule will have on compliance and financial transparency remains unclear. While the B.O. Rule intends to streamline compliance and create a more effective way of gathering information, there is speculation that the requirements will add to the compliance burden banks and other covered financial institutions face already. The Rule will exclude a wider range of entities from reporting requirements than the C.D.D. Rule currently does, including large operating companies.

IMPACT OF THE B.O. RULE ON TRUSTS

The majority of trusts used for estate planning purposes will not fall under the definition of a reporting entity. However, if the trust invests in a U.S. entity, information about the trust's Beneficial Owners will need to be reported to FinCEN as discussed above.

NEXT STEPS

FinCEN's next step is to draft rules that address access to B.O.I. maintained by FinCEN. Questions that must be decided include the following:

- Who may access B.O.I.?
- For what purposes may B.O.I. be accessed?
- What safeguards to protect B.O.I. of specific persons will be adopted?

"The majority of trusts used for estate planning purposes will not fall under the definition of a reporting entity."

TAX 101:
IS CRYPTO GROWING UP?

Author
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Tags
C-37/20
C-601/20
C.A.R.F.
Crypto
FTX
Intermediaries
Ponzi Scheme
Service Providers
U.K.J.T.

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INTRODUCTION

Crypto assets are rarely out of the news these days, and the last months have been no exception. The well-publicized troubles of the FTX exchange have made crypto headline news again, and depending on one's point of view, will simply underscore everything that some people think about the subject matter.

Some will say the FTX bankruptcy is exactly what was to be expected and confirms the view that crypto assets are some sort of Ponzi scheme.[1] Others will say this serves to justify the need for much greater regulation. And still others will say that this results from a rise in the power – and in some ways the monopoly – of the exchanges and that the concept of the exchange is exactly the sort of thing crypto was created to avoid.

But whatever one thinks, the author is confident that crypto in its broadest sense is here to stay because of the capability of the underlying technology to disrupt or enhance the financial services industry, and many other sectors as well.

RECOVERY OF ASSETS

But what if you are an investor and your crypto asset portfolio is held with an exchange such as FTX and the exchange has found itself in financial trouble, or worse still, seeks insolvency proceedings, resulting in liquidation? There are a number of challenges to investors having lost large or small fortunes.

The first challenge is the legal relationship between the investor and the exchange. In principle, one would expect the relationship to be fiduciary in nature, as between a trust and its beneficiary. Under this view, the exchange should have removed the investor's assets from the exchange balance sheet so that those assets would remain available for return to the investor, subject to liquidity, and any associated protocol terms. More importantly, they would not be part of the exchange's own assets, available to meet the demands of creditors in any liquidation.

However, the exchange has treated other people's assets as its own. Consequently, investors must join the long queue of other unsecured creditors. The likelihood of full recovery appears to be bleak.

There is much talk about the relationship between FTX and the Almeda hedge fund, which reportedly borrowed billions of dollars from FTX to make risky bets regarding

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[1] According to Wikipedia, Charles Ponzi was a swindler and con artist who operated in the U.S. and Canada in the early 1920's. He promised clients a 50% profit within 45 days or 100% profit within 90 days, funding payouts to existing investors with funds invested by later investors.

cryptocurrencies. If true, the facts are no different in principle, if not in materiality, from those recounted in Agatha Christie's *Death on the Nile*, where the trustee of a trust for the benefit of Lynette Doyle, née Ridgeway, borrowed significant funds from trusts settled by her father for her benefit. The funds borrowed were then invested by the trustee, for his benefit, in risky investments.

The trust or agency point was the subject of case law in New Zealand. In the case of *Ruscoe v. Cryptopia Ltd.* (in liquidation),[2] the High Court ruled that there was a trust relationship, applying the general tests of trust to the facts as understood, *viz.*, certainty of subject matter, objects, and intention.

It will also be interesting to understand better the accounting and audit processes. It seems the accounting profession is under constant criticism over work done and standards applied. If any of the media speculation has foundation, we could well see yet another accounting scandal. The expert who oversaw the Enron corporate scandal in 2001, John J. Ray III, has been appointed and so clearly he will bring much needed experience of corporate scandal to the resolution process. In terms of accounting, the Enron scandal saw the end of Arthur Andersen. Already there are various comments in the media attributed to him, suggesting the systems were poor.

One of the challenges in the general area of crypto asset is the lack of experts who genuinely understand the industry and the specific risks associated with the practical applications of the technology. What many crypto natives would say is the source of its strength – the dispensing of intermediaries and third parties having a long history in regulated sectors, or quasi-regulated sectors such as tax – is in reality its weakness. Crypto account has a dire need for checks and balances to prevent just the sort of situation now apparently arising in FTX.

A major fear is the lack of regulation and any protection for investors. Whereas regulation is anathema to many in the crypto asset world, each exchange that fails strengthens the case for regulation, particularly among investors worrying whether all value in their portfolio is lost.

In the U.K., the E.U., and most likely the U.S., the regulatory environment focuses heavily on the protection of client assets. The U.K. implemented the MIFID 1 and MIFID 2 rules prior to its departure of the E.U., and so such regulations apply to regulated entities. Of course, crypto asset are not currently regulated in the U.K., other than for A.M.L. purposes. Consequently, protections are not required, and so it would seem that investors in crypto bankruptcies like FTX will be at the mercy of the organization's own operating and accounting practices. While little is known of the operating and accounting practices at FTX, time will clearly tell, and we will see in due course how customer crypto assets were or were not managed and protected for the benefit of the investor. A number of worrying statements have been released from those close to the insolvency by way of media statements.

Regarding the tax issues for investors, crypto assets on the FTX exchange will generally have been embodied in exchange tokens. It is almost certain that gains and losses will be characterized as capital in nature but for dealers. In many countries, disposals generating capital gains may be taxed at preferential rates for individuals. The tax benefits for losses may be ringfenced so that only lower-taxed capital gains will be reduced by the losses.

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[2] [2020] NZHC 728; [2020] 2 NZLR 809 (8 April 2020).

In terms of the loss of crypto assets, the U.K. capital gains rules do allow for assets becoming of negligible value. In such cases, a deemed disposal is said to take place which can potentially crystallize a loss. That might be useful to set off against an investor's other capital gains, provided the loss is absolute, rather than partial. Unfortunately, partial losses are not enough to trigger a tax benefit. Comparable issues exist with liquidations. In most cases, no disposal occurs until the liquidators make a final distribution. In a bankruptcy such as FTX, that could be a long way down the line.

There is much media activity around the FTX story and the hacking and theft of crypto assets. For U.K. tax purposes, the loss of an asset due to theft does not amount to a disposal, and so the investor will not be able to access any resulting loss. If it becomes clear there is no chance whatsoever that the assets can be recovered, possibly after a period of time, then a negligible value claim may be available and with it, access to the associated losses.

LAW, PROPERTY, SITUS

Significant work has been done in various countries to better analyze crypto assets from a legal perspective. The U.K. is no exception to this, and over the last number of years, we have seen excellent work done. The U.K. Government set up the Lawtech Delivery Panel in 2018. It is a unique group of leaders and experts from the public and private sectors collaborating to accelerate the digital transformation of the legal sector for the benefit of society and the economy, and to ensure the U.K.'s continuing leadership in legal and court services. In November 2019, the panel set up the U.K. Jurisdiction Taskforce ("U.K.J.T.") (one of several of groups) to look at a number of legal issues, most significantly whether crypto assets amount to property and can be protected as such.

The outcome of the U.K.J.T. consultation was a report confirming, *inter alia*, that crypto assets are property and meet some of the relevant criteria in prior case law. In particular, the case of *National Provincial Bank v. Ainsworth*[3] adopted a definition of property as an asset that is definable, identifiable by third parties, capable of being assumed by third parties, and having some degree of permanence or stability.

A number of cases in the U.K. courts treated crypto assets as property: *Vorotyntseva v. Money -4 Limited t/a as Nebeus.com* and *Liam Robertson v. Persons Unknown*.

The U.K.J.T. analysis was taken on board in a number of subsequent proprietary injunction cases in the U.K., including the High Court (Commercial Court) case *AA v. Persons Unknown*[4] and the unpublished case *Robertson v. Persons Unknown*.

Under U.K. common law there are two types of property, *viz.*, a chose in possession and a chose in action. This was set out in *Colonial Bank v. Whinney*,[5] where Fry J. said the following: "All personal things are *either* in possession or action. The law knows no *tertium quid* between the two."

As this article goes to print, there is already a further consultation taking place in

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3 [1965] AC1175.

4 [2019] EWHC 3556.

5 [1885] 30 ChD 261.

the U.K., in short to establish the need or appetite for an additional (third) type of property, *viz.*, data objects.

WHAT ABOUT TAX?

The U.K. tax authority ("H.M.R.C.") has undertaken its own work, publishing comprehensive guidance on the taxation of crypto assets. Although comprehensive, with developing technology there will be changes required over time. Indeed, some areas of crypto asset have not yet been addressed. One example is Non Fungible Tokens ("N.F.T.'s"), where further guidance will be issued in due course. In broad terms, an N.F.T. IS linked to a unique digital asset that is not interchangeable. Typically, it is linked to artwork or collectibles. However, an N.F.T. can be linked to anything having value as long as it can be stored digitally.

"If the gains from a transfer of an N.F.T. or other crypto asset are considered to be U.K. situs income, adverse tax consequences will result for a non-dom living in the U.K. and electing to report income under the remittance basis."

Another significant area where H.M.R.C. has provided guidance relates to the concept of situs of the asset and the situs of gain at the time of transfer. The current stance of H.M.R.C. is that, where the beneficial owner of crypto assets is a U.K. resident and there is no associated or underlying asset, the crypto assets are U.K. situs. Several types of income and gains can be recognized when holding an N.F.T. or any other crypto asset:

- The asset can be sold.
- The asset can be mined.
- The asset can be "air dropped" in return for a service.
- The asset can be licensed.
- The asset can be used to purchase a product.

If the gains from a transfer of an N.F.T. or other crypto asset are considered to be U.K. situs income, adverse tax consequences will result for a non-dom living in the U.K. and electing to report income under the remittance basis. The non-dom may find that the income or gains from the disposal of an N.F.T. or other crypto asset is immediately taxed in the U.K. even if the proceeds are not remitted to the U.K.

Note that some advisers argue that the situs of crypto, including an N.F.T. can be removed from the U.K. by placing the crypto asset in the ownership of an overseas trustee. The principal makes sense, but currently practical barriers exist in the implementation. Many trustees are reluctant to hold or invest in crypto assets because of risk around A.M.L. issues. Also, persons providing custodian services for N.F.T.'s are low in number.

TRANSPARENCY AND REPORTING

Many commentators have stated in recent weeks that the issues of FTX may not have occurred with much better regulation and transparency.

A significant step towards a more open and transparent crypto asset environment is the consideration of the Crypto Asset Reporting Framework ("C.A.R.F.") proposed by the O.E.C.D.

The C.A.R.F. likely would not have prevented the FTX bankruptcy. However, regulatory responsibilities such as International Tax Reporting would have placed suspect transactions under the microscope. By having exchanges invest in compliance procedures, such as International Reporting, wider conversations with accountants and regulators would have taken place which may have had the effect of identifying compliance shortcomings.

So how will the C.A.R.F. work?

The C.A.R.F. has been designed to require those providing crypto asset services to undertake the necessary due diligence to identify those persons using and holding crypto assets, where those users are a reportable person.

There are four principal component parts to the C.A.R.F.:

1. The scope of crypto assets to be covered.
2. The entities and individuals subject to data collection and reporting requirements.
3. The transactions subject to reporting, as well as the information to be reported in respect of such transactions.
4. The due diligence procedures to identify crypto asset users and the relevant tax jurisdictions for reporting and exchanging information.

CRYPTO ASSETS IN SCOPE

The O.E.C.D. proposal focuses on the use of cryptographically secured distributed ledger technology ("D.L.T.") to track the creation, holding, and transfers of crypto assets. The C.A.R.F. also contemplates the use of "similar technology" to ensure that new technological developments will be addressed.

The term "Relevant Crypto-Assets" as used in the C.A.R.F. are crypto assets that give rise to reporting in connection with Relevant Transactions. Three categories of crypto assets are excluded from reporting requirements because they are thought to pose limited tax compliance risks. They are the following:

- Crypto assets that the Reporting Crypto-Asset Service Provider has adequately determined cannot be used for payment or investment purposes
- Central Bank Digital Currencies, representing a claim in Fiat Currency on an issuing Central Bank or monetary authority, which function similar to money held in a traditional bank account
- So-called "Specified Electronic Money Products" that represent a single Fiat Currency and are redeemable at any time in the same Fiat Currency at par value as a regulatory matter, in addition to meeting certain other requirements

Reporting on Central Bank Digital Currencies and certain Specified Electronic Money Products held in Financial Accounts will be included within the scope of the C.R.S.

INTERMEDIARIES AND SERVICE PROVIDERS IN SCOPE

Intermediaries and other service providers facilitating exchanges (i) between Relevant Crypto-Assets and (ii) between Relevant Crypto-Assets and Fiat Currencies play a central role in the crypto asset market. As such, it is proposed that those Entities or service providers that effectuate Exchange Transactions in Relevant Crypto-Assets as a business for or on behalf of customers would be considered Reporting Crypto-Asset Service Providers.

