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INSIGHTS

LET'S TALK ABOUT NOMAD EMPLOYEES!

TELECOMMUTING: GOOD INTENTIONS, BAD OUTCOME

TELEWORKING FROM BULGARIA: DIFFERENT ARRANGEMENTS HAVE DIFFERENT CONSEQUENCES

AND MORE

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About Us

EDITORS' NOTE

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

- **Let's Talk About Nomad Employees!** Employees working from overseas is hardly a new phenomenon. However, the COVID-19 pandemic forced employees to work remotely. Indeed, some were forced to work abroad under lockdown or shelter-in-place rules. Not surprisingly, remote working morphed into nomad employees choosing to work from anywhere, any place, in any time zone. The hiring of remote employees brings with it exposure to all sorts of remote taxes for the employer in each place where a remote worker is based. Is there a P.E. for corporate income tax? Is there a fixed base for V.A.T.? Are there income tax withholding obligations for compensation payments? Are there social security obligations? Martin Phelan, a Partner in the Dublin Office of Simmons & Simmons where he is Head of Tax, and Fiachra Ó Raghallaigh, an Associate in the Dublin Office of Simmons & Simmons, provide big picture commentary. Interestingly, the United Nations Tax Committee is examining the policy issues that face nations and employers.

- **Telecommuting: Good Intentions, Bad Outcome.** In 2017, the O.E.C.D. stated that the question of whether a home office constitutes a P.E. is rarely a practical issue because the majority of employees reside in the state where their employer has an office. Although that observation was undoubtedly accurate at the time, today it is safe to say that it did not age well. Paul Kraan, a Partner of Van Campen Liem, Attorneys and Tax Advisers, Amsterdam, and Mitchell Karman, an associate at Van Campen Liem, Attorneys and Tax Advisers, Amsterdam, explain the international tax implications of remote workers from a corporate income tax perspective, based on the O.E.C.D. Model Convention framework. Not surprisingly they point out ways in which the current framework arguably does not result in a desirable outcome. The article concludes with several recommendations.

- **Teleworking From Bulgaria: Different Arrangements Have Different Consequences.** Bulgaria has benefitted as a preferred remote working location for digital businesses. While it does not have a digital nomad visa for work, it has a cadre of skilled individuals working as computer engineers available to be employed by foreign based multinationals. In their article, Viara M. Todorova, a Partner of Djingov, Gouginski, Kyutchukov & Velichkov, Sofia, and Ivan Punev, a Senior Associate at Djingov, Gouginski, Kyutchukov & Velichkov, Sofia explain the specific tax issues that face a foreign company looking to engage local talent to carry on functions from Bulgaria. Several different arrangements are common, and each has its own set of employment tax obligations for the service provider and the company. Adding to the mix, the threshold of activity in Bulgaria that creates a P.E. is relatively low and the choice of arrangement can affect the outcome.

- **Tax Issues for Remote Workers and Their Swiss Employers.** While COVID-19 had a profound effect on remote working in various countries, Switzerland has long experience with one form of remoter worker – the daily commuter across national borders. Surrounded on three sides by Italy, France, and Germany, Switzerland has negotiated several tax agreements with its

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neighbors that split the income tax pie and address social security coverage. Some agreements have national coverage, while others have local coverage affecting only the cantons and municipalities that straddle a specific international frontier. The stakes are high for a Swiss employer as the income tax rates and the social security charges can vary dramatically based on which country is allocated the right to tax. Thierry Boitelle, the founder of Boitelle Tax Sàrl, Geneva, and Sarah Meriguet, a Senior Tax Attorney at Boitelle Tax Sàrl, Geneva, explain all.

- **A.T.A.D.3 and How to Deal With Uncertainty in its Interpretation: A Quantitative Approach.** A.T.A.D.3 adds a layer of complexity to an increasingly complex tax world. To illustrate, the rules under the Unshell Directive appear clear, but are nothing short of ambiguous. Moreover, certain elements of the A.T.A.D.3 analysis depend heavily on the facts and circumstances of the case, which often are not binary. Many questions are raised, and the answers affect the way operations will be carried out. Is an entity affected by A.T.A.D.3? What is A.T.A.D.3's expected impact on a structure? Should an entity report as a shell entity in its tax return? Can a position be improved and is it worthwhile to do so? Firm answers do not come easily and nuanced responses by advisers often mean one thing to the adviser and another thing to the client. In their article, Stephan Kraan and Mark van Casteren, Partners in Huygens Quantitative Tax Consulting, Amsterdam, suggest that the proper approach involves quantitative analysis rather than qualitative advice. The goal is to adopt a statistical approach to evaluate potential results based on probability. At that point, rational decisions can be made by management and advisers. It is a fascinating read.

- **French Tax Residence, Income Tax Treaties and Newcomers Regimes: Where Does France Stand?** The determination of an individual's tax residence is a delicate exercise, combining a review of factual elements in light of different sets of criteria and rules. Most jurisdictions other than the U.S. impose tax solely on the basis of residence. Hence, a definition of tax residence is required. French domestic tax law adopts a single definition of tax residence for personal income and inheritance taxes, relying on several alternative criteria. The matter of residence also can be looked at under a relevant income tax treaty. France has in effect a network of more than 120 income tax treaties. Michaël Khayat, a Partner of the Arkwood Law Firm, Paris, and Edouard Girard, an Associate of the Arkwood Law Firm, Paris, explain the criteria for determining tax residence under French domestic tax law and to resolve a dual resident situation under the O.E.C.D. Model Income Tax Treaty. They then address recent cases under which tax authorities challenged application of an income tax treaty for an individual claiming benefits under a favorable newcomer regime in a treaty partner jurisdiction.

- **Bittersweet Christmas in Spain – Beckham Regime 2.0 and Solidarity Tax.** Last year, Christmas in Spain brought with it good news for some individuals and bad news for others. Regarding the good news, the Beckham Regime was improved as was the start-up ecosystem regime for entrepreneurs. Regarding the bad news, Spain adopted a second wealth tax to soak up wealth tax that appropriately went unpaid where certain regions provided relief for assets situated in the local region. Spanish residents that previously paid no Wealth tax will be subject to the Solidarity tax. Luis J. Durá Garcia, the Managing Partner of Durá Tax & Legal, Madrid and Valencia, tells all.

- **Tax Considerations for a U.S. Holder Of Bare Legal Title in a *Usufruct* Arrangement.** When European parents engage in inheritance planning by transferring bare legal title in shares of a privately held company to children resident in the U.S., the gift may bring with it a pandora's box of tax issues. If the value of the bare legal title exceeds 50% of the value of the property when computed in accordance with U.S. tax rules for valuing split interests in property, the foreign company may become a C.F.C. That can trigger certain reporting requirements in the U.S. related to Form 5471 (Information Return of U.S. Persons With Respect To Certain Foreign Corporations) even though the children have no right to income from the company. Separate and apart from C.F.C. status, the basis which the children have in the shares is a carryover basis that will not be stepped up then the *usufruct* interest and the bare legal title are merged. Separate and apart from the foregoing issues is a potential F.B.A.R. filing requirement on FinCEN Form 114 (Report of Foreign Bank and Financial Accounts) with immediate effect. In their article, Nina Krauthamer, Wooyoung Lee, and Stanley C. Ruchelman explain these issues, why they pop up, and potential ways to mitigate some if not all of the problems.

- **Lost in Translation: Treatment of Foreign-Law Demergers Under U.S. Federal Tax Law.** At a certain point in the life of a corporation that operates more than one business, management may wish to separate the different businesses into two or more separate corporate entities. In most cases, demergers are structured based on the requirements of the corporate law in the place of domicile of the corporation. Typically, a demerger of a foreign corporation that follows the corporate law provisions of applicable foreign law would also be exempt from tax in the relevant country. However, when one of the shareholders is a U.S. individual or corporation, U.S. Federal tax considerations should be taken into account to prevent unexpected U.S. tax for a U.S. investor. Demergers are given tax-free treatment under U.S. tax law only if the requirements of Code §355 are met. If not met, both the corporation that undergoes the demerger and its shareholders recognize gain in connection with an actual or deemed distribution of appreciated property. While the foreign corporation may have no U.S. tax to pay, the U.S. investor may find that tax would be due in the U.S. if the foreign corporation undergoing the demerger is a C.F.C. Stanley C. Ruchelman and Daniela Shani explain the various categories of tax free demergers under U.S. tax concepts and the consequences of failing to meet the requirements in the context of a corporation formed outside the U.S.

- **All Eyes on the I.C.-D.I.S.C. Part I: the Export Gift That Keeps on Giving.** Regardless of their political affiliations, presidential administrations and members of Congress share the goal of maintaining U.S. competitiveness on the global market. We often hear statements directed toward strengthening the U.S. manufacturing sector and bringing production activity back to the U.S. These words would be futile without implementing initiatives favoring U.S. business interests. An often-overlooked incentive is the Interest Charge Domestic International Sales Corporation ("I.C.-D.I.S.C.") regime. For an export business operated in the form of an L.L.C. owned by individuals, an I.C.-D.I.S.C. can produce tax savings for export profits of about 40% for the owners, when operated properly. More importantly, it can be run on automatic pilot once set up. In Part I of a two-part series, Michael Bennett explains the basics of setting up and operating an I.C.-D.I.S.C. In Part II, he will discuss issues that have been raised in years past when the goal of a D.I.S.C. was to promote exports by permanently deferring the export profits rather than recognize taxable income immediately, but at lower rates.