Whether a crypto asset service provider is a Reporting Crypto-Asset Service Provider will depend on whether it meets any of the following criteria:

- It is tax resident in a jurisdiction adopting the rules.
- It is both incorporated in or organized under the laws of a jurisdiction adopting the rules and has legal personality or is subject to tax reporting requirements in a jurisdiction adopting the rules.
- It is managed from a jurisdiction adopting the rules.
- It has a regular place of business in a jurisdiction adopting the rules.
- It effectuates Relevant Transactions through a branch based in a jurisdiction adopting the rules.

REPORTING REQUIREMENTS

The C.A.R.F. seeks to identify "crypto assets users" and their relevant jurisdiction for reporting purposes. A crypto asset user is an individual or an entity that is a customer of a crypto asset service provider.

The C.A.R.F. defines a crypto asset service provider as any individual or entity that, as a business, provides a service putting into operation "effectuating" exchange transactions for or on behalf of customers, including by acting as counterparty or an intermediary to such exchange transactions or by making available trading.

The following three types of transactions are Relevant Transactions that are reportable under the C.A.R.F.:

- Exchanges between Relevant Crypto-Assets and Fiat Currencies
- Exchanges between one or more forms of Relevant Crypto-Assets
- Transfers (including Reportable Retail Payment Transactions) of Relevant Crypto-Assets

DUE DILIGENCE

The C.A.R.F. rules require crypto asset service providers to determine crypto assets users who are "reportable persons." This is done by way of identifying the user's tax residence. The service providers will require self-certifications from users at the point of commencing a new relationship, or, for pre-existing relationships, within 12 months of the new rules coming into existence.

The rules also apply to entity users, and in those circumstances, as well as determining the tax residence of the entity, the crypto asset service provider is also required to determine "controlling persons" by way of the KYC documentation, and then whether those controlling persons are reportable persons, again by way of self-certifications.

RESTRICTIONS ON TRANSPARENCY

On the subject of transparency, and what many see as the ever greater burden placed on commercial organizations to collect and report information, some readers will be aware of the recent Judgment of the European Court of Justice in relation to public ownership registers.[6] Whether these rulings will impact the exchange of information for tax purposes will no doubt become clearer over time, but given the fact that the information collected by the C.A.R.F. is for the use of the various tax authorities, tax authorities will argue that the information collected is for the sole use of tax authority for a legitimate reason. Such information can be exchanged with tax authorities in treaty partner jurisdictions for tax administration purposes. Read this way, there is infringement to expectations of privacy.

U.K. REGULATION

The U.K. Government set out in April 2022 its ambitions for crypto assets. The then Chancellor of the Exchequer, now Prime Minister, Rishi Sunak stated the goal of making the U.K. a global hub for crypto asset technology. In particular, the U.K. government recognized that crypto technology and stablecoins provide significant opportunities for efficiency in payment systems and platforms.

With a view to introducing regulation, consultations have been held over the past year regarding the regulation of stablecoins, D.L.T., and crypto asset promotions. Many organizations providing crypto services have been brought within the U.K. Money Laundry Regulations and are Obliged Entities under the rules, requiring them to undertake client due diligence. We would expect to see an acceleration of some of the regulation being considered. In light of FTX, the new rules likely will be directed at protection of investor assets.

WIDER TAX ISSUES AND HURDLES TO DEVELOPMENT

One of the key challenges currently for crypto asset in terms of taxation is the nature of D.L.T. and capital gains rules. Capital gains tax looks to tax any profit at a point of disposal. Because of the general approach of verification for D.L.T. (primarily blockchain) events, and the cancellation of the earlier blockchain record, this can trigger a "disposal" under the U.K. rules (Section 22 TCGA 1992).

It is important to analyze properly all crypto asset transactions, as lazy assumptions could well result in noncompliance, including paying tax on transactions that are not disposals. The same applies to N.F.T.'s, where sloppy analysis can lead to a completely incorrect taxation. This is also the case in terms of the commercial

[6] *Luxembourg Business Registers*, Joined Cases C-37/20 and C-601/20.

transaction itself. Many people mistakenly view the N.F.T. as the sole asset that is owned. However, an associated license agreement is attached to the N.F.T., which frequently is overlooked or misunderstood. This may result in significant legal disputes when a person will have paid a huge amount for an N.F.T. only to find that the really valuable part remains owned by someone else.

The world of intangibles is always thought provoking, but it is getting a whole lot more complex with the onset of cryptographically secured D.L.T.

MAJOR INTERNATIONAL TAX REFORM IN ISRAEL – PROPOSAL TAKES AIM AT TAX RESIDENCE RULES

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INTRODUCTION

In November 2021, the Israel Tax Authority ("the I.T.A.") Committee for International Tax Reform ("the Committee") published a report ("the Report") proposing substantial reform to international tax rules in Israel. While time has passed without the enactment of enabling legislation, the establishment of a steady government in Israel suggests that the likelihood of enactment may occur in 2023. Contributing to this view is the favorable consensus to the recommendations among members of the Israeli bar and accountants that practice in the area. This comes as no surprise as members of the Israel Bar Association and the Institute of Certified Public Accountants actively participated in compiling the report.

The Committee recommends significant changes regarding various provisions under the Income Tax Ordinance [New Version] 5721-1961 ("the Ordinance"). These include, *inter alia*, the definition of tax residence, exit tax, and foreign tax credit. The declared aims of the Report are an increase in transparency, the prevention of double taxation, and the adoption of enforcement tools to attack aggressive tax planning and money laundering.

This article focuses on recommendations relating to the definitions of tax residence and nonresidence covered by the Report.

TAX RESIDENCE RULES UNDER CURRENT LAW

Under existing law, tax residents of Israel are taxed based on worldwide income and gains. For this purpose, an individual is considered to be a resident of Israel if the facts indicate that his or her center of life is in Israel. An individual's center of life is in Israel based on the existence of ties to Israel, such as family, business, investments, and social activity. A rebuttable assumption of residence exists if an individual spends 183 days or more in Israel in one tax year, typically the calendar year. A separate rebuttable presumption exists if an individual spends 30 days in Israel in one tax year and 425 days over three consecutive tax years. including the year in examination. Individuals who believe their facts overcome the rebuttable presumption of residency must submit reports that identify the reasons supporting the conclusion as to nonresidence.

Administrative problems were regularly encountered with the two rebuttable presumptions and the application of the center of life test. Individuals regularly contended that their particular facts overcame the rebuttable presumption, while the I.T.A on the other hand ignored having the individual spend less time in Israel than the refutable number of days, claiming that the individual's center of life was in Israel. Fact patterns needed to be examined on a case-by-case basis, based on specific circumstances, facts, and evidence, often leading to inconsistent results and lack of clarity to taxpayers. Two cases demonstrate the fact finding that is required of an individual who challenges the presumption. In one case, the individual did his homework; in the other, significantly fewer facts were given and the result differed.

The first case is *Kfar Saba Assessing Officer v. Michael Sapir*.[1] There, an Israeli citizen, Mr. Sapir, moved to Singapore in 1994 with his wife and family. He, his wife, and his family returned to Israel in 1998. Then, in 2001, Mr. Sapir returned to Singapore. This time, his wife and children remained in Israel.

Mr. Sapir filed Israeli annual income tax reports but did not include his income in Singapore. The I.T.A. assessed tax on the worldwide income of Mr. Sapir, contending that he never relinquished Israeli residence. Among other justifications given was the location of his family in Israel.

The Tel Aviv District Court held that Mr. Sapir's center of life was in Singapore during his time of presence there. Important factual indicators were as follows:

- His ownership of an apartment in Singapore which served as his permanent home
- His permanent residence permit in Singapore
- Payments he made to a Singapore retirement fund, Singapore medical insurance policy, and other insurance coverage in Singapore
- The maintenance of a bank account in Singapore
- His social ties in Singapore
- His tax status in Singapore as a resident[2]

The Supreme Court dismissed the appeal filed by the I.T.A. explaining that a married couple may have different centers of life.

The second case is *Rafaeli v. Kfar Saba Assessing Officer*.[3] There, the individual was a super model, Bar Rafaeli. The years in issue were 2009 and 2010. The rebuttable presumption did not apply to the latter year because the requisite number of days spent in Israel was not met. That was not an impediment because the presumption favors the I.T.A. in that assuming no set of facts other than day count are found to be controlling, the presumption of residence applies based on the center of life test.

In broad terms, the relevant facts for and against residence were as follows:

- For nonresident status in Israel:
  - The individual had a relationship with the actor Leonardo DiCaprio, with whom she claimed to have lived while in the U.S. in California and New York.

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1 CA 4862/13 (March 20, 2014).

2 Singapore has a territorial tax system which limits the tax base to income arising from sources in Singapore.

3 AA 6418-02-16 (April 11, 2019).

- For resident status in Israel:
    - The individual came to Israel in the relevant years between 14 and 15 times each year for periods of 10-12 days on average each time.
    - Many of the trips to Israel coincided with family holidays and events and festivities.
    - The lend-a-star companies formed abroad that received her income and made investments on her behalf were managed and controlled in Israel, making them Israeli tax resident companies, a contact with Israel.
    - The individual did not indicate another country in which she was a resident for tax purposes under the laws of that country.
    - On a tax form in the U.S., the individual indicated that she was an Israeli resident for tax purposes.

"The Report proposes the adoption of a day-count system for an individual to be classified irrefutably as an Israeli resident for tax purposes."

The court determined that in both years, the individual's center of life was in Israel, where she had family ties and material connections.

TAX RESIDENCE UNDER RULES IN THE REPORT

Irrebuttable Classification as an Israeli Resident

The Report proposes the adoption of a day-count system for an individual to be classified irrefutably as an Israeli resident for tax purposes. If any of the following three tests are met, the individual would be considered a tax resident of Israel:

- An individual who is present in Israel for at least 183 days in each of two consecutive tax years.
- An individual who is present in Israel for at least 100 days in a tax year and at least 450 days over the three preceding tax years. This presumption will not apply if (i) the individual is physically present for at least 183 days in a foreign country, (ii) an income tax treaty is in effect between that foreign country and Israel, and (iii) the individual obtains a certificate of residency from the tax authority of that country.
- An individual that is present in Israel at least 100 days in a tax year when that person's spouse is an Israeli tax resident. For this purpose, the same rule applies if the individual shares a common household with a person that is not a spouse.

Irrebuttable Classification as a Foreign Resident

The Report also proposes the adoption of a day-count system for an individual to be classified irrefutably as a nonresident for tax purposes with regard to Israel. If any of the following tests are met, the individual would not be considered a tax resident of Israel:

- **An individual who is present in Israel for less than 30 days during a tax year for four consecutive tax years.** Here, the individual will be classified as a foreign resident as of the first day of the first year in the four-year period. This rule will not apply if the individual is present in Israel for more than 15 days (i) in the first month of the first year in the four-year period or (ii) in the last month of the last year in the four-year period.

- **An individual who is present in Israel less than 30 days during a tax year for three consecutive tax years.** Here, the individual will be classified as a foreign resident as of the first day of the second tax year in the three-year period. Again, this rule will not apply if the individual is present in Israel for more than 15 days (i) in the first month of the first year in the three-year period or (ii) in the last month of the last year in the three-year period.

- **An individual and spouse who are present in Israel for less than 60 days during a tax year for four consecutive tax years.** Here, both will be classified as foreign residents as of the first day of the first tax year in the four-year period. This rule will not apply if either the individual or the spouse is present in Israel for more than 30 days (i) in the first month of the first year in the four-year period or (ii) in the last month of the last year in the four-year period.

- **An individual and spouse who are present in Israel for less than 60 days during a tax year for three consecutive tax years.** Here, both will be classified as foreign residents as of the first day of the second tax year. This rule will not apply if either the individual or the spouse is present in Israel for more than 30 days (i) in the first month of the first year in the four-year period or (ii) in the last month of the last year in the three-year period.

- **An individual and spouse who (i) are present in Israel for less than 100 days each year for four consecutive tax years, (ii) are present for at least 183 days in a foreign country with which Israel has in effect an income tax treaty, and (iii) hold a residency certificate from the treaty partner foreign country.** Here, both will be classified as foreign residents as of the first day of the first tax year in the four-year period. This rule will not apply if the either the individual or the spouse is present in Israel for more than 50 days (i) in the first 100 days of the first year in the four-year period or (ii) in the last month of the last year in the four-year period.

- **An individual and spouse who (i) are present in Israel for less than 100 days each year for three consecutive tax years, (ii) are present for at least 183 days in a foreign country with which Israel has in effect an income tax treaty, and (iii) hold a residency certificate from the treaty partner foreign country.** Here, both will be classified as foreign residents as of the first day of the second tax year in the four-year period. This rule will not apply if the either the individual or the spouse is present in Israel for more than 50 days (i) in the first 100 days of the first year in the three-year period or (ii) in the last month of the last year in the three-year period.

The Center of Life Test

The test based on center of life factors will continue to apply in all fact patterns that are not controlled by the irrebuttable presumptions of residence or nonresidence in Israel.

CONCLUSION

While the aim of the Report was to simplify the residence test in order to create much needed certainty for taxpayers and the I.T.A., it is not clear that the method proposed will achieve its goal.

Yes, individuals who cross the irrebuttable rules of residence will no longer be able to challenge the I.T.A. in court. Yes, the I.T.A. will not be able to challenge the non-resident status of an individual who resides in a treaty partner country, is present in that country for at least 183 days, and has a residence certificate issued by the country's tax administration.

That leaves everyone else having contacts with Israel and another country. For those individuals having facts that do not fit squarely within a presumption of residence or nonresidence, the facts and circumstances will continue to be examined in order to identify the center of life for an individual. More importantly, by eliminating cases at the fringes that should never have been brought because the individual clearly was a resident, as in the *Rafaeli* case, or clearly was a nonresident, as in the Sapir case, the I.T.A. can better direct its attention to the broad class of individuals having some contacts in Israel and other contacts abroad. The only certainty that these individuals will have is that the I.T.A. will be less resource-bound when reviewing claims of nonresidence.

Finally, the Report did not address specific circumstances relating to cultural changes in the work environment as a result of COVID-19. The concept of digital nomads, frontier workers, and remote workers are not addressed.

SWISS LUMP SUM TAX REGIME – BASED ON ANNUAL EXPENDITURES

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Forfait
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Lump Sum Taxation
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Tax Treaty
Wealth Tax

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INTRODUCTION

Switzerland can be an attractive country of residence for foreign nationals not pursuing an economic activity in Switzerland.

Besides the ordinary income and wealth tax regime, Switzerland provides for advantageous tax regimes for expatriates (in terms of extensive deductible expenses related to the expatriation) and for high-net-worth individuals.

ORDINARY TAX REGIME

Under the ordinary Swiss tax regime, individuals having a domicile in Switzerland or residing in Switzerland are fully taxable on worldwide income and wealth.

An individual is domiciled in Switzerland for tax purposes if he or she is present in Switzerland with the intention of settling permanently in Switzerland. This generally occurs when an individual has both a physical presence in Switzerland and the intention to settle permanently in Switzerland. The intention must be clearly evident to third parties from the factual background. Consequently, domicile is the place where an individual's center of personal and business interests are located.

An individual is deemed to be resident for tax purposes in Switzerland if he or she is physically present in Switzerland without notable interruption during

- 30 days and carries on a lucrative activity in Switzerland, or
- 90 days without carrying on a lucrative activity in Switzerland.

A taxpayer who is a tax resident abroad and stays in Switzerland only for educational or medical purposes is not treated as a resident of Switzerland for tax purposes.

Under the ordinary tax system, resident taxpayers are liable for Swiss income, wealth, and inheritance taxes.

Income and wealth taxes are basically levied on worldwide net income at several levels that include the Swiss Federal, Cantonal, and Municipal governments. In comparison, worldwide net wealth is exempt from Swiss Federal tax.

Some Cantons provide a tax shelter (*bouclier fiscal*), according to which the Cantonal and Municipal income and wealth taxes cannot exceed a certain percentage of annual taxable income. The tax shelter is intended to eliminate the risk of confiscatory taxes for individuals having relatively low income, but significant taxable assets. To illustrate, the Cantonal and Municipal income and wealth taxes in Geneva are capped at 60% of the annual taxable income. On the other hand, Geneva considers a person to recognize deemed minimum income corresponding to 1% of net wealth.

FAVOURABLE LUMP SUM TAX REGIME

Individuals taking residence in Switzerland for the first time or after an absence of at least ten years, without carrying out a lucrative activity in Switzerland, may opt for the lump sum tax regime instead of the ordinary tax regime.

Under the lump sum tax regime, the taxable base is determined on the Swiss and foreign living expenses of the entire family. Included in the tax base are items such as

- Food and clothing
- Housing
- Cleaning and maintenance expenses
- Private personnel costs
- Travel and vacations
- Maintenance costs for horses
- Maintenance costs for automobiles, yachts, and aircraft
- Other living expenses

The total amount of annual expenditures constitutes the taxable base for lump sum taxpayers. That base is subject to the ordinary progressive income tax rates at Swiss Federal, Cantonal, and Municipal levels.

In addition to income tax, wealth tax is levied at Cantonal and Municipal levels based on total taxable wealth. In general, total taxable wealth is computed as a multiple of the taxable base for income tax purposes. That base is increased by a certain percentage and is subject to progressive wealth tax rates.

The lump sum tax regime is applicable to an individual only if requested in a written submission to the Cantonal tax authorities. Once the regime applies, an individual must report changes in facts that may have an impact on the taxable base.

Application Conditions

To apply the lump sum tax regime, the following conditions must be met:

- **Residency in Switzerland**
  - Establish residence in Switzerland for the first time or after an absence of 10 years
  - Physical presence on at least 90 days each year without notable interruption (fictive domicile does not give right to lump sum taxation)
  - Meeting the above two conditions affects only Swiss tax. It does not

mean that a person is viewed to be a Swiss resident under all Swiss income tax treaties. For treaty purposes, the residence article of an applicable in a treaty must be reviewed. In several income tax treaties, Swiss resident individuals who elect the lump sum regime are not considered to be residents of Switzerland for treaty purposes unless regular Swiss tax is applied to income from sources in the treaty partner jurisdiction.

- **Prohibition to carry out any lucrative activity in/from Switzerland**
  - In principle, activity outside Switzerland is allowed.
  - However, in an age of remote working by entrepreneurs and executives, identifying the location of an activity may be difficult in certain circumstances. Where the location is blurred, the source of the income will be the decisive factor, rather than the place where the services take place.
  - Management of personal assets is allowed. Management may be carried out through a Swiss family office or a Swiss holding company, provided that the taxpayer is not classified as a securities or real estate dealer by the Swiss tax authorities.
- Not available for Swiss citizens

"The taxable base computed by reference to annual expenditures cannot be lower than a minimum taxable amount provided by the Swiss Federal and Cantonal tax acts."

Minimum Taxable Base

The taxable base computed by reference to annual expenditures cannot be lower than a minimum taxable amount provided by the Swiss Federal and Cantonal tax acts.

At the Swiss Federal level, the taxable base cannot be less than the highest of the following amounts:

- CHF 421,700 in 2023
- Seven times the annual deemed rental value of an individual's primary residence that is owned, or if not owned, the effective rent of the taxpayer's primary residence
- Three times the expenses for lodging (*e.g.*, hotel where an apartment is not leased) and food
- The comparative calculation, which is the sum of the following elements:
  - Swiss source income (on Swiss real estate, movable assets located in Switzerland, financial assets invested in Switzerland, Swiss pensions, Royalties on Swiss source copyright and patents, etc.)
  - Foreign source income for which application of a double tax treaty is requested by the taxpayer (*i.e.*, treaty-favored income)

The purpose of the comparative calculation made in the annual tax return is to verify that the annual tax liability of the lump sum taxpayer levied on the taxable base is not lower than the tax liability that would be levied on the elements of the comparative calculation. Only the maintenance expenses for property and ordinary bank charges paid for the management of movable assets can be deducted from the comparative calculation.

At the Cantonal level, each Canton is free to set its minimum taxable base, lump sum taxable wealth, or an increase of the initial taxable base for wealth tax purposes. Beginning in 2009, many Swiss-German Cantons, such as Zürich, Schaffhausen, Appenzell-Ausserrhoden, and Basel abolished the lump sum tax regime at the Cantonal level. Beginning in 2016, many other Cantons strengthened their lump sum regimes by introducing new provisions in line with Swiss Federal harmonization principles.

Cantons providing the lump sum tax regime, also provide for a minimum taxable base amounting to at least seven times the deemed rental value or effective rent paid for main residence, as well as for a comparative calculation considering not only income on Swiss assets but also related wealth. Regarding the minimum taxable base at the Cantonal level, thresholds vary significantly from one canton to another as do the rates. To illustrate:

- The Canton of Geneva provides a minimum taxable base of CHF 400,000, for wealth tax purposes the taxable base is increased by 10%.
- The Canton of Vaud provides a minimum taxable base of CHF 415,000, including the increase of 15% for wealth tax purposes.
- The Canton of Valais provides for a minimum taxable base of CHF 250,000. Lump sum wealth tax is levied on the taxable base multiplied by four. As a result, a lump sum taxpayer resident in Valais who can claim the minimum taxable base will be taxed at the Cantonal level on CHF 250,000 and at the Swiss Federal level on CHF 400,000 for income tax purposes. The minimum taxable wealth is CHF 1 million.
- The Cantons of Lucerne, St-Gallen, and Schwyz provide for a minimum taxable base of CHF 600,000. The wealth tax is levied on 20 times the taxable base, amounting to CHF 12 million. Ordinary rates on income and wealth are lower in these Cantons than in Geneva and Vaud, where rates are among the highest.

Examples

Mr. A is not a Swiss citizen. He resides in Switzerland with members of his family. The family reports annual worldwide expenditures of CHF 500,000. Mr. A owns residential property in which he and his family reside. The deemed annual rental value of Mr. A's main place of residence is CHF 100,000, resulting in a taxable annual base of CHF 700 000 (CHF 100,000 × 7). In these facts, the taxable base for lump sum taxation is the deemed rental value of the main residence.

- In Geneva, the taxable base of CHF 700,000 is increased by 10%, *i.e.*, a total of CHF 770,000 subject to tax at the ordinary income tax rates, yielding an annual tax liability of approximately CHF 300,000.
- In Valais, the taxable base would be CHF 700,000 for income tax, which is multiplied by four, for wealth tax purposes, amounting to CHF 2.8 million. The annual tax liability would amount to approximately CHF 260,000.

- In Schwyz, the taxable base would be CHF 700,000 for income tax purposes and CHF 14 million for wealth tax purposes. The annual tax liability would amount to approximately CHF 200,000.

The deemed rental value is determined by the Cantonal tax authorities and is primarily based on the value of the property. Therefore, the value itself may be significantly different from one canton to the other for the same category of property.

RESIDENCE PERMIT

Switzerland has specific rules regarding residence permits depending on whether the individual is a national of a Member State of the E.U. Under those rules, E.U. citizens must demonstrate sufficient means of subsistence to obtain a residence permit. In comparison, non-E.U. citizens can obtain a residence permit if it is in the fiscal interest for the Canton of residence.

A fiscal interest exists if the projected tax liability for the individual equals or exceeds a certain minimum amount. This amount varies from Canton to Canton. To illustrate:

- In the Cantons of Geneva and Vaud, the amount ranges between CHF 300,000 and CHF 350,000.
- In the Canton Schwyz, the amount is approximately CHF 500,000.
- In the Cantons of Valais, Zug, and Ticino, the amount is approximately CHF 270,000.

Note that the minimum tax amounts provided above are indicative of the amounts agreed based on negotiations with the competent tax authority on a case-by-case basis.

As a result of Brexit, U.K. nationals are considered to be non-E.U. nationals when applying for the Swiss lump sum tax regime. However, negotiated amount for U.K. nationals may be reduced in certain Cantons. To illustrate, in the Canton of Vaud, the tax liability is often between CHF 180,000 to CHF 200,000 for individuals above the age of 55 years.

TAX RESIDENCY AND DOUBLE TAX TREATIES

Switzerland has income tax treaties covering income taxes and net wealth taxes with around 100 countries. The income tax treaties with Germany, Austria, Belgium, Canada, the United States, Italy, and Norway do not recognize lump sum taxpayers as residents of Switzerland unless income arising in those countries are included in the comparative calculation. The treaty provisions are not identical. As a result, lump-sum tax agreements will vary depending on the country of origin of the income.

SWISS GIFT AND INHERITANCE TAXES

At the Cantonal level, gift and inheritance taxes are levied. Only the Canton of Schwyz has no gift or inheritance taxes.

Cantons are free to set tax rates. Most Cantons have a low rate, if not a complete exemption, for gifts and inheritances between spouses and for donees, and heirs in direct blood line to the donor or decedent.

In some Cantons, lump sum taxpayers remain subject to gift and inheritance at a very reduced rate. Again, those Cantons provide for a full exemption for surviving spouse and for donees and heirs in direct line to the donor or decedent.

PRE-IMMIGRATION ESTATE TAX PLANNING

Pre-immigration tax planning is necessary to mitigate Swiss gift and inheritance taxes. The creation of a foreign trust or foundation often is an efficient solution for estate tax planning purposes. A Luxembourg *Société de gestion de patrimoine familial* ("S.P.F.") is popularly used, also. In certain cases, the use of a Swiss holding company may be an option to consider for Swiss tax residents with foreign assets.

Trusts and Foundations

The Swiss foundation is exclusively used for charitable purposes. In case of a non-charitable foundation, any distribution from the foundation to a beneficiary would be characterized as a gift to an unrelated party and may be subject to gift or inheritance tax at the highest possible rate, generally between 40 to 50%.

The tax treatment of a settlor of a trust depends on whether the trust is irrevocable. As a general principle, a revocable trust is treated as transparent under Swiss tax law. This means that the settlor continues to be treated as the owner of the asset. A Federal Tax Circular on Trusts describes the circumstances in which a trust is considered to be non-transparent. When a trust is non-transparent, the establishment of a trust is immediately subject to gift tax. When transparent, there is no gift tax at formation, but inheritance tax is imposed at the conclusion of life. The guidance in the Federal Tax Circular should result in similar treatment at the Cantonal level, as a result of harmonized practice between Swiss Federal and Cantonal tax rules.

For an individual anticipating a move to Switzerland, the establishment of an irrevocable trust yields gift and estate tax benefits when the settlor can demonstrate two facts:

- Assets were transferred irrevocably to the trust or foundation before becoming a Swiss tax resident.
- The trust (or the foundation) is not transparent.