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- **Updates & Tidbits.** This month, Michael Bennett and Wooyoung Lee look briefly at four items. The first is *Bittner v. U.S*., a Supreme Court case holding that the non-willful penalty for failing to file a complete and accurate F.B.A.R. form is $10,000 for the annual form and not $10,000 for each account. The second is *Aroeste v. U.S*., a U.S. District Court case holding that a dual resident individual whose residence is allocated to a treaty partner jurisdiction is not a U.S. person for purposes of filing F.B.A.R. reports. The third is a concession by the I.R.S. that a person had reasonable cause for the failure to file Form 3520 (Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts) when following bad advice from his tax adviser. Finally, the BE-12 Benchmark Survey of Foreign Direct Investment in the U.S., conducted every five years by the Department of Commerce's Bureau of Economic Analysis, is due this year. The final due date for filing is (i) May 31 for those filing by mail or fax or (ii) June 30 for those filing electronically.

We hope you enjoy this issue.

- The Editors

LET'S TALK ABOUT NOMAD EMPLOYEES!

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Tags
Nomad Employee
S.M.E.

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INTRODUCTION

Employees working from overseas is hardly a new phenomenon. However, the COVID-19 pandemic created an unusual situation where many employees were required by force of circumstance to work from their homes in a different jurisdiction to the one where their corporate employer was located. Initially, many tax authorities opted to lenient treatment for the temporary foreign presence. In particular, cross-border workers were often granted waivers from applicable tax regimes for a certain period of time, to allow them to work from home full-time. As the pandemic receded, so too have many of the forbearance measures it created for remote working across borders.

Yet, while tax policies can be changed overnight, cultural changes generally cannot. Building on advances in information technology over the past thirty years, the COVID-19 pandemic has created widespread acceptance of remote and hybrid work in all areas of the econoour. This comes at a time when, recent layoffs in the IT sector aside, demand in many countries for skilled professionals in the IT sector and beyond far outstrips supply. Add to the mix the high rental costs and bad weather in many northern European cities, and it is understandable that companies and employees are interested in the idea of working from anywhere. It must be said that, although most of the media commentary around digital nomads has focused on stories of sun-soaked, cocktail drinking, and well-paid nomads, their employers also benefit from an expanded hiring pool and reduced relocation costs in this global war for talent.

Our colleague Monique van Herksen, tax partner in the Simmons & Simmons Amsterdam office, recently prepared a paper for the U.N. Tax Committee entitled "We Need to Talk about (the Taxation of) Nomad Employees." Her paper highlights that many countries are trying to attract digital nomads, with at least 49 offering Nomad visas that typically grant 12-month permits (which may be extended) that allow a visitor a right to stay in a country and work remotely via a computer or laptop for a foreign-based employer or business. Depending on the jurisdiction, the benefits can come with tax challenges for both employer companies and employees.

CORPORATE TAX

The first tax risk for companies is the unintended creation of a fiscal permanent establishment ("P.E.") in a foreign jurisdiction through the activities of nomad employees. The risk of nomad employees creating a P.E. depends on the nature of the role they perform, the duration for which they are working in the relevant jurisdiction and the number of employees working in the same jurisdiction. Staff performing back office or administrative functions are generally less likely to create P.E.'s as many

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jurisdictions and treaties consider activities that are merely preparatory or auxiliary to the business do not constitute P.E.'s. However frontline staff, sales staff, or staff performing the core profit-generating function of the business trigger considerably greater risk of creating a P.E.

The inadvertent creation of a P.E. can potentially lead to significant corporate tax exposure to companies due to unaccounted for tax liabilities that cause interest and penalties to accumulate. However, the main source of worry for many companies is their limited knowledge and experience of the tax law in the P.E. jurisdiction. For companies that lack the infrastructure required to meet the additional compliance obligations, the quantum of tax exposure is often a secondary concern to the administrative challenges it creates.

Small- and medium-sized enterprises ("S.M.E.'s") face a significant exposure where senior management decide to work remotely from abroad. Senior management exert significant influence over the profitability of S.M.E.'s, thus increasing the potential exposure. Additionally, if enough senior management relocate to the same jurisdiction, this could potentially impact the place of effective management and control of the company and hence its tax residence.

Therefore, it is important that companies that wish to employ digital nomads carefully consider the impact this might have on their compliance obligations and corporate tax exposure. Depending on the circumstances, the existence of a P.E. can lead to a determination that a fixed establishment exists for value added tax ("V.A.T.") purposes (discussed below).

VALUE ADDED TAX

The existence of a P.E. for corporate tax purposes may lead local tax authorities to consider or apply greater scrutiny to whether a fixed establishment also exists for V.A.T. purposes. However, the definition of a fixed establishment for V.A.T. purposes differs from that of a P.E. for corporate tax purposes in certain key respect. Therefore, not all P.E.'s create fixed establishments for V.A.T. purposes.

For V.A.T. purposes, a fixed establishment is usually defined as an establishment with a sufficient degree of permanence and an adequate structure in terms of human and technical resources such as an office, computer, office equipment. However, our colleague Monique van Herksen points out in her report to the U.N. Tax Committee, advances in technology mean that very little substance is often required to create the human and technical resource necessary to deliver a service, which can be done via a laptop or a mobile device. As such, the level of substance deemed necessary to create a fixed establishment for V.A.T. purposes is becoming increasingly harder to define. V.A.T. cases continue to be heard at the CJEU and in local courts, seeking to challenge or clarify the level of substance required to qualify as a fixed establishment.

Where the Nomad employee's activities result in the employer making supplies of goods or services in that jurisdiction, this could create unexpected V.A.T. liabilities for the employer. The consequences of inadvertently creating a V.A.T. fixed establishment can be quite severe, including V.A.T. costs, interest, penalties and fines. In some jurisdictions, failure to register for V.A.T. can even extend to criminal liability! The V.A.T. risk posed by the presence of Nomad employees in a foreign jurisdiction should therefore not be underestimated.

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EMPLOYMENT TAX

Allowing employees to work from abroad may create additional employment tax obligations for employers. Employment tax obligations may arise under the domestic employment rules of the country in which the Nomad employee is physically present and working. Under Article 15 of the O.E.C.D. and U.N. Model Conventions, salaries and wages may be taxed in the country where the employment is exercised or in the country of the employer. Taxing rights are largely determined by the amount of working time the employee spends in each country, and whether or not the wage and salary costs are borne by a domestic employer or a P.E. in the overseas jurisdiction.

"In general, it is the employee who indicates where the place of tax residence, and they will have to comply with the respective reporting requirements."

As our colleague Monique van Herksen explains in her report to the U.N. Tax Committee, the greatest compliance burden triggered by an accidental P.E. is the administration of wage/payroll withholding tax obligations in the P.E. jurisdiction. Companies that become liable to wage/payroll withholding in another country generally end up seeking the services of payroll service providers. Payroll service providers usually process employee payroll, calculate and handle income and social security taxes and employer social security contributions, keep employment and payroll records on file, and prepare the necessary quarterly and year-end payroll reports. This reduces the compliance burden on the employer, but creates an additional cost.

Employers may also be responsible for making contributions to the social security system of the P.E. jurisdiction. However, exemptions may be available under bilateral social security totalization agreements. Social security totalization agreements work much like double taxation agreements by eliminating dual social security coverage and taxation, and ensures that employees do not lose benefit rights because they have divided their careers between two countries. Exemptions require that such totalization agreements are available between the countries in question, which may not always be the case. Therefore, this issue needs to be considered on a country by country and case by case basis.

PERSONAL INCOME TAX

Individual employee tax residence may be an overlooked issue in the Nomad employee discussion, and there may be many compliance obligations for Nomad employees such as foreign bank account reporting requirements. The digitalized and globalized econoour increasingly presents challenges for the residency concept, given the ease of mobility and the ability to work remotely.

In general, it is the employee who indicates where the place of tax residence, and they will have to comply with the respective reporting requirements. Tax residency can subsequently be verified based on facts and circumstances, and resolved in a treaty context under the tiebreaker rule in case of dual residence where a treaty applies.

COMMENTARY

Many countries have strategies in place to attract Nomad employees by providing specific visa regimes that attract remote workers. As our colleague Monique van Herksen points out in her paper, these Nomad employees can contribute to the local econoour by paying income taxes on their wages and being consumers of local

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products and services. Their children may go to local schools and they themselves may become part of the fabric that makes up the local community. Their social and professional networks may help attract further business to the country, either by way of competing employers setting up business in the country or by enticing foreign employers to set up a local presence. Often, Nomad employees have particular technical skills that are in demand. They may serve to inspire or train local talent to develop similar careers, or help deter such local talent from migrating to other jurisdictions.