A trust is transparent where the settlor retains any of the following rights or powers:

- The right to be a beneficiary of the trust
- The right to revoke or appoint a trustee
- The right to designate new beneficiaries
- The right to replace a protector having powers similar to those of the trustee
- The right to amend the trust deed or to have it amended
- The right to revoke or liquidate the trust
- A veto power against the trustee's decisions regarding the assets

An advanced tax ruling confirming the non-transparency of the trust or foundation is highly recommended before migrating to Switzerland.

Corporate Structures

In certain cases, the use of a Swiss holding company may be an option to consider for Swiss tax residents with foreign assets. A Swiss holding company enjoys the benefit of participation relief for qualifying dividends and capital gains, or full participation exemption if it is a pure holding company. It also enjoys a full credit for Swiss withholding tax on dividend payments to Swiss residents, and access to the broad Swiss treaty network. Dividends to Swiss substantial interest shareholders are partially exempt from income tax.

A Luxembourg *Société de gestion de patrimoine familial* ("S.P.F.") is also a structure with some popularity.

PRACTICAL ASPECTS

Social Security Contributions

Swiss lump sum taxpayers also need to contribute to the Swiss Social Security until they reach the age of 65 years for men or 64 years for women. In 2025, contributions will be required for both men and women until the age of 65 years is reached. The exact amount of contribution will depend on the taxable base confirmed by the tax authorities under the lump sum tax regime.

Private International Law

Before migrating, it is important to verify the Swiss civil law aspects and consequences for the family such as matrimonial law and accuracy of any prenuptial agreement, the applicable inheritance law, and the need to update any existing will.

CONCLUSION

Switzerland provides for a very attractive lump sum tax regime for H.N.W.I. and U.H.N.W.I., which is not based on worldwide income and wealth but determined on the annual expenditures of the family and therefore corresponds to the family standard of living.

Compared to other countries with similar regimes, the significant advantage of Switzerland resides in its political and economic stability. Whether COVID-19, the war in Ukraine, and energy availability and prices, Switzerland has demonstrated a certain pragmatism and avoided social demonstrations.

Switzerland is also a leader in innovation and technology, fosters a liberal economic system, maintains close ties to other markets, supports an excellent education and health care system, has outstanding infrastructure, and a high quality of life. But most importantly, it allows a U.H.N.W.I. to be taxed on their annual expenditures subject to a written approval of the Cantonal tax authorities, instead of ordinary worldwide income and wealth taxes.

"Compared to other countries with similar regimes, the significant advantage of Switzerland resides in its political and economic stability."

CODE §245A – SOMETIMES, THINGS ARE MORE THAN THEY APPEAR

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Participation Exemption
Specified Foreign Corporation
Subpart F

INTRODUCTION

Section 245A of the Internal Revenue Code of 1986 (the "Code") effectively exempts U.S. corporations from U.S. Federal income tax on dividends received from certain foreign subsidiaries. It allows a deduction equal to the amount of the dividend received. Code §245A applies only where certain conditions are met and only with respect to dividends received "by a domestic corporation which is a United States shareholder."

Nevertheless, Code §245A can also apply to dividends received by a controlled foreign corporation from a qualifying participation in a lower-tier foreign corporation. The question presented in that fact pattern is how Code §245A is applied.

- Is the controlled foreign corporation entitled to claim the deduction as dividends are received?
- Or is a U.S. corporation that is a U.S. Shareholder with regard to both the distributing and the recipient foreign corporations entitled to claim the deduction at the time Subpart F income is reported in its U.S. tax return?

Significantly different results may apply depending on the answer. Interestingly, the differences affect U.S. taxpayers other than the corporation that is a U.S. Shareholder.

CODE §245A: THE U.S. PARTICIPATION EXEMPTION REGIME FOR FOREIGN DIVIDENDS

Code §245A was added to the Code as part of the Tax Cuts and Jobs Act of 2017 (the "T.C.J.A.").[1] It is effective for distributions made after December 31, 2017.

Prior to the T.C.J.A., the U.S. international tax system was largely a worldwide system of taxation. Except as provided under Subpart F, active business income of foreign subsidiaries was taxed only upon repatriation, *i.e.*, when distributed to the U.S. corporate shareholder.[2]

The imposition of U.S. tax on repatriated income of foreign subsidiaries placed U.S. multinational corporations at a disadvantage compared with foreign corporations

1 Pub. L. No. 115-97, §14101(a).

2 In contrast to active business income, passive income of foreign subsidiaries has been taxed by the U.S. shareholder on an annual basis under the Subpart F regime or the P.F.I.C. regime where the foreign corporation is treated as a Qualified Electing Fund. Both sets of rules are beyond the scope of this article.

based in countries that employed a territorial system of taxation dividend income received from foreign subsidiaries.[3] Examples include the U.K. and other G-7 countries. This was especially true because the nominal U.S. corporate tax rate was very high relative to the corporate tax rates in other countries, reaching 35% at the time.[4]

In 2017, Congress decided to eliminate the taxation of repatriated income of foreign subsidiaries and to reduce the corporate income tax rate to 21%. The main purpose was to allow U.S. multinationals to better compete against foreign multinationals.[5] This is when Code §245A came into play, effective in 2018.

CODE §245A - HOW DOES IT WORK?

Code §245A provides that, in the case of any dividend received from a 10%-owned foreign corporation by a U.S. corporation that is a U.S. Shareholder, the U.S. corporation is allowed a deduction in an amount equal to the foreign-source portion of the dividend (also known as a dividend-received deduction or a "D.R.D."). As a result of the D.R.D., the dividend income is fully offset, resulting in a nil rate of U.S. Federal corporate income tax.

An important point to bear in mind is that, where the distributing corporation is a controlled foreign corporation ("C.F.C.") as defined in Code §957(a), some of its income might already have been taxed in the U.S. under the U.S. anti-deferral regimes in advance of any distribution ("Previously Taxed Income").[6] To prevent the same income from being taxed a second time, the Code provides that Previously Taxed Income is not to be taken into account for U.S. Federal tax purposes when actually distributed to the U.S. Shareholder.[7] Accordingly, ordering rules published by the I.R.S. provide that any amount distributed by a C.F.C. will first be considered as being made out of Previously Taxed Income.[8] Only the remainder of the dividend amount, if any, will be potentially subject to Code §245A D.R.D.

For the D.R.D. to apply, the following five conditions must be met:

- The dividend must be received from a "specified 10-percent owned foreign corporation" (a "Specified Foreign Corporation" or "S.F.C."). An S.F.C. is a foreign corporation if at least one of its shareholders is a corporation that is "U.S. Shareholder."[9] A corporation is "U.S. Shareholder" if it was formed in the U.S. and it owns, either directly or indirectly, or is considered as owning under special attribution rules, shares representing 10% or more of the voting power or value of the distributing corporation.[10]

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[3] S. Comm. on the Budget, 115th Cong., Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Prt. No. 115-20, at 358 (Comm. Print 2017).

[4] Of course, corporations with sophisticated tax departments were tasked to manage the effective rate.

[5] S. Comm. on the Budget, 115th Cong., Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Prt. No. 115-20, at 358 (Comm. Print 2017).

[6] Mainly, the Subpart F regime governed by Code §§951 to 965 and the G.I.L.T.I. regime under Code §951A. The G.I.L.T.I. regime became effective as of 2018.

[7] Code §959(a).

[8] I.R.S. Notice 2019-01.

[9] Code §245A(b).

[10] Code §951(b).

- The dividend must be received by a domestic corporation that is a "U.S. Shareholder" with respect to the distributing corporation.
- The U.S. Shareholder must meet a minimum holding-period requirement of more than 365 days during a two-year period beginning one year before the ex-dividend date.[11]
- The dividend must be a foreign source dividend, determined by reference to the undistributed foreign earnings of the Specified Corporation.[12]
- The dividend must not be any of the following: (i) a hybrid dividend,[13] (ii) a purging distribution by a passive foreign investment company ("P.F.I.C.") generally made as a condition of becoming a "pedigreed Q.E.F.,[14] (iii) any other distribution from a P.F.I.C."[15] that is not a C.F.C.,[16] and (iv) an extraordinary disposition amount during the taxable year preceding application of the D.R.D.[17]

In this article, we focus on the second requirement listed above, according to which the dividend must be received by a domestic corporation.

As explained below, the D.R.D. should also apply if the dividend is received by a C.F.C. owned by a domestic corporation, provided the domestic corporation is U.S. Shareholder with respect to the distributing corporation and all other requirements listed above are met.

". . . the D.R.D. should also apply if the dividend is received by a C.F.C. owned by a domestic corporation, provided the domestic corporation is U.S. Shareholder with respect to the distributing corporation and all other requirements listed above are met."

DIVIDEND RECEIVED BY A CONTROLLED FOREIGN CORPORATION – WHAT IS THE PROBLEM?

The plain language of Code §245A provides that a D.R.D. may apply where a dividend is received by a domestic corporation which is a U.S. Shareholder. Allowing for a D.R.D. to apply only with respect to dividends received by domestic corporations makes sense – Code §245A was enacted to incentivize U.S. corporations and to remove fiscal barriers imposed on U.S. multinational corporations, not on foreign corporations.

However, multinational U.S. corporations typically own several tiers of foreign corporations. Therefore, a dividend distributed by an S.F.C. might be received by an upper-tier foreign corporation rather than directly by the U.S. parent corporation. Then what? Should Code §245A apply in such a case? Three scenarios are relevant to our discussion. The third scenario would be at the focus of this article.

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[11] Code §246(c)(5).

[12] As defined in Code §245A(c). A deduction for the U.S. portion of the dividend, if any, is available under Code §245, in full or in part, depending on the circumstances and provided certain conditions are met.

[13] Code §245A(e).

[14] Code §245A(f).

[15] Defined in Code §1297.

[16] Defined in Code §957(a).

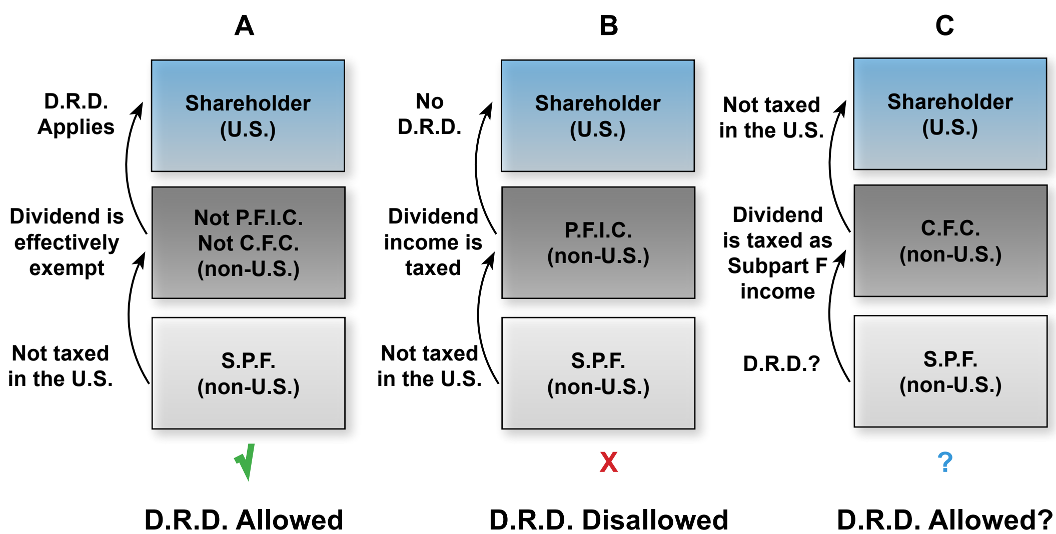
[17] Treas. Regs. §1.245A-5.

First, if the upper-tier foreign corporation is neither a P.F.I.C.[18] nor a C.F.C., the dividend income received will not be subject to U.S. Federal income tax when and as received by an S.F.C. When the proceeds of the dividend are distributed to a U.S. corporation that is a U.S. Shareholder, a 100% D.R.D. may apply under Code §245A. All in all, no U.S. Federal income tax would apply on the dividend amount.

Second, if the upper-tier foreign corporation is a P.F.I.C.[19] that is not a Q.E.F.[20] and not a C.F.C., the dividend income will be taken into account for U.S. Federal tax purposes when and as distributed to a corporation that is a U.S. Shareholder. Code §245A explicitly disallows the D.R.D on distributions from a P.F.I.C.[21] Therefore, U.S. Federal tax will be imposed when the dividend is distributed to the U.S. Shareholder, typically under the excess distribution regime applicable to P.F.I.C. distributions.

Third, if the upper-tier foreign corporation is a C.F.C., the dividend received will be considered Subpart F income,[22] if no exception applies,[23] and the U.S. Shareholder will be required to include in its gross income its *pro-rata* share of the C.F.C.'s dividend income.[24] In other words, the corporate U.S. Shareholder will be subject to U.S. tax on the dividend income distributed by an S.F.C. to a C.F.C. When a distribution is further made to the U.S. corporate shareholder by the C.F.C, no additional U.S. tax will be imposed and thus the D.R.D. will be technically irrelevant at that point.[25] However, U.S. tax would have already been imposed at the C.F.C. level, effectively subjecting the dividend income to U.S. Federal tax.

The different scenarios are demonstrated through the following diagram:



[18] Defined in Code §1297.

[19] Whether the upper-tier foreign corporation is a "passive foreign investment company" and how to avoid such status, is beyond the scope of this article.