As such, taking a welcoming approach towards Nomad employees and their corporate employers may contribute to the attractiveness of a country for business, or at least favor the country over other countries that take strict and unaccommodating positions. For developing countries, this has the potential to mitigate or even reverse the brain drain they have experienced for decades, where their most educated workers leave the country to work for overseas employers and end up remaining overseas. Encouraging skilled workers to remain *in situ*, and even attracting skilled employees from overseas, could allow developing countries to eventually grow new industries and move up the value chain. However, the mobility of highly skilled workers may also lead to tax competition, putting downward pressures on personal tax rates.

However, as our colleague Monique van Herksen points out in her paper, companies still have significant worries about remote work and Nomad employees. When surveyed to rank the order of identified tax challenges, being able to identify and meet mandatory compliance obligations came out as a strong number one, with resolving the P.E. exposure as a direct number two, and as a close number three, certainty on being able to administer wage withholding taxes correctly. Transfer pricing concerns ranked as number four, and V.A.T. concerns as number five. Company policies to address Nomad employees fall at the crossroads between the tax and H.R. functions in many companies, thus creating coordination problems. Given the resource constraints on their existing tax and H.R. department, most companies opt for rather restrictive policies such as allowing employees to work abroad for periods of less than 30-60 days.

Countries that want to attract Nomad employees should therefore provide clear rules and administrative mechanisms to

- minimize the compliance burden on corporate employers,
- provide certainty as to the tax exposure, and
- provide a variety of options to pay tax.

The above could include relatively easy steps such as providing clear and accessible guidance on matters such as tax compliance and filing obligations, P.E. and fixed establishment creation, and employee/wage withholding obligations. Of equal importance is the actual administrative burden and cost imposed on companies in attempting to achieve tax certainty and meet their compliance obligations. For example, companies would generally rather to pay wage/payroll withholding taxes directly to local tax authorities over dealing with payroll providers. Also worth noting is that advance transfer pricing agreements are often too time consuming and burdensome for companies to use in practice, particularly where employees are based abroad for relatively limited periods of time.

CONCLUSION

The COVID-19 pandemic demonstrates that countries can accommodate the business challenges presented by Nomad employees without compromising their tax revenue. However, as the pandemic recedes, many countries are returning to their pre-pandemic restrictive approach while others are making conscious efforts to attract and retain Nomad employees. From the perspective of companies that want to hire and attract Nomad employees, the biggest issue is the compliance cost. Countries seeking to attract Nomad employees would do well to focus on providing tax certainty and minimizing the administrative burden they create. Given the global war for talent, this is likely to be a live issue for some time. And as countries begin to wake up to the possibility of brain drain and the loss of tax revenue, it is likely that the issue of Nomad employees will be as pertinent to the 2020's as B.E.P.S. was to the 2010's.

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TELECOMMUTING: GOOD INTENTIONS, BAD OUTCOMES

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Tags
Article 5
At the Disposal of the Employer
Dependent Agent P.E.
Fixed Place of Business P.E.
O.E.C.D. Model Convention
Remote Workers

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INTRODUCTION

In 2017, the O.E.C.D. stated that the question of whether a home office constitutes a permanent establishment ("P.E.") is rarely a practical issue because the majority of employees reside in the state where their employer has an office.[1] Although that observation was undoubtedly accurate at the time, today it is safe to say that it did not age well.

COVID-19 pandemic has disrupted our conventional *modus operandi* in the office, since being able to work remotely abruptly shifted from being a mere perk to becoming an absolute necessity. The mandated rise of remote working brought to light its benefits. While employers can reduce office expenses and expand the talent pool beyond the local area, employees save time and expense of commuting and improve work-life balance. In the aftermath of the pandemic, remote work arrangements persist in corporate business practices.

As the necessity for employees to be physically located in the office decreases, the physical distance between the remote workplace and the employer's workplace has increased in many instances. As the number of cross-border employees increased, practical challenges that were previously considered rare become more prevalent. That being said, employers now face challenges involving the existence of a potential foreign P.E. that results from an employee's presence abroad. The question arises whether the pre-pandemic international tax framework is still adequate in today's world of telecommuters.

In this article, we first provide a summary of the international tax implications of remote workers from a corporate income tax perspective, based on the O.E.C.D. Model Convention framework. Thereafter, we discuss a number of situations in which the current framework arguably does not result in a desirable outcome. We conclude by providing recommendations.

OVERVIEW OF THE CURRENT INTERNATIONAL TAX FRAMEWORK

Many jurisdictions impose a tax on profits derived by entities established within their borders, regardless of where those profits are generated. Additionally, countries may levy taxes on entities that have a P.E. within their borders, even though the corporate seat and headquarters of an entity are established elsewhere.

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[1] O.E.C.D. Model Tax Convention on Income and on Capital, commentary on article 5 concerning the definition of a P.E., paragraph 19 (2017).

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For employers who hire remote workers, it is essential to be aware of the potential tax implications of their employees' activities. If a remote worker's activities constitutes a P.E. under foreign law, an employer may have tax obligations in foreign jurisdictions, even though it may not be aware of the existence of a P.E. With respect to remote workers in particular, employers need to give careful consideration to their status and determine if their home office can be deemed a fixed place of business or whether the activities of the employee may constitute a dependent agent P.E.

Home Office: a Fixed Place of Business?

Within the O.E.C.D. Model Treaty framework, a place of business may exist if an enterprise merely has a certain amount of space at its disposal in a jurisdiction.[2] Whether a home office may constitute a place of business of the enterprise therefore boils down to question of whether such home office can be considered as being at the disposal of the employer.

In this regard, the O.E.C.D. commentary states that a home office may be considered to be at the disposal of the enterprise if it is used on a continuous basis for carrying on business activities for the enterprise and it is clear that the enterprise requires the individual to use that location to carry on the enterprise's business, for example by not providing an office. Reading between the lines of the O.E.C.D. commentary,[3] it could be argued that a home office is considered to be at the disposal of the employer if (i) there is a certain degree of continuity with respect to working from home and (ii) the employee is required by the employer to use the premises of the home as an office.

Remote workers could be considered to continuously work from home with minimal risk of creating a P.E. if that use reflects the choice of the remote worker, not the employer. However, the criterion of the employer requiring its employees to use their home office is far less obvious.

If, for example, an employer would assign an employee to a foreign country in the interest of the company but does not provide for an office space abroad, it could be said that the employee is required by the employer to use a home office. However, that same employee might also migrate for personal reasons, while continuing to work for the company from a home office abroad. In that fact pattern, it could not be said that the employee was required by the employer to use a home office abroad, as long as an office was still available in the state of the employer. The intention of the parties therefore appears to be decisive.[4]

In addition, the home office must be considered to be "fixed" in order for it to qualify as a P.E. In this sense, a certain degree of permanence is required. For remote workers in particular, this should entail that incidentally working abroad (on a non-recurring basis) should not result in the creation of a fixed place of business. The O.E.C.D. commentary does not identify an exact threshold that is considered as sufficiently permanent, but it does mention that experience has shown that P.E.'s generally are not deemed present in situations where the activities are maintained for fewer than six months.[5]

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[2] O.E.C.D. Model Tax Convention on Income and on Capital, commentary on article 5 concerning the definition of P.E., paragraph 12.

[3] *Id.*, paragraph 18.

[4] *Id.*, paragraph 19.

[5] *Id.*, paragraph 28.

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Home Worker: a Dependent Agent?

In a scenario where the employee's home office is not considered a P.E., nonetheless a P.E. may still be constituted if the employee's activities result in the creation of a dependent agent P.E. In short, a dependent agent P.E. may arise where an employee acts on behalf of the enterprise and, in doing so, habitually concludes contracts or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise. In that instance, a physical location is not required because it is the specific activity of the remote worker that places the employer at risk. This contrast with the fixed base P.E., where it is the combination of premises and any activity that placed the employer at risk.

DOES THE O.E.C.D. FRAMEWORK PROVIDE FOR REASONABLE OUTCOMES FOR REMOTE WORKERS?

Above we discussed the current international tax framework for employers of remote workers. Although the framework may successfully avoid double taxation, still it can be contended that the existing system – in particular in relation to the constitution of a P.E. – does not always produce outcomes that could be considered fair or desirable.

Intentions Resulting in Disparities

Based on the current O.E.C.D. commentary and as discussed above, an employee dispatched abroad by an employer could be said to be required by the employer to use a home office, whereas an employee who voluntarily works abroad may not. In the latter case the employee's home office may not result in a P.E., whereas in the first case it would.

The main benefit of such interpretation is that a company only has tax obligations in those jurisdictions where it actually intends to conduct business. At the same time, it could result in a disparity of taxation for cases with a more or less similar fact pattern within any one jurisdiction. Suppose there are two companies with employees in a foreign jurisdiction, and both employees carry out identical activities. In such a case, if one company dispatched its employee, it would constitute a P.E., while the other company, due to a lack of intention, may not. It could be argued that for the purpose of determining a P.E. presence, the assessment should be limited to the factual activities being conducted in that jurisdiction (objective test), regardless of whether the employer intended those activities (subjective test).

Artificial Avoidance of P.E.'s

Based on the current guidance, it appears that a home office P.E. can be avoided by not requiring employees to use their home office. In other words, a P.E. would not ordinarily exist if the employer provides office space to the remote worker.