[20] Within its meaning in Code §1295.

[21] Code §245A(b)(2).

[22] Code §§ 952(a)(2), 954(a) & 954(c)(1)(A).

[23] See mainly Code §§954(c)(3) & (6).

[24] Code §951(a).

[25] Code §959(a).

Scenario C illustrates that, if Code §245A would not apply to a dividend received by a C.F.C from an S.F.C., the dividend will be subject to U.S. Federal tax under the Subpart F regime. In this case, no participation exemption would apply and the intended purpose of the D.R.D. would be frustrated.

Since many U.S. multinational groups own S.F.C.'s through tiered C.F.C.'s, a narrow reading of Code §245A could impose a real obstacle in accomplishing the purpose of the U.S. participation exemption regime. A more liberal interpretation of Code §245A is therefore required, and it can be achieved through either of the following two theories:

- The C.F.C. will compute its income as if it were a domestic corporation, which includes Code §245A. Therefore, any dividend received by the C.F.C. will be regarded as being received by a domestic corporation.
- The C.F.C.'s Subpart F income resulting from the dividend and included in the U.S. Shareholder's gross income, will be treated as a dividend received by the U.S. Shareholder for purposes of Code §245A.

Interestingly enough, each of these theories can be supported by one or more related Code provisions as well as legislative history.

RELATED CODE PROVISIONS

Each of the Code provisions described below can support the notion that Code §245A was intended to apply on any dividend received by a C.F.C. from an S.F.C.

Code §964(a) and I.R.S. Regulations Treat a Foreign Corporation as a Domestic Corporation for Purposes of Computing Income

Code §964(a) and I.R.S. regulations promulgated thereunder,[26] provide that the taxable income of a C.F.C. will be determined by treating such corporation as a domestic corporation.[27] This provision is a key feature of the Subpart F regime because it allows a U.S. Shareholder to determine the C.F.C.'s income under U.S. Federal tax principles.

In applying Code §964(a) to Code §245A, a dividend received by a C.F.C. should be treated as having been received by a domestic corporation.

Under Code §951(b), a U.S. Shareholder Includes an Indirect Shareholder

As mentioned above, Code §245A requires that a dividend distributed by the foreign corporation will be received by a domestic corporation that is a "U.S. Shareholder with respect to such foreign corporation."

The term "U.S. Shareholder" is defined in Code §951(b). Under that provision, a domestic corporation can be considered a U.S. Shareholder of a foreign corporation whether it owns shares in the foreign corporation directly or indirectly through an upper-tier foreign corporation.[28] It follows that Code §245A allows for an indirect ownership of the S.F.C. by the U.S. Shareholder.

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26 Tres. Reg. §1.952-2(b).

27 Certain exceptions apply but none of them relate to Code §245A.

28 Code §958(a)(2).

Where the U.S. Shareholder indirectly owns the S.F.C. through an upper-tier foreign corporation, it can be expected that any dividend distributed by the S.F.C. will be received through such upper-tier foreign corporation. Since Code §245A allows for an indirect ownership of the S.F.C. through an upper-tier foreign corporation, it can be inferred that it also allows for an indirect receipt of the dividend through the upper-tier foreign corporation.

Under Code §245A(e)(2), an Exception Applies to Dividends Received by a C.F.C. Evidencing That Absent any Exception, a D.R.D. Applies to C.F.C.'s

As an exception to the general rule regarding the D.R.D., Code §245A(e)(1) provides that the D.R.D. will not apply with respect to a hybrid dividend received by a U.S. Shareholder from an S.F.C. that is a C.F.C. Code §245A(e)(2) further provides that the D.R.D. will not apply with respect to a hybrid dividend received by a C.F.C. from an S.F.C. that is a C.F.C.

The exception under Code §245A(e)(2) would not have been required had the D.R.D. not applied to dividends received by C.F.C.'s. The fact that Congress enacted this exception can be read to confirm that D.R.D. may apply to dividends received by a C.F.C. under the general rule and absent any exception.

Under Code §964(e)(4), the D.R.D. Applies on a Dividend That is Deemed Received by a C.F.C., Implying That a D.R.D. Applies to a Dividend That is Actually Received by a C.F.C.

Code §964(e)(4) provides that if a C.F.C. is treated as receiving a dividend under circumstances set forth in Code §964(e)(1),[29] a D.R.D may apply to that deemed dividend pursuant to the following mechanism:

- The deemed dividend is treated as Subpart F income.
- The U.S. Shareholder includes in its gross income its *pro-rata* share of the Subpart F income.
- The D.R.D. under Code §245A is allowable as if the Subpart F income were a dividend received by the U.S. Shareholder.

Under this view, if a D.R.D. may apply to a dividend deemed received by a C.F.C., it may also apply to a dividend actually received by a C.F.C.

I.R.S. Regulations Under Code §956 Allow for a D.R.D. on a Hypothetical Distribution From a Lower-Tier C.F.C.

At a high level, Code §956 requires any U.S. Shareholder of a C.F.C. to include in gross income the C.F.C's investments in U.S. property (the "Code §956 Amount"). Final regulations corrected in 2019 reduce the Code §956 Amount by amounts that the U.S. Shareholder could have deducted as a D.R.D. under Code §245A had the Code §956 Amount been distributed to it (a "hypothetical distribution").

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29 Under Code §964(e)(1), if a C.F.C. sells stock in a lower-tier C.F.C. in which it owned 10% or more of the voting power at any time during the 5 years preceding the sale, part of the gain will be treated as a dividend, to the extent of the lower-tier C.F.C.'s accumulated earnings and profits attributable to the sold stock.

These regulations, that allow for a D.R.D. to apply to a hypothetical distribution, also allow for a D.R.D. to apply on a hypothetical distribution from a lower-tier C.F.C. that is indirectly held by a U.S. Shareholder through another foreign entity, as if the distribution were made directly to the U.S. Shareholder.[30]

Allowing the D.R.D. to apply on a hypothetical distribution from a lower-tier C.F.C. confirms that the Treasury's view is that a D.R.D. can generally apply to dividends distributed by lower-tier foreign corporations.

THE LEGISLATIVE HISTORY

In addition to the Code provisions mentioned above, the legislative history also supports the notion that Code §245A was intended to apply on any dividend received by a C.F.C. from an S.F.C. Once again, two different interpretative theories may apply.

The C.F.C. may be Treated as a Domestic Corporation

Code §245A was described in the Congress' Committee of Conference Report published in regard to the T.C.J.A.[31] In that report, immediately after the words "domestic corporation," there appears a footnote that reads as follows:

> * * * including a controlled foreign corporation treated as a domestic corporation for purposes of computing the taxable income thereof. See Treas. Reg. Sec. 1.952-2(b). Therefore, a C.F.C. receiving a dividend from a 10-percent owned foreign corporation that constitutes Subpart F income may be eligible for the D.R.D. with respect to such income.

Based on the Committee's approach, Congress intended that the C.F.C. will be treated as a domestic corporation for purposes of the D.R.D. and, accordingly, the C.F.C. itself may claim the dividend-received deduction under §245A. As a result, the C.F.C.'s Subpart F income will not include the dividend income received from the S.F.C.

"Allowing the D.R.D. to apply on a hypothetical distribution from a lower-tier C.F.C. confirms that the Treasury's view is that a D.R.D. can generally apply to dividends distributed by lower-tier foreign corporations."

The C.F.C.'s Subpart F Income May be Treated as a Dividend Received by the U.S. Shareholder

A somewhat different approach was expressed in the Joint Committee on Taxation report (the "Bluebook").[32] According to the Bluebook:

> A corporate U.S. Shareholder of a C.F.C. receiving a dividend from a 10-percent owned foreign corporation shall be allowed a deduction with respect to the subpart F inclusion attributable to such dividend in the same manner as a dividend would be allowable under §245A."

According to this approach, it is the U.S. corporate shareholder who will be eligible for the D.R.D. with respect to the Subpart F inclusion, not the C.F.C. receiving the dividend. The D.R.D. would apply to the Subpart F inclusion in the same manner as a dividend would be allowable under Code §245A.

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30 Treas. Reg. §1.956-1(a)(2)(ii).

31 H.R. Rep. No. 115-466, at 599, n.1486 (2017) (Conf. Rep.).

32 Joint Comm. on Tax'n, General Explanation of Public Law 115-97 (JCS-1-18), at 348 (Dec. 20, 2018).

The Bluebook's approach essentially achieves the same result of reducing the U.S. Shareholder's Subpart F liability by the dividend amount in a three-step process: First, the dividend received by the C.F.C. will be treated as Subpart F income. Second, the U.S. Shareholder's *pro rata* share in that Subpart F income will be included in the U.S. Shareholder's gross income. Lastly, the U.S. Shareholder would claim a D.R.D. under Code §245A to offset its Subpart F inclusion.

WHICH APPROACH SHOULD BE ADOPTED?

In the previous sections we established that a D.R.D. may apply under Code §245A with respect to a dividend received by a C.F.C., not only with respect to a dividend received by a domestic corporation.

However, in absence of clear guidance on point, it remains unclear what interpretative approach should be adopted – should it be the Committee's approach, treating the C.F.C. as a domestic corporation and allowing the C.F.C. itself to claim the D.R.D.? Or should it be the Bluebook approach, treating the Subpart F inclusion attributed to the dividend as a dividend and allowing the U.S. Shareholder to utilize the D.R.D. to offset such Subpart F inclusion?

While both interpretations have supporting arguments, we are inclined to believe that the Bluebook's approach, which allows for the D.R.D. to apply at the level of the corporate U.S. Shareholder, is the better of the two approaches.

- The Bluebook approach goes hand-in-hand with the participation exemption regime which Congress sought to implement through Code §245A. Under the Bluebook approach, a D.R.D. will be allowable only "in the same manner as a dividend would be allowable under §245A." Therefore, the D.R.D. will be allowed only for a U.S. Shareholder that is a corporation, rather than an individual, that owns, directly or indirectly, 10% of the voting power or the value of the foreign corporation. In that way, a participation exemption will be granted only and exactly in the special circumstances articulated by Congress. Of course, if the individual were to make an election under Code §962 to compute tax under Subpart F as if a corporation, the D.R.D. would be available until an actual dividend is received.[33] In comparison, if the D.R.D. is allowable at the C.F.C. level, as suggested under the Committee's approach, a participation exemption will be available even where the C.F.C. is owned by an individual shareholder. This benefit goes beyond the purpose of Code §245A and is not the goal that Congress wished to achieve.

- The Bluebook approach is harmonized with Code §964(e)(4). As explained above, in certain circumstances a C.F.C. is treated as receiving a deemed dividend under Code §964(e)(1). Code §964(e)(4) provides that Code §245A may apply to such deemed dividend and, to that end, it is the U.S. Shareholder, not the C.F.C., that would be eligible for a D.R.D., subject to a 3-step process. The Bluebook approach follows the exact same path as Code §964(e)(4) and, by that, it creates a coherent and harmonized statutory scheme.

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[33] Code §962(d).

- The Bluebook approach is not in conflict with the provisions of Subpart F. Subpart F requires any U.S. Shareholder in a C.F.C. to include in her gross income her *pro-rata* share in the C.F.C.'s Subpart F income. The term "Subpart F" income is defined to include certain types of income, including dividends received by the C.F.C.[34] (subject to certain exceptions).[35]

  Under the Bluebook approach, dividend received from the S.F.C. is expected to be treated as Subpart F income of the C.F.C. under the ordinary rules of the Subpart F regime. Similarly, the U.S. Shareholder is expected to include in its gross income its *pro-rata* share of Subpart F income. It is only at that point that the U.S. Shareholder may claim a D.R.D., and then, only to the extent it is eligible under the requirements of Code §245A. This way, the Bluebook approach allows the Subpart F regime and the participation exemption regime to co-exist side by side. As illustrated above, the Committee's approach is in conflict with the provisions of Subpart F as explained above. It would effectively allow an individual U.S. Shareholder to avoid income as dividends would flow up a chain of S.F.C.'s ultimately to the individual. That would not occur were all corporations U.S. domestic corporations.

- While the D.R.D. under Code §245A is fundamentally different from the indirect foreign tax credit that existed under prior law,[36] nothing in the legislative history suggests that the class of persons benefitting under the D.R.D. should be broader than the class of persons that previously benefitted from indirect foreign tax credit. The indirect foreign tax credit could be claimed only by domestic corporations owning 10% or more of the voting stock of the foreign corporation paying the dividend. If the D.R.D. is applied at the level of the C.F.C., effectively all U.S. persons who are shareholders of an S.F.C. could benefit by the deduction because the D.R.D. would reduce earnings and profits thereby reducing the portion of all distributions treated as dividend income.[37]

CONCLUSION

The legislative history and the related provisions of the Code, read as a whole, confirm that Congress intended for the D.R.D. under Code §245A to apply with regard to dividends received by C.F.C.'s.

While some portions of the legislative history suggest that the D.R.D. may be claimed at the level of a C.F.C., other parts of the legislative history support the approach that a dividend received by a C.F.C. from 10% owned foreign corporation should first be treated as the C.F.C.'s Subpart F income and included in the U.S.

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[34] See Code §§952(a) and 954(c)(1)(A).

[35] See, mainly, Code §§954(c)(3) & (6).

[36] Code §902 as in effect up to 2018.