This was the case in a Spanish tax ruling from 2022.[6] In summary, the case concerned a U.K. employee of a U.K. company who continued working for the company

6 SG de Fiscalidad Internacional, Nº de consulta V0066-22, 18 January 2022.

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while stranded in Spain due to the then applicable COVID-19-related travel restrictions. As a result, the employee exceeded the 183 days threshold and became a Spanish tax resident. Following the lift on travel restrictions, the employee decided to remain in Spain even though the company asked him to return to the office in the U.K. This eventually led to the employee's resignation when he refused to move back. The U.K. company approached the Spanish tax authorities to confirm that no permanent establishment was constituted either on the basis of a fixed place of business or the existence of a dependent agent.[7]

For the duration of the travel restrictions, the tax authorities concluded that no permanent establishment was constituted in this case, as the activities lacked a sufficient degree of permanence. For the period following the lift of restrictions, the authorities concluded that the home office was not at the disposal of the U.K. company and therefore did not constitute a permanent establishment. In this respect, the authorities particularly considered the facts that the worker unilaterally decided to remain in Spain, the U.K. office remained available to the employee – meaning that he was not required to use his home office – and the U.K. company did not bear any expenses for the home office.

The Spanish ruling sheds some light on the tax implications for remote workers from a Spanish perspective. Nevertheless, the question remains within which boundaries the mere availability of office space in the employer's resident state should lead to the conclusion that telecommuters are not required to use their home office abroad. It would be all too easy of employers to simply avoid a foreign P.E. by offering local office space to their cross-border workers, which means an empty desk in the home office of a company.

This would result in the somewhat odd situation that activities conducted in the employer's state could impact the presence of a P.E. in the other state, whereas one might expect the presence of a P.E. to be determined on its own merits.

Dependent Agents Provision Outdated?

To expand its market to foreign territories, a company may have dependent agents or employees habitually conclude contracts in those territories. In those instances, it seems reasonable that the foreign jurisdiction would impose corporate income tax on the profits resulting from the company's activities within its borders. The O.E.C.D. Model Treaty also facilitates this by considering a dependent agent as a P.E., and allowing for taxation of the foreign company.

However, for remote telecommuters the aforementioned condition may work out somewhat arbitrarily. For instance, where a law firm permits a senior associate and a junior associate to work remotely from a foreign country, in principle both lawyers would probably continue to do the same work for the same clients, meaning that their physical location is irrelevant to the firm's operations. Indeed, clients may not even be aware of the names or physical location of the attorneys working on their matters. However, if the senior associate habitually seeks new clients based in the country and elsewhere, and to that end negotiates retainers with prospective and existing clients through digitals means, a P.E. in the foreign country may exist even

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[7] For a discussion of this and other recent cases, see Sunita Doobay, "Tax Cases Affecting Remote Workers and Their Employers," *Insights* Vol. 9, No. 5 (September 2022).

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though the prospective clients are based elsewhere. This would not apply to the junior associate – who is typically not involved in generating new assignments – even though otherwise their situations would be comparable. Thus, despite the fact that both lawyers would essentially perform the same activities and would likely not compete locally, only the senior associate might qualify as a P.E. This may trigger tax implications due to a relatively minor difference in the actual activities. The method of allocating such income to a P.E. is beyond the scope of this article.

While having the mandate to negotiate contracts may seem a reasonable criterion for dependent agent P.E.'s engaging in traditional business, this may not necessarily be the case for employers of telecommuters. Especially where the employees' activities are completely unrelated to their physical location and employees do not compete locally, the mere fact that one has a mandate to negotiate and conclude contracts may not be an obvious distinction in determining a company's taxable presence.

"While having the mandate to negotiate contracts may seem a reasonable criterion for dependent agent P.E.'s engaging in traditional business, this may not necessarily be the case for employers of telecommuters."

E-Commerce and Remote Working: Two Sides of the Same Coin?

In literature, it has been argued that due to the digitalization of the global economy, the current P.E. standards which attribute significant value to physical presence should shift to an approach which uses tests of economic presence or digital presence at the location of consumption.[8] Currently, digital companies may conduct business in a jurisdiction electronically without the need for a physical presence. As a result, the classical P.E. criteria do not allow countries to tax those results.[9] This phenomenon also led to the discussion of so-called "digital P.E.'s."[10]

If it is considered fair to tax a company's profits solely because it has a digital P.E. from competing in the local market through electronic means, but without a physical presence (outside activity, but inside sale), one could also argue that there should not be a P.E. in the opposite case, *i.e.*, where a company does have a physical presence, but does not compete locally as the employee is only working remotely through electronic means (inside activity, but outside sale).

In any case, the introduction of a digital P.E. would entail a radical overhaul of the current P.E. definition, as it would attribute little value to physical presence and focus more on where the service or product is eventually consumed. It is also not unimaginable that the international community will distance itself from the idea of a digital P.E. and shift toward source-based taxation instead.[11]

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[8] Benjamin Hoffart, "Permanent Establishment in the Digital Age: Improving and Stimulating Debate Through an Access to Markets Proxy Approach," 6 *Nw. J. Tech. & Intell. Prop. 106* (2007).

[9] Polezharova & Krasnobaeva, "E-Commerce Taxation in Russia: Problems and Approaches," *Journal of Tax Reform*. 2020;6(2):104–123.

[10] O.E.C.D. (2001), *Attribution of profit to a permanent establishment involved in electronic commerce transactions*, a discussion paper from the technical advisory group on monitoring the application of existing treaty norms for the taxation of business profits.

[11] See: Spinosa & Chand, "A Long-Term Solution for Taxing Digitalized Business Models: Should the Permanent Establishment Definition Be Modified to Resolve the Issue or Should the Focus Be on a Shared Taxing Rights Mechanism?" *INTERTAX*, Volume 46, Issue 6 & 7.

PROPOSED IMPROVEMENTS FOR TELECOMMUTERS

The existing international framework was established to cater to conventional businesses. To operate in foreign territories, companies had to establish a physical presence or assign a representative to conclude local market contracts. Clearly, this approach did not take into account the current ease and prevalence of telecommuting, which could lead to the establishment of a P.E. with activities that are not necessarily related to the jurisdiction asserting the existence of a P.E. In order to modernize the current rules and have them lead to a more desired outcome, several adjustments can be made.

First of all, it could be considered to include a *de minimis* rule for P.E.s. This could greatly reduce the risk for employers of remote workers not meeting their tax compliance obligations, especially in cases where they have few employees in a jurisdiction. Such a *de minimis* rule could for example entail a minimum number of employees, revenue, transactions, or time spent.

It is currently uncertain whether a home office can be considered a fixed place of business. The determining factor appears to be whether the employer requires its employees to use a home as an office space. However, this criterion is open to interpretation and may be interpreted differently by various legal systems. It is recommended that a clear decision is made on this matter, either considering the home office as a fixed place of business, or not. Preferably, such assessment should be made based on its own merits, without taking into account external factors such as the availability of other office spaces or the reason for using a home office in the first place.

Moreover, the requirement of an employee being authorized to negotiate and finalize contracts as a means of establishing a dependent agent permanent establishment may lead to undesirable consequences, particularly in situations where employees do not effectively operate in the market of their home jurisdiction. In such cases, the criterion may work out quite arbitrarily.

CONCLUSION

The increase in remote work has prompted concerns about the effectiveness of the existing global tax system, especially for employers with telecommuting employees. While the O.E.C.D. Model Convention offers guidance on classifying a home office as either a permanent establishment or a dependent agent, it remains difficult to apply these standards to remote workers.

Employers must assess the status of each remote worker and whether that worker's home office qualifies as a fixed place of business or a dependent agent, but this could lead to unjust results under the current framework. As remote work becomes more prevalent, policymakers should review the global tax framework and establish more precise and practical regulations that are equitable to all parties involved.

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TELEWORKING FROM BULGARIA: DIFFERENT ARRANGEMENTS HAVE DIFFERENT CONSEQUENCES

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Tags
Bulgaria
Consulting
Crypto
Dependent Agent P.E.
Digital Nomad
Employment
Fixed Place of Business P.E.
Freelancer
Remote Work

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INTRODUCTION

Remote working was born in the pandemic as an emergency way for business to be carried on during a global lockdown. Now that the pandemic has passed, working remotely remains a preferred mode for many employees and is offered as part of a hybrid working mode by many employers. As a result, work time is commonly shared between business office spaces and remote locations, such as home, coworking spaces, or the beach. This trend cuts across various industries and is attractive for young employees looking for adventure and opportunities to travel the world. It is also attractive for those with a longer work record who prefer the comfort of their own home. Whatever the reason, remote working allows undeniable flexibility and work-life balance advantages for employees and cost-effectiveness for employers.

Employer acceptance of remote working for existing staff opens the door to remote working arrangements where the employee is located in a time zone that can be eight or more hours ahead of the business premises of the employer. Typically, these remote worksites are attractive for employers having difficulty finding competent employees locally.