[37] Under Code §316(a), the term "dividend" means any distribution of property, including money, out of earnings and profits after February 28, 2013 or out of earnings and profits of the taxable year in which the distribution is made, without regard to the earnings and profits at the time of the distribution. Amounts distributed in excess of earnings and profits are treated as a reduction in the shareholder's basis in the shares. When basis is reduced to zero, amounts distributed are treated as capital gains. See Code §301(c).

Shareholder's gross income. Only at the shareholder level may a D.R.D. be claimed by the U.S. Shareholder, and only by a corporation, provided all the requirements of Code §245A are met.

Such interpretative approach to Code §245A results in eliminating the taxable income arising from a Subpart F inclusion when a corporation is the U.S. Shareholder, thereby effectively achieving the purpose of the participation exemption regime that was introduced into the U.S. international tax system effective in 2018.

IS THE N.I.I.T. AN INCOME TAX, A SOCIAL SECURITY TAX, OR NEITHER? DOUBLE TAXATION OF INCOME HANGS IN THE BALANCE

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Tags
Foreign Tax Credit
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BACKGROUND

Congress enacted the N.I.I.T. in 2012 as part of a 2010 law amending the Affordable Care Act ("A.C.A."), more popularly known as "Obamacare." Its creation corresponded to a 0.9% increase in the Medicare tax, which is imposed on wages and self-employment income. With the increase in tax on earned income, Congress wanted a parallel tax on unearned income and capital gains.

The N.I.I.T. is a 3.8% tax on a taxpayer's investment income, broadly equivalent to passive income. This includes income from interest, dividends, annuities, royalties, and rents. It also is imposed on capital gains. The N.I.I.T. does not tax investment income that is not otherwise included in Federal gross taxable income. Individuals are subject to the tax if their income is above certain thresholds. For 2023, the thresholds are $200,000 for single filers and $250,000 for married taxpayers filing jointly.

The N.I.I.T. applies to individuals, estates, and trusts. Individuals who are neither U.S. citizens nor U.S. residents for income tax purposes of the U.S. are exempt from the tax.[1] U.S. citizens who reside abroad are subject to the N.I.I.T. in addition to U.S. income tax. They also may be subject to income tax in the country where they reside. U.S. tax law provides no statutory relief from the N.I.I.T. for such taxpayers. The N.I.I.T. is due and the position of the I.R.S. is that the N.I.I.T. cannot be reduced by a foreign tax credit and may or may not be eliminated by a Social Security Totalization Agreement.

This article addresses recent experiences of U.S. citizens resident abroad when computer-generated tax returns provide no relief that can reduce the N.I.I.T.

TAX TREATIES AND FOREIGN TAX CREDITS

U.S. citizens or green card holders who have connections to multiple countries through citizenship or residence may find themselves subject to tax in more than one country with regard to the same item of income. Where that occurs relief may be available under the foreign tax credit of U.S. domestic law or an applicable income tax treaty. Both provide for a foreign tax credit. With limited exceptions that vary among treaties, all U.S. treaties provide that the limitations of the foreign tax credit under U.S. tax law control the application of foreign tax credit relief under treaty. In either event, the principle is simple: U.S. taxpayers should be taxed only once on an item of income rather than twice or not at all.

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1 Treas. Reg. §1.411-2(a)(1).

Despite the N.I.I.T.'s name as well as its location in Subtitle A (Income Taxes), the foreign tax credit provisions of income tax treaties do not provide relief against the N.I.I.T. The mechanics of the foreign tax credit rules in the U.S. limit the scope of relief granted by tax treaties. U.S. tax law allows a foreign tax credit, but it provides relief only for taxes imposed by Chapter 1 of the Internal Revenue Code of 1986, as amended (the "Code").[2] Regrettably for taxpayers, the N.I.I.T. is a tax that appears in Chapter 2A of the Code. Consequently, regulations issued by the I.R.S. under the N.I.I.T.[3] disallow credits that can be taken against Chapter 1 taxes – specifically the foreign tax credit – from reducing the amount of N.I.I.T. due. Exceptions apply only if the Chapter 1 credit specifically states that it may be claimed to reduce the amount of N.I.I.T. due and payable. Currently no credit in Chapter 1 contains that language.

While domestic law does not provide a foreign tax credit, it is theoretically possible an income tax treaty provides such authority.[4] Indeed, the Treasury Department and I.R.S. leave open this possibility. But in doing so, they caution that treaties with language substantially similar to Article 23(2) of the U.S. Model Income Tax Treaty do not provide a basis for taking the foreign tax credit against the N.I.I.T.[5] In the 2016 version of the Model Treaty, that provision reads:

> 2. In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income applicable to residents and citizens:
>
> > a) the income tax paid or accrued to __________ by or on behalf of such resident or citizen; and
> >
> > b) in the case of a United States company owning at least 10 percent of the voting stock of a company that is a resident of __________ and from which the United States company receives dividends, the income tax paid or accrued to __________ by or on behalf of the payor with respect to the profits out of which the dividends are paid.
>
> For the purposes of this paragraph, the taxes referred to in subparagraph (a) of paragraph 3 and paragraph 4 of Article 2 (Taxes Covered) shall be considered income taxes.

The relevant paragraphs of Article 2 that identify taxes covered by the Model Treaty state the following:

> 3. The existing taxes to which this Convention shall apply are:
>
> > a) in the case of [name of treaty partner]: * * *[;]

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2 Code §27.

3 Treas. Reg. §1.1411-1(e).

4 See the preamble published by the I.R.S. at the time Treas. Reg. §1.1411-1 was adopted, T.D. 9644.

5 *E.g.*, Switzerland-U.S. Income Tax Treaty Art. 23(2).

b) in the case of the United States: the Federal income taxes imposed by the Internal Revenue Code (which do not include social security and unemployment taxes) and the Federal taxes imposed on the investment income of foreign private foundations.

4. This Convention also shall apply to any identical or substantially similar taxes that are imposed after the date of signature of this Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws or other laws that relate to the application of this Convention.

The U.S. Tax Court confirmed the position in *Toulouse v. Commr*.,[6] where the I.R.S. disallowed a foreign tax credit claimed to reduce N.I.I.T., and the Court upheld the disallowance.

"In broad terms, S.S.T.A.'s are to social security taxes as income tax treaties are to income taxes."

In comparison, the I.R.S. recognizes that tax treaties with a dual-resident article can provide relief from N.I.I.T. for a dual-resident individual (other than a U.S. citizen) electing to be treated solely as a resident of the treaty partner country. That individual will be exempt from the N.I.I.T.[7] When the dual resident individual is a green card holder, electing relief under the dual-resident article may not be attractive for reasons unrelated to the N.I.I.T.

S.S.T.A.'S

Another, less prominent form of international tax agreement is the Social Security Totalization Agreement ("S.S.T.A."). In broad terms, S.S.T.A.'s are to social security taxes as income tax treaties are to income taxes. S.S.T.A.'s generally allow covered taxpayers to eliminate exposure to double social security taxation, while aggregating coverage under the social security system of each country for purposes of qualifying for benefits. This enables an individual who pays social security taxes to one country for a period of time and then to the other country for a period of time to bundle the coverages for purpose of determining benefits. At that point, only a *pro rata* payment is made by a country based on the periods for which social security taxes were actually paid.

The default rule under S.S.T.A.'s is that employees are taxed by the country where they are employed, not the country where they reside or their employer is based. Self-employed individuals are taxed based on residence. An exception known as the detached-worker rule allows migrating workers who expect to return to their home country within five years to be taxed only by their home country.

From the U.S. side, S.S.T.A.'s explicitly cover taxation under the Federal Insurance Contributions Act ("F.I.C.A.") and the Self-Employed Contributions Act ("S.E.C.A."). These are known as "payroll taxes" because they are levied on wages. F.I.C.A. applying to employee payrolls and S.E.C.A. applying a mirror tax on the income of

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6 157 T.C. 49 (2021). For a full discussion of the issues addressed in *Toulouse*, see Andreas A. Apostolides and Wooyoung Lee, "Toulouse or not Toulouse? N.I.I.T.-Picking the Reach of the U.S. Foreign Tax Credit," Volume 8 No. 6 *Insights* (November 2021): p.28.

7 Treas. Reg. §1.1411-2(a)(2).

self-employed individuals. The S.E.C.A. tax is the sum of the employee's share of social security tax and a percentage of the employer's share of that tax. The base is generally net income from self-employment, and most of the tax is capped. Each tax is split into social security and Medicare portions that fund Social Security and Medicare benefits.

Some practitioners believe that S.S.T.A.'s cover the N.I.I.T. The scope of S.S.T.A.'s is not necessarily limited to the enumerated taxes. They also cover legislation which amends or supplements the listed taxes. To illustrate, Paragraphs 1 and 3 of Article 2 (Material Scope) of the Switzerland-U.S. Social Security Totalization Agreement provide:

> 1. For the purpose of this Agreement, the applicable laws are:
>
> * * *
>
> b. as regards the United States of America, the laws governing the Federal old-age, survivors, and disability insurance program:
>
> -- Title II of the Social Security Act and regulations pertaining thereto, except sections 226, 226A and 228 of that title, and regulations pertaining to those sections,
>
> -- Chapters 2 and 21 of the Internal Revenue Code of 1986 and regulations pertaining to those chapters.[8]
>
> * * *
>
> 3. Except as provided in the following sentence, this Agreement shall also apply to legislation which amends or supplements the laws specified in paragraph 1. This Agreement shall apply to legislation or regulations which extend the existing laws to other categories of beneficiaries or which involve a new branch of Social Security only if both Contracting States so agree.

The provision is generally understood to require that a tax be a social security tax to be covered by an S.S.T.A. Whether the N.I.I.T. can be considered a social-security tax is at the heart of this ambiguity. In the context of Switzerland, the N.I.I.T. appears in Chapter 2A of the Code, not Chapter 2 or 21 tax.

CLAIMING A FOREIGN TAX CREDIT TO REDUCE N.I.I.T.

Congressional Intent

There seems little doubt that amending or supplementing the Medicare tax (*i.e.*, the Medicare portions of F.I.C.A. and S.E.C.A.) was the Congressional intent for enactment of the N.I.I.T. That would place the N.I.I.T. within the literal language of most S.S.T.A.'s. The N.I.I.T. was brought into existence by the Health Care and Education Reconciliation Act of 2010 (H.C.E.R.A.). With the new health care law calling for

[8] Chapters 2 and 21 contain S.E.C.A. and F.I.C.A., respectively. The N.I.I.T. is located in Chapter 2A.

an expansion of Medicare, Congress presumably believed increased funding was required. One of the first mentions of the N.I.I.T. is a 2010 legislative proposal of the Obama Administration to institute a 2.9% tax on unearned income for individuals reporting taxable income above certain thresholds. The proposed tax revenues were to fund Medicare.

As if to further underscore the point, Chapter 2A of the Code is entitled "Unearned Income Medicare Contribution," and Code §1411 is the only section that appears in Chapter 2A. This was an important distinction for the court in *Toulouse*, which looked to the location within the Code to conclude that the social security tax imposed by the foreign country was not an income tax that could be claimed as a foreign tax credit against taxable income. The court stated the following:

> The Code is divided into subtitles, and subtitles are divided into chapters, which impose separate and distinct taxes. Section 1, which is in chapter 1, subtitle A, Income Taxes, of the Code, imposes a tax on the taxable income of individuals (regular tax). Compare ch. 1, sec. 26(b) (referring to tax imposed by section 1 as "regular tax liability") with ch. 23, sec. 3301 (imposing a tax on employers on wages that they pay to their employees).
>
> Of relevance here, section 27 provides a credit for "[t]he amount of taxes imposed by foreign countries * * * against the tax imposed by this chapter to the extent provided in section 901." Section 901 provides a foreign tax credit against regular tax. It clearly states that "the tax imposed by this chapter [1] * * * [is] credited" with specified amounts. Thus, both sections 27 and 901 clearly provide that the foreign tax credit allowable under the Code reduces only tax imposed under chapter 1, such as the section 1 regular tax. See also sec. 61 (defining gross income for purposes of the section 1 regular tax); sec. 63(a) (defining taxable income for those purposes).
>
> Section 1411 is in chapter 2A, subtitle A, Income Taxes. Thus, the foreign tax credit under section 27—which applies to "the tax imposed by this chapter [1]"—does not by its terms apply to offset net investment income tax.
>
> * * *
>
> Congress has allowed a foreign tax credit only against taxes imposed under chapter 1. There is no Code provision for a foreign tax credit against the net investment income tax. * * * [The relevant income tax treaties] do not provide an independent basis for a foreign tax credit against the net investment income tax.

In Practice

While the N.I.I.T.'s initial purpose is unambiguous, it is much less clear whether the N.I.I.T. is functionally a social-security tax. A distinctive feature of payroll taxes is that their revenues flow to specially earmarked funds for Social Security and Medicare. By contrast, the U.S. Federal income tax feeds into the Treasury Department's general fund. Despite the recommendation of the Obama Administration, the N.I.I.T. does so as well. This may have been a result of congressional mandates for new legislation to be revenue neutral, leading to the need to treat the N.I.I.T.

as an increase in general income tax in order to match expenditures.[9] In its 2021 Greenbook announcing a legislative agenda for the year, the Treasury Department acknowledged that the N.I.I.T. feeding into the Treasury Department's general fund is inconsistent with the fact that F.I.C.A., S.E.C.A., and N.I.I.T. are intended for the same purpose.[10] Nonetheless, the effect is that, today, the N.I.I.T. looks less like a social-security tax and more like an income tax.