Bulgaria has benefitted as a preferred remote working location for digital businesses. This article addresses the Bulgarian experience with a focus on tax issues for a remote employee and an employer based in Western Europe or the U.S. Several different arrangements are common and each has its own set of employment tax obligations on the service provider and the company that engages the individual. Perhaps more importantly, the choice of arrangement can affect whether the company has a permanent establishment in Bulgaria.

SERVICE-PROVIDER CATEGORIES AND THE OBLIGATIONS UNDER EACH

When a U.S., U.K., Dutch, or Spanish company is willing to engage an individual to work remotely from Bulgaria in the field of asset management consultancy, cyber security solutions, or financial investment/venture capital, it usually thinks of an employment contract with the individual or a local employer of record that organizes local reporting and withholding obligations for tax and social security purposes. However, from a Bulgarian perspective, additional options should be considered that weigh all the positives and negatives for the company and the individual when choosing the most appropriate arrangement for each particular case.

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Possible Options for Engagement

A foreign entity can hire personnel in Bulgaria under an employment contract or a consultancy (service) agreement without establishing a local presence. Alternatively, the foreign entity may consider engaging the individuals under service agreements, allowing the individuals to act as freelancers. In the latter fact pattern, the individual must register as a freelancer. A third option is a consultancy service agreement between the foreign entity and a Bulgarian company that is wholly owned by the individual performing the services.

A direct relationship with the Bulgarian individual triggers certain registration and reporting obligations and liabilities for the foreign corporation. These include registering as insurer in Bulgaria for payment of social security contributions and health care coverage contributions, and payment of income tax.

Employment Contract

Under Bulgarian law, an employer must report the execution of an employment contract. The report is filed with the Bulgarian National Revenue Agency ("N.R.A.") not later than three days from the date of execution. On an ongoing basis, the employer must calculate, withhold, and remit amounts due for personal income tax, social security contributions, and health care coverage contributions arising out of the employment relationship.

When the employer is a foreign entity without any form of presence in Bulgaria, it should register as an insurer in the Bulgarian BULSTAT Register, a national administrative register for business units and other persons operating in Bulgaria. It also must obtain a general tax registration number with the Bulgarian N.R.A. (performed *ex officio*) in order to be in the position to remit payments due for the social security and health care coverage contributions for the employee.

Whether the foreign employer will be obligated for collection and payment of income tax for the employee's salary depends on whether the employer maintains a permanent establishment ("P.E.") or a fixed base in Bulgaria. If the employer is acting through a P.E. or fixed base in Bulgaria, it will be responsible for the withholding and payment of personal income tax related to the employee's compensation. Absent a P.E. or fixed base in Bulgaria, it is the employee's responsibility to pay his/her personal income taxes.

Services Agreement

It is also possible for a Bulgarian individual to be engaged under a consultancy (service) agreement. There are generally two options in this case – (i) the person does not have the capacity of a self-insured independent contractor ("freelancer") or (ii) the individual is a freelancer. Each of the two options has different implications for the foreign entity.

When the individual is not registered as a freelancer, the foreign entity must be registered as an insurer and will be responsible for the collection and payment of the social security contribution and healthcare coverage contributions for the individual. Those payments are made to various Bulgarian budget accounts. This obligation is mandatory with regard to all payments to Bulgarian tax resident service providers who are not freelancers.

In terms of payment of personal income tax for the individual by a foreign company with no P.E. or fixed base in Bulgaria, the Bulgarian individual is responsible for paying the income tax. Only foreign companies with a P.E. or fixed base in Bulgaria are required to withhold and pay income tax to the state budget on the account of an individual who is not a registered freelancer.

"If the authorities recharacterize a consulting arrangement into an employment arrangement, the principal will be subject to the obligations of employers."

In short, the position of a foreign company acting as a principal under a consultancy service agreement with a Bulgarian individual who is not a freelancer is the same as that of an employer in an employment relationship between such parties when a P.E. exists.

One of the key risks to be evaluated when considering a consultancy arrangement between a company and an individual is whether an employment relationship exists between the company and the individual. Bulgarian authorities may take that position whenever the actual arrangements and features resemble those inherent to employment. Factors include

- fixed hours of work,
- employer-like control powers over the contractor,
- assignments focus on the working process rather than the final outcome, and
- whether the individual is not registered as a self-insured freelancer.

If the individual service provider is bound by exclusivity restrictions and provides services for a single entity, this may be considered as an additional indication to be added on top of the other factors listed above.[1]

If the authorities recharacterize a consulting arrangement into an employment arrangement, the principal will be subject to the obligations of employers.

Conversely, if the arrangement between a foreign entity and a Bulgarian contractor does not resemble an employment relationship (*i.e.*, the agreement is result-oriented and it is not focused on the working process, it does not provide for fixed working hours, etc.) and if the contractor is registered in Bulgaria as a self-insured freelancer, the risk of requalification of the consultancy relationship as being of an employment nature will be minimal.

Contract With a Freelancer (Self-Insured Individual)

A foreign entity is free to enter into a contractual relationship with independent contractors. Pursuant to Bulgarian law, certain categories of professionals may register as freelancers and perform professional activities at their risk and for their account as independent contractors. Examples of professionals who may be categorized as freelancers include notaries, lawyers, medical doctors, architects, journalists, artists, insurance agents, and financial consultants. Other individuals may also be freelancers if they perform activities on their own risk and for their own account.

A freelancer must register with the BULSTAT Register kept with the Bulgarian Registration Agency. Freelancers must remit their social security contributions and health

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[1] This factor may also be taken into account for the purposes of evaluating the existence of a permanent establishment maintained by the foreign entity. This is discussed below.

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care coverage contributions to the respective Bulgarian state funds, if and when due, as well as amounts due for personal income tax. All such charges are for the account of the freelancer, and not for the account of the client.

In comparison, if the individual is contracted under an employment contract or does not have the capacity of a freelancer, the payment levy will be allocated between the employer or principal and the employee or service provider/consultant.[2] In that instance, all contributions should be transferred to the budget accounts by the company, acting as an employer or principal.

Similar to the situation concerning the service agreement option, if the individual service provider is bound by exclusivity restrictions and provides services for a single entity, the arrangement may be taken into account when determining whether the principal maintains P.E. in Bulgaria.

Contract With a Bulgarian Company Owned by the Individual

Another option for a foreign company involves the execution of a consultancy service agreement between the foreign entity and a Bulgarian sole-shareholder company owned by the Bulgarian consultant. That arrangement involves no direct relationship with the individual. For that reason, the potential obligations and liabilities related to the payment of personal income tax, social security contributions and health care contributions, and similar levies in Bulgaria are placed on Bulgarian company of the individual. From the viewpoint of a foreign company, the arrangement provides the same favorable protection against unanticipated payment obligations imposed under Bulgarian law as is provided in an arrangement with a freelancer.

Tax Aspects of the Arrangement

Payroll taxes in Bulgaria are associated with personal income tax, social security contributions, and health care coverage contributions. These payments are made to the Bulgarian budget accounts irrespective of the form of contract under which the individual is hired. However, in the case of freelancers, the obligations lie entirely with the freelancers themselves.

Individuals working under a service/consultancy agreement are entitled to claim a deduction for statutory recognized expenses. The deduction is set at 25% of their income and is used when calculating income tax, social security contributions, and health care coverage contributions.

Personal income tax in Bulgaria is levied at a flat rate of 10%.

Social Security Aspects

The amounts due as social security coverage and health care coverage contributions are determined as a percentage of the total "social security coverage and health care coverage income" of the individual, *i.e.*, the gross monthly income of the individual from employment and other activities, which is set at a maximum monthly amount by a special law. Currently, the maximum amount is €1,700. Should the individual's remuneration exceed that maximum amount, no additional social security or health care coverage contributions will be due on the excess amount.

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[2] The allocation is discussed below in relation to employer-employee arrangements and social security contributions and health care contributions.

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In principle, social security payments are made to different social security funds. For employees, payments are to be made for all risks covered by such funds. For freelancers and other service providers, only certain risks are covered.

The monthly social security contribution rates for employees vary between 24.7% and 25.4% of social security coverage and health care coverage income. Payment of the contributions is allocated on a 60/40 basis between the employer and the employee.

The monthly social security contribution rate for individuals contracted under service agreements is 23.3% of total monthly social security coverage and health care coverage income. Where the service provider is not registered as a freelancer, the payment levy is allocated on a 60/40 basis between the principal and the service provider. The principal has the obligation to withhold the individual's share and to pay the total social security contribution to the Bulgarian budget. If the service providers are freelancers, the contribution obligation belongs solely to them.

Irrespective of the capacity of the individual as an employee or freelancer, all Bulgarian citizens are required to have health care coverage. The health care coverage contribution is set at 8% of the individual's social security coverage and health care coverage income. The payment obligation for employees and service providers who are not freelancers is allocated on a 60/40 basis between the employer or principal and the individual. A freelancer is solely responsible for health care contributions.

Labor Law Aspects

Bulgarian labor law is extremely employee-protective and a foreign company willing to engage an individual in Bulgaria under an employment relationship should be aware that the mandatory rules of Bulgarian labor laws will always apply to work performed in Bulgaria even when foreign law purportedly governs the employment relationship. This rule covers employment by local employers as well as foreign employers. Choice of law provisions of a contract could not affect such rules.

The provisions of Bulgarian labor law set minimum standards in regard to working time, overtime and night work, minimum wages, minimum leave requirements, health and safety during remote work, potential disciplinary sanctioning, termination, minimum redundancy costs, and equal treatment of the employee in comparison to others.

The relevant statutory rules are extensive, and their particular implication should be analyzed on a case-by-case basis, depending on the particular circumstances. Among others, termination of employment and protection against dismissal could be of notable significance for a foreign employer since those are governed by a restrictive regulatory framework.

Employer of Record

As a general rule, Bulgarian employment law is not familiar with and does not expressly regulate the concept of employer of record, as such. However, it recognizes a similar concept in connection with work agency arrangement, where one company (a temporary work agency) hires employees and leases them to another company (its client). The employees perform work for and under the direction of the latter. The temporary work agency activities, however, are subject to a number of specific rules and requirements provided by Bulgarian law, including a special registration for the

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agency with the Bulgarian Employment Agency and joint and several liability of the agency and the client for any unpaid employment-related obligations (*e.g.*, salaries) towards the employees.

Nonetheless, a number of such service providers operate in Bulgaria. Some are independent and others are part of international groups engaged in human resources, such as Oyster. They offer a service similar to that or an employer of record outside the context of a temporary work agency. These companies are exposed to potential risks under Bulgarian law.

PERMANENT ESTABLISHMENT EXPOSURE (O.E.C.D. GUIDELINES)

The initial concern of a company in one jurisdiction engaging personnel to work remotely in another jurisdiction is the risk of establishing a P.E. in that other jurisdiction. As with service providers in other jurisdictions, this risk exists when the service provider is located in Bulgaria.

The assessment of whether a P.E. of a foreign company arises in Bulgaria is made on the basis of domestic rules and the rules under an applicable income tax treaty entered into by Bulgaria. When interpreting and applying the provisions of a treaty, the Bulgarian tax authorities follow the guidelines in the O.E.C.D. Commentary on the Model Tax Convention (the "Commentary").

"The initial concern of a company in one jurisdiction engaging personnel to work remotely in another jurisdiction is the risk of establishing a P.E. in that other jurisdiction."

Treaty Definition

Pursuant to the most commonly used P.E. definition under Bulgarian legislation and in treaties, two main fact patterns can trigger the existence of a P.E. The first is the dependent agent P.E. (the "D.A. P.E.") and the second is the fixed place of business P.E. (the "F.P.O.B. P.E.").

The D.A. P.E.

In general, a D.A. P.E. exists when an agent has authority to conclude contracts in the name of a foreign principal or when the agent habitually plays the major role leading to the execution of contracts in the name of its foreign principal and the foreign principal routinely concludes those contracts without material modification to the negotiated terms.[3] Following the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the "M.L.I."), the broader D.A. P.E. concept has been adopted by Bulgaria, which has agreed to apply Article 12 to its covered treaties.

Consequently, where Bulgaria's treaty partners have agreed to the application of the broader provision of the M.L.I., Article 12 has been revised to conform to the M.L.I. Where a treaty partner jurisdiction has not adopted the revision to Article 12, the revised D.A. P.E. rule is not applicable.

The F.P.O.B. P.E.

The F.P.O.B. P.E. exists if the foreign entity maintains a fixed place of business located in Bulgaria through which the foreign entity's business is wholly or partly carried

[3] See B.E.P.S. Action 7.

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on. The definition is broad enough to cover a place of management, a branch, and an office.

Where a P.E. in Bulgaria is maintained, the profit realized through the P.E. is subject to corporate tax in Bulgaria. The tax rate is 10%.

Application of the Rules

Under the D.A. P.E., the P.E. exposure should not be high for a foreign company where (i) a Bulgarian resident individual is contracted without any authority to conclude contracts on behalf of a foreign entity and (ii) the broader M.L.I. concept is not applied by the country of residence of the employer. For example, the U.K. has entered a reservation to the application of Article 12. As a result, the broader D.A. P.E. concept does not apply when evaluating whether a U.K. resident company maintains a P.E. in Bulgaria as a result of the appointment of an agent in Bulgaria.

Conversely, where (i) a Bulgarian resident individual is engaged in negotiating contracts on behalf of a foreign entity that are rarely modified in a material way and (ii) the broader D.A. P.E. concept is applied by the country of residence of the foreign corporation, the risk of a Bulgarian P.E. would be quite high, especially when an employment contract option is implemented. For example, Spain has adopted the expanded D.A. P.E. provision of the M.L.I. As a result, the expanded D.A. P.E. rule applies to Spanish resident companies that have appointed agents in Bulgaria.

Given the teleworking mode of work, the F.P.O.B. P.E. criterion would be of significant relevance when a Bulgarian individual uses a home office for the performance of services in carrying out duties specified in a contract with a foreign company. One exception likely exists. It is expected that the Bulgarian tax authorities would follow the O.E.C.D. guidance[4] for determining whether an individual's home office location is a fixed place of business of an employer.

Under the O.E.C.D. guidance, the issue of whether a P.E. exists is determined based on facts and circumstances. In general, a place must have a certain degree of permanence and must be at the disposal of an enterprise in order for that place to be considered to be a F.P.O.B. P.E. With the remission of the COVID-19 pandemic, and cessation of the public health measures, remote working from home could be considered to have certain degree of permanence, but that change alone will not necessarily result in the home office giving rise to a F.P.O.B. P.E. A further examination of the facts and circumstances is required to determine whether the home office is at the disposal of the employer enterprise.

When the individual is required by the enterprise to work from home (*e.g.*, by not providing an office to an employee in circumstances where the nature of the employment clearly requires an office), the home office may be considered to be at the disposal of the enterprise. Arguably, if an office is made available to the individual, who chooses to work from home, the home should not be regarded at the disposal of the enterprise.[5] Of course the answer may differ if the individual uses a series of shared work spaces, none of which are permanent or used for long periods of time.

4 O.E.C.D. Secretariat Analysis of Tax Treaties and the Impact of the COVID-19 Crisis (3 April 2020 version), subsequently revisited by Updated O.E.C.D. guidance on tax treaties and the impact of the COVID-19 pandemic (21 January 2021).

5 For a full analysis of recent cases see Sunita Doobay, "Tax Cases Affecting Remote Workers and Their Employers," *Insights* Vol. 9 No. 5 (September 2022).

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Although the O.E.C.D. guidance focuses on the extraordinary circumstances caused by the pandemic, its basic approach could be used by analogy for the purpose of analyzing home office arrangements in general. Also, the main considerations and factors that are taken into account when evaluating the existence of a P.E. could be used for consultancy (service) arrangements.

In sum, each case of remote working from a home office requires careful evaluation as to whether the home office is at the disposal of the foreign company. A helpful factor is that foreign company does not reimburse the individual for any of the home office expenses incurred. The risk may be further reduced in Bulgaria if the resident individual is engaged under a consultancy service agreement and carries on business as a self-insured freelancer or through a Bulgarian company.

TAX CONSIDERATIONS FOR THE INDIVIDUAL

Bulgarian Tax Resident

All the considerations outlined above will be valid for a Bulgarian tax resident individual engaged by a foreign company to work remotely from Bulgaria. The Bulgarian individual is subject to personal income tax of 10% on worldwide income and social security coverage and health care coverage contributions in the ranges indicated above.

Nonresident Individual

A nonresident individual willing to work remotely from Bulgaria for a foreign company must pay attention to the period of presence in the country. Presence on too many days could result in residence for income tax purposes.

An individual who is physically present in Bulgaria for more than 183 days in any 12-month period will become a Bulgarian tax resident under Bulgarian law and under the residence article of a relevant treaty. Although the general rule is that work should be taxed where performed, treaties limit Bulgarian taxing rights for foreign treaty country residents for the first 183 days of employment in Bulgaria. Salaries remain taxable in the individual's home country, rather than Bulgaria.

Social security payments will always be due where work is performed, but E.U. tax resident freelancers could benefit from their foreign social security coverage health care coverage payments for the first 24 months of operations in Bulgaria. For tax residents outside the E.U., (*e.g.* Ukrainian), an applicable social security totalization agreement may provide specific rules, but in the general case these payments should be payable in Bulgaria. A totalization agreement does not exist with the U.S.

VISAS AND WORK PERMITS

Digital Nomad Visas

Unlike its neighbors Greece, Romania, North Macedonia, and Serbia, Bulgaria has no specific visa regime luring digital nomads to Bulgaria, although it is becoming more and more popular for some foreigners willing to experience Bulgaria. Popular hubs for digital nomads in Bulgaria are Sofia, the capital, Plovdiv, second-largest city, and the mountain town of Bansko. Bansko reports having the highest proportion

of coworking spaces and holds a nomad summer fest. Another available option is teleworking from a caravan by the seaside.

Whichever location is chosen, the following rules apply to foreign visitors.

E.U., E.E.A., or Swiss Citizens

E.U., E.E.A., and Swiss citizens enjoy a facilitated work and travel regime in Bulgaria.