APPLICATION OF S.S.T.A.'S TO N.I.I.T.

The N.I.I.T. also differs from F.I.C.A. and S.E.C.A. mechanically. The latter two laws include statutory provisions that allow overrides by S.S.T.A.'s.[11] None exists for the N.I.I.T. This could prove a technical barrier to claiming an exemption from the N.I.I.T. under an applicable S.S.T.A. instead of claiming a foreign tax credit against the N.I.I.T.

Government Position

It is more likely that the I.R.S. views the N.I.I.T. as an income tax for which no foreign tax credit is allowed and not a social-security tax. As cited earlier, the I.R.S. did not rule out the idea that income-tax treaties might provide relief against the N.I.I.T. If the I.R.S. thought the N.I.I.T. was not an income tax, it would presumably eliminate this possibility. Internal agency documents also indicate that the I.R.S. does not think the N.I.I.T. is covered by S.S.T.A.'s.[12]

Most S.S.T.A.'s predate the N.I.I.T., and some practitioners surmised that the failure of S.S.T.A.'s to explicitly cover the N.I.I.T. was merely a timing issue. But no S.S.T.A. that was signed or came into force after March 2010 (when the H.C.E.R.A. was enacted) or December 2012 (when the N.I.I.T. came into force) mentions the N.I.I.T.

RESOLUTION

Some tax advisers have reportedly advised taxpayers to take the position that an applicable S.S.T.A. exempts U.S. citizens and green card holders from the N.I.I.T., provided the individuals reside outside the U.S. and expressly identify the issue on an income tax return on Form 8833 (Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)). Some of those advisers report that tax returns on which the treaty-based position was taken were reviewed in the course of I.R.S. examinations, and the issue was not raised. One case where the I.R.S. did not ignore this position as to S.S.T.A.'s is now the subject of refund litigation. A taxpayer who

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9 Changes to other taxes during the H.C.E.R.A.'s drafting meant that its final projected revenue was far lower than initially projected, which was a problem because certain congressional rules require legislation to be revenue neutral. Congress added the N.I.I.T. to the H.C.E.R.A. but had to direct its revenue toward the general fund in order to make up the shortfall. Kofsky and Schmutz, "What a Long Strange Trip It's Been for the 3.8% Net Investment Income Tax," 78 Md. L. Rev. Online 14 (2019): p. 26-32.

10 General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals.

11 Code §§3101(c), 3111(c), 1401(c).

12 Social Security and Self-Employment Tax Obligations of U.S. Individuals Working Outside the United States, I.R.S. Nationwide Tax Forum 2019.

was a U.S. citizen and South Korean resident paid $600,000 in N.I.I.T. before later filing an amended return claiming a refund, based on the S.S.T.A between the U.S. and Korea. The I.R.S. has proposed disallowing the claim.

Taxpayers are not the only ones to have noticed the discrepancy between intent and practice, as the 2021 Greenbook indicated. The Greenbook proposed redirecting N.I.I.T. funds into the same Medicare fund as F.I.C.A. and S.E.C.A. Were this step taken, the N.I.I.T. would seem to be the functional equivalent of a social security tax. However, coverage by an S.S.T.A. may not be automatic. Each S.S.T.A. contains its own provisions calling for extension of the agreement to reflect new categories of beneficiaries. As mentioned above, the Switzerland-U.S. S.S.T.A. requires both countries to agree on the extension. In comparison the Netherlands-U.S. S.S.T.A. provides for automatic extension unless notification is given to the other country within three months of enactment that extension of the agreement is not intended.[13] The U.S.-U.K. S.S.T.A. provides that it applies to:

> * * * any identical or substantially similar taxes that are imposed after the date of signature of this Convention in addition to, or in place of, the existing taxes.* * *[14]

Whether the N.I.I.T. would be viewed to be an identical or substantially similar tax is an open question.

"Whether the N.I.I.T. would be viewed to be an identical or substantially similar tax is an open question."

[13] Netherlands-U.S. S.S.T.A. Art. 2(3).

[14] U.K.-U.S. S.S.T.A. Art. 2(4).

ANTI-ABUSE DEVELOPMENTS: A NEW NORMAL IN THE NETHERLANDS

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Tags
Article 10a
Conduit Financing
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Economic Substance
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Hunkemöller
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INTRODUCTION[1]

"*Doe normaal*" is practical advice in the Netherlands encouraging one to *act normal*. In the past, that phrase would describe commonly used plans to reduce tax. Today, if the old normal is followed by a group effecting an acquisition, it could end up facing unintended consequences. Legislators and tax authorities are increasingly examining traditionally "normal" acquisition structures and financing arrangements in a quest to combat deemed abusive tax arrangements. Like its fellow E.U. Member States, the Netherlands has shifted its tax policy agenda in recent years in line with international and E.U. initiatives to target abuse.

The U.S. has targeted abusive arrangements for several decades via common law doctrines and codified anti-abuse rules, including the economic substance doctrine and conduit financing regulations. Consistent with these U.S. provisions, the E.U. is imposing its own anti-abuse rules, scrutinizing transactions lacking a business motive and structures with interposed entities deemed to be artificial.[2] Member States are now charged with enforcing these policies, and often do so without clear guidance. The result is an ever-evolving landscape that is detrimental to taxpayers following previously accepted methods.

This article highlights the features of anti-abuse provisions originated in the U.S. and their latest counterparts in the E.U. It then analyzes how the new normal established by E.U. developments pose tax risks to existing acquisition structures and intercompany financing arrangements within the E.U., specifically through the lens of the Netherlands. Among the latest possible tax risks, this article considers the effects of recent case law challenging the deductibility of interest on intercompany loans used to finance acquisitions and the risk of potential withholding taxes on outbound payments. In certain situations, a group can face both consequences if it adheres to the traditional way of doing business.

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1 The author acknowledges Thomas de Booij, a tax adviser in the Amsterdam office of Dentons, who assisted in the review of this Article.

2 See Council Directive (EU) 2016/1164 of 12 July 2016, Article 6 General anti-abuse rule and the *Danish Cases* (joined dividend cases C-116/16 and C-117/16; joined interest cases C-115/16, C-118/16, C-119/16, and C-299/16).

DEVELOPMENT OF ANTI-ABUSE RULES AND CURRENT EFFECTS

Economic Substance Doctrine

Seemingly in line with tax authorities around the world, the I.R.S. announced it could "bring up the economic substance doctrine to a greater extent than in the past."[3] Look no further than the complaint filed in October against Liberty Global, Inc. alleging the company employed a series of transactions lacking economic substance with the goal to avoid G.I.L.T.I. and capital gain taxes.[4] Additionally, the I.R.S. issued interim guidance in April 2022 making it simpler for examiners to raise the economic substance doctrine and assert penalties by eliminating the prerequisite of first receiving executive level approval.[5]

The economic substance doctrine ("E.S.D.") is a common law doctrine now codified under §7701(o). A transaction or series of transactions will be treated as having economic substance only if (i) the transaction changes the taxpayer's economic position in a meaningful non-tax way and (ii) the taxpayer has a substantial non-tax business purpose for entering into the transaction.

The I.R.S. can employ the economic substance doctrine when the tax results of a transaction are inconsistent with congressional intent. In such cases, the I.R.S. will recharacterize a transaction to reflect the true economic reality and assess taxes accordingly.

G.A.A.R.

A foreign, younger relative of the U.S.'s economic substance doctrine is the E.U.'s general anti-abuse rule ("G.A.A.R.") articulated in Article 6 of the A.T.A.D. According to the G.A.A.R., a Member State shall ignore an arrangement or series of arrangements if (i) the main purpose or one of the main purposes is to obtain a tax advantage that defeats the object or purpose of the law and (ii) the arrangement is deemed to be non-genuine to the extent it is not put into place for valid commercial reasons that reflect economic reality.

The uses of "transaction" in the E.S.D. and "arrangement" in the G.A.A.R are virtually interchangeable. An arrangement is a broader term meant to include not just a transaction, but also any agreement, understanding, or scheme. The E.U. will generally refer to arrangements in its anti-abuse initiatives.

While both the E.S.D. and the G.A.A.R target abusive arrangements, based on a plain reading, the E.S.D. concentrates on business motives whereas the G.A.A.R. primarily focuses on tax motives underlying an arrangement, even if valid business considerations exist. In this sense, the G.A.A.R. can be a more difficult and less defined test, blurring the line on how far tax authorities may go.

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3 Andrew Velarde, "Government's Use of Economic Substance Doctrine May Increase," Tax Notes, Oct. 17, 2022.

4 *United States v. Liberty Global*, No. 22-cv-02622 (D.CO).

5 LB&I-04-0422-0014.

Fraus Legis

The Netherlands chose not to implement the E.U. G.A.A.R. Instead, it relies on the Dutch common law doctrine *fraus legis*, which effectively works in the same manner. Like the G.A.A.R., *fraus legis* allows tax consequences of certain arrangements to be ignored if (i) the decisive purpose for entering into an arrangement was to realize a tax benefit (considering the artificiality of an arrangement lacking a business motive) and (ii) the arrangement is contrary to the object and purpose of the law. *Fraus legis* can be applied only if no specific anti-abuse rule is applicable to challenge the *bona fide*s of a transaction.

As will be demonstrated in the following section, *fraus legis* has been applied as a backstop to anti-abuse legislation, making for a win-win situation for the Dutch Tax Authority ("D.T.A.").

Interest Expense Deductions – to Permit or Deny?

The Netherlands applies many specific anti-abuse rules of Dutch tax law, including Article 10a of the Corporate Income Tax Act 1969. The D.T.A. has successfully applied Article 10a in combination with *fraus legis* to deny interest expense deductions on intercompany loans within typical acquisition structures. However, an open question remains as to whether interest expense deductions can be denied when the intercompany loan is constructed under arm's length terms and conditions.

Article 10a denies a taxpayer interest expense deductions in respect of debts insofar as these debts are related to the acquisition or increase of an interest in an entity that is or becomes affiliated with the taxpayer.[6] An acquired entity is considered affiliated with a taxpayer when (i) the taxpayer holds at least a one-third interest in the entity, (ii) the entity holds at least a one-third interest in the taxpayer, or (iii) a third-party holds at least a one-third interest in both the taxpayer and the acquired entity.[7] As of 2017, the affiliated entity definition extends to a cooperating group, whereby the cooperating group's total interest taken together is at least one-third.[8]

Two exceptions exist to this rule. A deduction of interest is still permitted where (i) the taxpayer demonstrates that the loan and transaction are based predominantly on business considerations or (ii) the interest income is taxed at a rate of at least 10% in the hands of the direct recipient or a direct or indirect shareholder of the recipient.[9]

A presumption exists that a loan and transaction entered into for the acquisition or expansion of an interest in an entity that only becomes associated with the taxpayer after the acquisition or expansion are predominantly based on business considerations. The presumption does not apply if the loan is deemed to be a wholly artificial arrangement. Regrettably, if equity capital of the group is diverted into debt capital for no commercial purpose other than the generation of a tax benefit the arrangement is deemed to be wholly artificial.[10]

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6 Article 10a(1)(c) C.I.T.A.

7 Article 10a(4) C.I.T.A.

8 Article 10a(6) C.I.T.A.

9 Article 10a(3) C.I.T.A.

10 Supreme Court 2 September 2022, nr. 20/03948, ECLI:NL:HR:2022:1121.

In cases where Article 10a is inapplicable due to the entities involved not meeting the affiliation threshold (generally for arrangements preceding the 2017 cooperating group provision), the D.T.A. has applied *fraus legis* to sidestep the issue and deny interest expense deductions.

Over the years, it has been typical to finance acquisitions through intercompany loans originally stemming from contributed equity, as it is explicit in Dutch case law that a taxpayer is free to choose the most beneficial form of financing of a company in which it participates.[11] As evidenced by recent court decisions in the Netherlands, this principle may have its limitations.

Recent Challenges in the Courts

Limitations on the choice of financing gained momentum following the July 2021 landmark Dutch Supreme Court case, *Hunkemöller*.[12] The case involved a private equity structure that acquired a retail business headquartered in the Netherlands. Four French investment entities (transparent under French law and opaque under Dutch law) wholly owned a Dutch HoldCo, which acquired all the shares of the Dutch retail group using a combination of equity and shareholder loans. The shareholder loans were financed through equity of the investment group. After the acquisition, the Dutch HoldCo formed a fiscal unity with the retail group and used the interest from the shareholder loans to offset income.

"The decision informed the business community that limits exist to a taxpayer's discretion on the choice of financing."

The D.T.A. initially denied the interest expense deductions arguing Article 10a. However, the court deemed the provision inapplicable since none of the French entities held a one-third interest in the Dutch HoldCo. Nonetheless, the D.T.A. successfully argued that if Article 10a was inapplicable, then *fraus legis* should cause the interest expense deduction to be disallowed – the overall transaction involved the diversion of equity into a shareholder loan, which was wholly artificial and lacked business considerations aside from the realization of tax benefits. Further, the interest income went untaxed due to the hybrid mismatch of the French entities. The Court found the arrangement to be against the object and purpose of the law (of Article10a) and disallowed the deduction of interest associated with the loan. The decision informed the business community that limits exist to a taxpayer's discretion on the choice of financing.