E.U. citizens are entitled to enter the territory of the Republic of Bulgaria with a valid passport or identity card. They may reside in Bulgaria for up to three months without any other registration needed. To continue for more than three months, an E.U. citizen must apply for the issuance of (i) a prolonged residence certificate, allowing stay up to five years and (ii) a permanent residence certificate, allowing unlimited residence in the country, after the five-year stay. The application must be submitted prior to the expiration of the three-month term and five-year term respectively.

Free movement of workers is one of the fundamental principles of the European Union. E.U. citizens are entitled to work in Bulgaria without applying for and obtaining a work permit or complying with any other registration regime. They may reside in Bulgaria for that purpose and may enjoy equal treatment in terms of health, social security, and civil rights as Bulgarian citizens, except where Bulgarian citizenship is required by law.

"E.U., E.E.A., and Swiss citizens enjoy a facilitated work and travel regime in Bulgaria."

Other Citizens and the Blue Card Regime

In comparison to E.U. citizens, the opportunity of a long-term stay entails a process that is more burdensome in terms of procedure and requirements. Generally, foreigners may enter the territory of Bulgaria only with a visa issued in compliance with applicable Bulgarian legislation. However, pursuant to Council Regulation (E.U.) 2018/1806, certain exhaustively enlisted nationals, including citizens of the U.S., Canada, Australia, North Macedonia, Ukraine, or Israel may enter the Republic of Bulgaria without visas and remain for a total term of 90 days within each 180-day period.

If a foreigner does not fall within the foregoing exception, a short-term type C visa must be obtained. The standard type C visa entitles the holder to remain in Bulgaria for 90 days within each six-month period. These visas are typically issued to contractors of Bulgarian commercial entities, nonprofit organizations, or trade representative offices for the purposes of a commercial visit. They are also available to visiting family members of Bulgarian citizens, E.U. citizens, or foreigners with prolonged or permanent residence status.

In order for a foreigner to reside in Bulgaria beyond the 90-day period, the individual must obtain a long-term residence type D visa, and after entering Bulgaria on its grounds, apply for a prolonged residence permit.

The type D visa is valid up to six months as of the date of its issuance and entitles its owner to stay in Bulgaria for up to 180 days and to leave and enter Bulgaria repeatedly within the term of validity of the visa. The grounds on which a type D visa can be issued must be consistent with the grounds for obtaining the prolonged residence permit. The application for issuance of the type D visa must be submitted personally by the foreigner to the Bulgarian embassy in the country of permanent residence of the applicant not earlier than three months prior the date of the visit.

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Once a foreign citizen enters Bulgaria under a type D visa, the application process for the issuance of a prolonged residence permit can be initiated. A prolonged residence permit entitles the holder to reside in Bulgaria for a term of up to one year, and may be extended for one year if the original grounds for issuance continue. The application is filed with the Migration Directorate, part of the Bulgarian Ministry of Internal Affairs. The application must be filed not later than 14 days prior to the date of expiry of the D visa. A prolonged residence permit may be obtained for various reasons, such as the foreign citizen (i) has been appointed as the general manager of a Bulgarian entity, (ii) has been appointed as an authorized representative of a Bulgarian trade representative office, etc.

As a matter of principle, a person other than a citizen of an E.U. jurisdiction, an E.E.A jurisdiction, or Switzerland may work for a Bulgarian employer only after being granted a work permit. Work permits are granted where, for example, (a) the maximum number of foreign employees has not been reached or (b) the individual has a special professional qualification. All permits are issued for work with a specified Bulgarian employer, and for the workplace, position, and term specified in the permit. This means that a holder of a work permit cannot change employers freely. A work permit is issued for a term of up to three years, with a possibility for extension.

The E.U. Blue Card Regime is another option that allows a third-country citizen to work in Bulgaria. In line with E.U. steps towards building a common migration policy and Council Directive 2009/50/E.C. of May 25, 2009, known as the "E.U. Blue Card," Bulgaria has introduced an option for the holder of an E.U. Blue Card to reside and work in Bulgaria for up to five years pursuant to a speedy authorization process. The eligibility requirements for the Blue Card are mainly related to professional qualification, skills, and experience, which simplifies the process. Subject to certain requirements and restrictions, the holder of an E.U. Blue Card can work remotely in Bulgaria or abroad, can change employers, and can participate in the social security system for Bulgarian employees.

ADDITIONAL TAX CONSIDERATIONS

In addition to the P.E. exposure discussed above, which is normally one of the main concerns when foreign companies assess engaging a remote worker in Bulgaria, V.A.T. and invoicing should be considered in cases where the service provider is a self-insured freelancer or is employed by a company that is wholly owned by the Bulgarian service provider.

In terms of V.A.T., the rate is 20%. Considering the fact that services are being rendered to a foreign company, the place of supply of such services is considered to be abroad. Consequently, Bulgarian V.A.T. will not be charged. If, under the laws of its country of establishment, the foreign company must reverse-charge V.A.T. on the service fees paid to the Bulgarian service provider, V.A.T. leakage may occur. The V.A.T. leakage could be eliminated if the Bulgarian remote worker is taken on as an employee. However, the saving in V.A.T. may be offset by having to deal with the P.E. issues in Bulgaria that were discussed above, including (i) 10% Bulgarian corporate income tax, (ii) registration for administrative and tax purposes in Bulgaria, and (iii) calculation, withholding and remittance of social security coverage and health care coverage contributions and personal income tax for the employee. Each alternative has pluses and minuses.

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PAYMENT MODES INCLUDE CRYPTOCURRENCY

Along with the increasing popularity of remote work arrangements and digital nomads, payment of remunerations (or part thereof) may be effected with cryptocurrency. Recent global surveys and polls show that a growing number of employees and service providers (especially – although not exclusively – Millennials and Gen Z) are interested in receiving some or all of their remuneration in cryptocurrencies or N.F.T.'s. Respectively, the number of companies offering such payments as part of the onboarding package and the individual's engagement is increasing as well.

The crypto rush did not miss Bulgaria, and it is not uncommon for people to pay with cards issued by crypto exchanges. Some stores are accepting payments in crypto, and there are also cases where individuals get paid in crypto for work or services rendered.

Nonetheless, certain mandatory rules of Bulgarian law must be taken into account. For example, the Bulgarian Labor Code provides that the employment remuneration must be paid in cash, meaning a fiat currency. However, bonuses and other additional payments and benefits granted to employees may be paid in crypto. As the Bulgarian Labor Code is not applicable in a consultancy service relationship, the parties are free to agree on payment in crypto, whether in full or in part.

CONCLUSION

Remote work and widespread acceptance of crypto currency and blockchain technologies have much in common, and it is not surprising that these trends are developing very rapidly and oftentimes together. Aside from the fact that both trends are made possible and facilitated by technology, they are also driven by the same needs and desires of modern people, namely the endeavor to achieve greater flexibility, personal freedom, and decentralization.

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TAX ISSUES FOR REMOTE WORKERS AND THEIR SWISS EMPLOYERS

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Cross Border
Remote Worker
Permanent Establishment

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INTRODUCTION

The COVID-19 pandemic and the health measures implemented by governments led to an unprecedented globalization of remote working. In some instances, work was done at home, in other instances, executives were stranded abroad. Either way, this new form of work is prevalent in border areas where employees living on one side of a border work at a facility on the other side of the border.

Remote work implies particular constraints in tax and social security matters, both for border workers and for their employers. For the employee, identifying the country that has primary right to levy tax and social security contributions on salaries is a major concern. For employers, besides concerns about obligations to withhold tax and social security contributions on salaries paid, permanent establishment and the place of effective management concerns arise.

Aware of such challenges, European governments and the O.E.C.D. focused on the need to adapt the traditional taxation system, which is mainly based on the territoriality principle. Switzerland, which is very attractive for skilled foreign labor, is particularly concerned by these issues and is obliged to deal with its neighboring countries. The Swiss cross-border workforce is growing each year. There were 380,821 border workers as of the fourth quarter of 2022,[1] consisting of 214,235 French residents, 89,378 Italian residents, 65,958 German residents, and 12,250 Austrian residents. That was twice the number of cross-border worker that existed in 2002. The number of cross-border workers is predicted to double again in the next 10 years.

This article discusses the implications of remote working practices in the Swiss context, looking at income tax and social security charges on mobile workers and the allocation of the company's taxable profits between Switzerland and its neighboring countries.

INCOME TAX AND SOCIAL SECURITY CHARGES

Under Swiss domestic law, persons who are not fiscally domiciled in Switzerland are subject to Swiss income tax if a jurisdictional nexus exists, such as employment in Switzerland.[2] Where a nonresident individual does not work full time in Switzerland, only compensation for days worked in Switzerland is taxed. This applies to cross-border workers who commute daily to a place of work in Switzerland. It applies also to weekly workers who remain in Switzerland during the week but

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1 According to the F.S.O. – Statistics on cross-border workers 2023.