The diversion of equity into debt is not automatic grounds for abuse. In a case involving a comparable fact pattern that was decided one week prior to *Hunkemöller*, the Dutch Supreme Court ruled that no abuse of law existed where the funds used by a shareholder to finance the loan were acquired initially by way of a third-party bank loan.[13] The Court concluded that the two-step arrangement did not lose the link with the external loan and is therefore not abusive.

Throughout 2022, the D.T.A. continued to find success in the courts challenging interest expense deductions in the spirit of Article 10a.[14] That was until the Dutch

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11 Supreme Court 9 July 2021, nr. 19/05112, ECLI:NL:HR:2021:1102.

12 Supreme Court 16 July 2021, nr. 19/02596, ECLI:NL:HR:2021:1152.

13 Supreme Court 9 July 2021, nr. 19/05112, ECLI:NL:HR:2021:1102.

14 See Supreme Court 15 July 202, nr. 20/03946, ECLI: NL: HR: 2022:1085. and nr. 20/02096, ECLI:NL:HR:2022:1086 (cases remanded to rule on applicability of *fraus legis* to deny interest deductions); District Court of North Holland 12 August 2022, nr. AWB-18_2897, ECLI:NL:RBNHO:2022:6584 (interest deduction disallowed on shareholder loans used to acquire Dutch company).

Supreme Court paused to reconcile the issue with recent holdings of the C.J.E.U. and the European Free Trade Association ("E.F.T.A.") Court.[15]

Taxpayers may still have room to finance an acquisition of a Dutch target with an intercompany loan if the conditions, including interest rate, are consistent with arm's length terms. The Dutch Supreme Court raised the issue in its September 2, 2022, opinion in which it asked the C.J.E.U. for guidance on whether Article 10a can be applied to loan interest where the agreed loan conditions are arm's length.[16]

The case involved a Dutch HoldCo that acquired all the shares in a Dutch Target Co. The acquisition was financed via intercompany loans from a Belgian coordination center, which obtained the funds shortly before through a capital contribution. The lower courts disallowed the interest expense deduction based on Article 10a because the funds used for the acquisition diverted equity into debt. For that reason, the arrangement was deemed to be wholly artificial and lacking a business purpose. *Fraus legis* was not at stake since the affiliated entity threshold was met.

The Dutch Supreme Court expressed the opinion that the interest expense deduction should be completely denied even if the loan contains arm's length terms and conditions. The key factor was the artificial reduction in the Dutch tax base inherent in the transaction. The Court acknowledged, though, that this line of reasoning might run contrary to the C.J.E.U. decision in *Lexel*, which involved a cross-border internal acquisition financed through an intercompany loan. The C.J.E.U. assessed the validity of Swedish law similar to Article 10a and held that intercompany loans containing arm's length terms and conditions cannot be considered wholly artificial.[17] The C.J.E.U. concluded that only the non-arm's length portion of the interest rate could be denied due to the E.U. principle of proportionality. Denying anything more would go beyond what is necessary to prevent wholly artificial arrangements. In 2022, the E.F.T.A. Court came to a similar conclusion in *PRA Group Europe AS v. Norway*.[18] According to the E.F.T.A. Court, a domestic tax law denying interest expense deductions for anti-abuse purposes must focus on the portion of interest expense that exceeds an arm's length amount.

Lexel involved an internal acquisition, whereas the Dutch case involved an external acquisition. The Supreme Court asked the C.J.E.U. if this distinction has any bearing on the principle laid down in *Lexel*. Further, the Court asked whether the application of Article 10a is a breach of E.U. law in situations where a loan is concluded under arm's length terms and conditions.

The decision is expected within the next two years and will provide much needed clarity for the choice of acquisition financing. If the C.J.E.U. interprets Article 10a in line with *Lexel* and *PRA Group Europe AS*, the decision will effectively create an arm's length safe harbor permitting the deductibility of interest associated with intercompany loans funded by group equity. In this light, it will be imperative to document not only the arm's length interest rate, but also additional arm's length terms and conditions, including the debt-to-equity ratio, payment schedule for interest and principal, and creditor rights.

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[15] The E.F.T.A. Court is the equivalent of the C.J.E.U. in matters relating to E.E.A. E.F.T.A. states (Iceland, Liechtenstein and Norway).

[16] Supreme Court 2 September 2022, nr. 20/03948, ECLI: NL: HR: 2022:1121.

[17] Court of Justice of 20 January 2021, Lexel AB, C-484/19, ECLI:EU:C:2021:34.

[18] E.F.T.A. Court, 1 June 2022, E-3/21.

Despite the potential arm's length safe harbor for interest expense deductions, the same arrangement could subject the interest payment to Dutch withholding tax. If the arm's length safe harbor does not prevail, debt financing could potentially take a double hit – a denial of interest expense deduction and subject to withholding tax. Financing an acquisition with 100% equity won't resolve these concerns, since a deduction is not available, and dividend payments could similarly be subject to withholding tax. Prudence suggests that taxpayers review their structures and financing arrangements to adjust terms and conditions, if any, that run afoul of *fraus legis* and Article10a and a withholding tax regime that is described in the following section.

WITHHOLDING TAXES – TO COLLECT OR NOT TO COLLECT?

Like the use of intercompany loans to finance acquisitions, the use of interposed entities in acquisition structures has been market standard for years. Multinational groups typically establish layers of interposed entities to hold an acquisition vehicle established in the jurisdiction of the target in order to facilitate an investment or series of investments. Today, however, tax authorities are scrutinizing the economic reality of the interposed entities and asserting that some act as conduits permitting related-party income streams to avoid withholding taxes while the income goes untaxed at the level of the ultimate beneficial owner.

U.S. Conduit Financing

While scrutiny applied to conduit financing arrangements is relatively new in the E.U., the U.S. has long combatted the use of these arrangements initially highlighted in the 1971 Tax Court case *Aiken Industries*.[19] The court held that the interest paid to an interposed company was not exempt from U.S. withholding taxes, as the interposed company was deemed a conduit established for the sole purpose of avoiding withholding taxes.

In *Aiken Industries*, a U.S. subsidiary intended to pay interest to its foreign parent domiciled in the Bahamas, which did not have an income tax treaty in effect with the U.S. It was advised that a 30% withholding tax would be imposed on the payment of interest. To address the issue, the Bahamian parent sold the note to a second-tier Honduran subsidiary. At the time, an income tax treaty existed between the U.S. and Honduras that provided full tax exemption for the payment of interest. The I.R.S. challenged the arrangement and the U.S. Tax Court ruled in its favor. According to the court, the Honduran entity was merely a conduit for the passage of interest payments from the U.S. subsidiary to the Bahamian parent and denied access to treaty benefits. The Honduran entity had no actual beneficial interest in the interest it received because it was committed to pay out exactly what it collected and had no opportunity to realize a profit. Withholding tax was levied on the interest payment because the economic owner of the payment was the Bahamas corporation.

The primary holding of *Aiken Industries* has since been codified in Code §7701(l), which authorizes the conduit financing regulations found in Treas. Reg. §1.881-3. The conduit financing regulations allow the I.R.S. to disregard intermediate conduit entities in a financing arrangement and assess withholding taxes by looking only at the U.S. payer and the ultimate foreign recipient. An intermediate entity is generally

[19] *Aiken Industries v. Commr.*, 56 T.C. 925 (1971).

regarded as a conduit if its participation reduces withholding tax owed pursuant to a tax avoidance plan.

The Danish Cases

While *Aiken Industries* was decided over half a century ago, it was not until 2019 when the E.U. reached similar landmark decisions in what are known as the *Danish Cases*.[20] The *Danish Cases* confirmed the ability of Member States to enforce anti-abuse rules in E.U. directives in the absence of domestic legislation if appropriate to deny withholding tax benefits in artificial conduit arrangements.

Each case generally involved the use of common international private equity structures whereby dividend or interest payments were made from a Danish entity to an E.U. resident entity and then eventually paid forward to an ultimate parent entity in a third country. In order to benefit from withholding tax exemptions under E.U. law, the C.J.E.U. held the recipient must be the beneficial owner of the income. The court articulated that the beneficial owner is an entity that benefits economically from the income received and has the power to freely determine its use. A conduit company is the opposite of a beneficial owner because the entity lacks substance and is not put in place for valid business reasons reflecting economic reality. Conduit indicators identified by the court include the following:

- The existence of a legal or contractual obligation to pass the income to another person, so that the payee has no right to use or enjoy the proceeds of the income
- The fact that income is passed on shortly after receipt to other entities which do not qualify for benefits
- The fact that the entity makes an insignificant profit from the income it receives because it is obligated to pass the funds on to other entities
- The entity's sole activity is the receipt of passive income and the payment of that income to another party

The impact of the C.J.E.U. judgments can be felt throughout the E.U. as tax authorities have since placed greater emphasis on combatting entities without substance and an apparent economic purpose.

What Do the Dutch Have to Say About It?

Domestic Law

Dutch tax policy has traditionally focused on promoting the Netherlands as a center for global trade. Key to this policy was the absence of withholding taxes on payments of interest, royalties, and direct investment dividends to recipients outside the Netherlands. That policy has changed significantly in recent years following international and E.U. developments.

"Dutch tax policy has traditionally focused on promoting the Netherlands as a center for global trade. Key to this policy was the absence of withholding taxes on payments of interest, royalties, and direct investment dividends to recipients outside the Netherlands."

[20] Joined dividend cases C-116/16 and C-117/16; joined interest cases C-115/16, C-118/16, C-119/16, and C-299/16.

In accordance with the *Danish Cases* and to distance itself as a conduit facilitator, the Netherlands amended its minimum substance requirements for foreign entities claiming an exemption from withholding tax. Minimum Dutch substance requirements include the following factors:

- At least half the board members reside in the jurisdiction of the recipient.
- The board members have qualified knowledge to complete tasks that are required for the position.
- The recipient employs qualified personnel.
- Board meetings and key board decisions take place in the jurisdiction of the recipient.
- Main bank accounts are managed and held in the jurisdiction of the recipient.
- Books and records are kept in the jurisdiction of the recipient.
- Wage costs exceed €100,000.
- For a period of at least two years, the recipient has equipped office space in the jurisdiction where activities are actually performed.

While no longer functioning as a safe harbor, entities who satisfy the minimum substance requirements can shift the burden to the D.T.A. to prove that the arrangement is abusive.

In cases where abuse is deemed to be present, the Netherlands can levy withholding taxes on dividend, interest, and royalty payments made to foreign entities. The Netherlands has historically applied a dividend withholding tax under certain conditions. Currently, the rate is 15%. As of January 1, 2021, the Netherlands applies a conditional withholding tax on interest and royalties if, *inter alia*, an arrangement is deemed abusive. The tax is assessed at the highest corporate rate, currently 25.8%. A conditional dividend withholding tax in line with the conditional interest and royalty withholding tax will take effect January 1, 2024.

Both the dividend withholding tax and conditional withholding tax on interest and royalties contain similar anti-abuse rules to prevent interposed conduit entities from enjoying an exemption from withholding tax.[21] A withholding tax generally will be imposed on dividend, interest, or royalty payments if (i) the recipient is included in the structure mainly to avoid withholding tax and (ii) the payment is part of an artificial arrangement that has not been put in place for valid business reasons that reflect economic reality.

If the recipient entity is considered the beneficial owner of the income and satisfies the minimum substance requirements, the entity and transaction are presumed to have been put in place for valid business reasons that reflect economic reality. Consequently, the income will likely avoid Dutch withholding tax.

In situations where the D.T.A. believes the entities were put in place for the avoidance of tax and not valid business reasons that reflect economic reality, a withholding tax

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[21] Article 2.2(1)(c) Withholding Tax Act 2021 and Article 4(3)(c) Dividend Withholding Tax 1965.

can be levied on interest and dividends paid up the structure. In conjunction with a denial of interest expense deductions, these highlighted tax risks can have a significant impact on the rate of return of an investment or a group's operating profit.

Treaty Considerations

Withholding taxes assessed in abusive situations can nevertheless be mitigated if the recipient is resident in a jurisdiction that has concluded an income tax treaty with the Netherlands that permits the reduction or exemption from withholding taxes on dividends, interest, or royalties. The Netherlands, though, has ratified the M.L.I. and elected to include the Principal Purpose Test ("P.P.T."). The P.P.T. will apply to deny treaty benefits if, having regard to all relevant facts and circumstances, it is reasonable to conclude that obtaining the treaty benefit was one of the principal purposes of an arrangement or transaction that directly or indirectly results in that benefit. If granting the benefit would be in accordance with the object and purpose of the relevant provisions, the treaty benefit will not be denied.

The P.P.T. will apply in tax treaties concluded with Netherlands if the treaty partner has also ratified the M.L.I. and adopted the P.P.T. If there is no P.P.T. or alternative anti-abuse provision in the treaty between the Netherlands and recipient jurisdiction, successfully combating the undesired use of the tax treaty becomes difficult.

CONCLUSION

The E.U. is catching up to the U.S. in combatting deemed abusive tax practices, with new initiatives, directives, and landmark cases challenging the status quo. Traditional acquisition and financing methods are under scrutiny, and those that do not reflect economic reality may lead to undesired tax consequences. International taxpayers should review their structures and take action where necessary to remain compliant in this evolving landscape. This is especially true in the Netherlands, as the legislature and the D.T.A. continue to redefine what are acceptable arrangements. Perhaps taxpayers could heed the advice of the Dutch adage "*doe normaal*" after all, so long as they are conforming to the "*nieuw normaal*."

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