2 Article 5 al 1 let a F.D.T.A.

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regularly return home on weekend, provided their center of vital interests is abroad. The physical and effective activity on Swiss territory is the link for tax liability in Switzerland.[3]

Wages paid to cross-border workers are subject to wage withholding tax that varies with the compensation amount and the personal situation of the employee, such as marital status and the number of dependent children, if any.[4]

If an individual is employed in Switzerland but maintains the center of his or her vital interests abroad, the relevant bilateral tax treaty between the country of residence and Switzerland specifies the circumstances in which tax is imposed in Switzerland or the country of residence. In principle, income tax treaties that are based on the O.E.C.D. Model Tax Convention provide that employment income is taxable in the state where the individual performs services for an employer, with a split between several states if the employee works in several states.

Most income tax treaties entered into by Switzerland include a provision under which the right to tax is retained by the country of residence of the employee where the following three conditions are met:

- The employee is present in Switzerland not more than 183 days in any 12-month period.
- The income is paid by an employer who does not reside in Switzerland.
- The remuneration is not borne by a permanent establishment in Switzerland.

The right to tax shifts to Switzerland if any of the three conditions is not met.

SWISS – FRENCH AGREEMENTS ON CROSS-BORDER WORKERS

Different rules apply to cross-border workers. Switzerland has in effect several agreements regarding taxing rights on cross-border workers. These agreements differ from one neighboring country to another and sometimes even from one canton to another.

Regarding France, which is home to most of the Swiss cross-border workers, the tax treatment of the cross-border workers' income varies according to the canton in which the employee regularly works.

Agreement of April 11, 1983 (Taxation of Cross-Border Workers)

This agreement between France and Switzerland applies to compensation income of cross-border workers in eight cantons, Basel Stadt, Basel Land, Bern, Jura, Neuchatel, Solothurn, Vaud, Valais/Wallis. In deviation from the France-Switzerland Income Tax Treaty, it provides that compensation of French resident cross-border workers in relation to each of the covered cantons is taxed exclusively in France. In turn, France pays 4.5% of the aggregate gross cross-border workers' salaries to the canton of employment. Under the agreement, the tax is levied directly on the

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[3] Federal Court decision from 25 March 2011 ATF 137 II 246.

[4] Article 91 F.D.T.A.

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employee, who makes payments in installments. The Swiss employer does not file any form or make any tax payment in France.

Cross-border workers are defined as (i) any person resident in one state, (ii) who pursues an activity as an employed person in the other state, (iii) with an employer established in that other state, and (iv) who returns, as a general rule, daily to a place of residence in the first state.

"In the post-COVID-19 period, remote working will likely continue. Considering the challenges it represents for cross-border workers and their employers, France and Switzerland have agreed to facilitate remote working on a permanent basis."

France-Switzerland Agreement of 1973

This agreement only relates to cross-border workers living in the French departments of Ain or Haute-Savoie and employed in the canton of Geneva. It provides that Geneva pays the neighboring departments of Ain and Haute-Savoie a special compensation of 3.5% of the gross salaries paid to all cross-border workers living there and working in Geneva. The allocation of taxing rights as such is provided by the France-Switzerland Income Tax Treaty, which determines that the income of the cross-border worker is taxable solely where employment services are performed, *i.e.* in Geneva for the cross-border workers covered by this agreement. France also imposes tax on its residents, but allows a credit equal to the amount of French tax due on the Swiss employment income.

France-Switzerland Income Tax Treaty (Applicable to the Cantons that are not Part of the 1983 Agreement on Taxation of Cross-Border Workers)

French cross-border workers are generally taxed in Switzerland, except that French tax is imposed on compensation for each day worked in France, generally at home. This results in excessive administrative and tax burdens for both employees and the employers. A Swiss employer is obliged to collect French tax from compensation payments, deposit the tax in France, and file the necessary forms. A Swiss employer with no permanent establishment in France must engage a tax representative in France to complete the paperwork and make payments. At that point, the compensation taxed in Switzerland is reduced.

COVID-19 Agreement

During the COVID-19 period, Switzerland concluded agreements with several other countries. Regarding France, an agreement was concluded as of May 13, 2020, and renewed several times until December 31, 2022 in order to address the tax effect of remote working during the period covered. Under these agreements, remote workers residing in France and working at home for a Swiss employer were exclusively taxed in Switzerland. The income was exempt from French tax even though France was the place where services were performed.

Post COVID-19 Agreement

In the post-COVID-19 period, remote working will likely continue. Considering the challenges it represents for cross-border workers and their employers, France and Switzerland have agreed to facilitate remote working on a permanent basis. The agreement which was reached on December 22, 2022, is not yet published and supposed to be signed and ratified before June 30, 2023, but is provisionally applied since January 1, 2023, and introduces a tolerance threshold if a not more than 40% of the workweek is performed remotely in France. The agreement will take the form of an amendment protocol to the France-Switzerland Income Tax Treaty.

Two situations must now be distinguished:

Workers Subject to the Cross-Border Regime in the Covered Cantons

Those who work in one of the eight signing cantons of the 1983 agreement on taxation of cross-border workers retain the status as cross-border workers. Their salary is taxed exclusively in France and France will continue to remit a subsidy to the covered cantons as long as the percentage of total days worked in France does not exceed 40% of the total days worked for the Swiss employer in the covered cantons.

Other Cross-Border Workers

Other workers are generally covered by the existing France-Switzerland Income Tax Treaty as modified by the Post COVID-19 Agreement. Regarding cross-border workers, days remotely worked from France remain taxed in the state of an employer in Switzerland on condition that the total number of remote workdays in France does not exceed 40% of total days worked. In consideration of maintaining the right to tax such income in Switzerland, adequate compensation (yet to be defined) will be paid to France, where the cross-border worker's place of residence is located.

Where the number of days worked in France exceeds 40% of the total number of days worked, compensation for days worked in France will be taxed in France. In addition, cross-border workers will lose their special status as quasi-residents who may benefit from certain tax deductions in Switzerland.

Several points await clarification for other cross-border workers taxable in France on French source compensation. Switzerland and France have not agreed to a tax collection assistance procedure. Consequently, a Swiss employer is still required to deduct tax at source in France. Special authorization must be obtained in order to collect and pay the tax of a foreign jurisdiction without violating Swiss law.

OTHER AGREEMENTS ON CROSS-BORDER WORKERS

Italy-Switzerland Agreement

In 2020, Switzerland and Italy entered into an agreement on cross-border workers, approved by the Italian Senate in February 2023. Under the terms of the Agreement, compensation received by cross-border workers residing in Italy who work as an employee in the border area in Switzerland for a resident employer there remain taxable only in Switzerland. This rule is effective for periods beginning after December 31, 2018. However, each of the cantons of Graubünden, Ticino and Valais must make compensating payments to Italian border municipalities through December 31, 2033. The compensatory payments equal 40% of the Swiss federal, cantonal, and municipal taxes on compensation collected from cross-border workers resident in Italy. The compensation is made in Swiss francs through a single payment during the first six months of the year following that to which the financial compensation refers.

Germany-Switzerland Income Tax Treaty

The Germany-Switzerland Income Tax Treaty addresses cross-border workers in Article 15a, which is a carveout from the general rules applicable to employment

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that appear in Article 15. Article 15a provides for taxation in the State of residence. Nonetheless, the State in which employment is carried out by a cross-border worker may also tax the activity performed, but at a rate that is capped at 4.5%. To benefit from the capped rate, an official certificate issued by the tax authorities in the country of residence must be provided. The definition of a cross-border worker in this treaty is similar to the definition in the 1983 agreement between France and Switzerland discussed above, except that a 60-day cap is placed on the number of days for which the cross-border worker does not return home at the end of the day. If the 60-day cap is exceeded, Article 15a is no longer applicable.

MEMBERS OF THE BOARD OF LEGAL ENTITIES

Remuneration paid to a nonresident taxpayer in his or her capacity as a member of the board of a legal entity having its seat in Switzerland is taxable in Switzerland. Income tax treaties concluded with neighboring states allocate the exclusive right to tax those payments to the jurisdiction in which the corporate seat is located.

SOCIAL SECURITY ASPECTS: LIABILITY OF THE SALARY TO SOCIAL SECURITY CONTRIBUTIONS

In Swiss-E.U. relations, social security matters are governed by the European coordination regulations, which have applied to Switzerland from April 1, 2012.[5] The general principle found in those regulations is that employees can participate in only one social security system and pay social security contributions to only system even when their compensation is earned in several countries. Consequently, if an employee resides in one Member State and works exclusively in another Member State, the employee participates only in the social security system of the Member State where his or her employer is located. In comparison, if an employee carries out substantial activity in his or her state of residence, the social security legislation of that Member State would apply. For this purpose, substantial activity occurs if the employee works more than 25% of the time in his or her Member State of residence.

In principle, a tolerance threshold of 25% can produce unique results. Likely, it does not mean that the employee can work remotely for one full workday and one-quarter of a workday each week without entailing any change in the applicable social security system. In reality, the threshold likely cannot be measured in terms of portions of the day. Rather, it likely is limited to one day each week for three weeks, and two days during the fourth week or one week out of every four weeks, adjusted for holidays. Whichever measurement applies, the Swiss employer must deduct and pay French social security contributions on the entire salary once the 25% standard is exceeded, which will not be known until the latter part of the year in most instances.

During the COVID-19 pandemic, Switzerland concluded derogation agreements with neighboring states to freeze the situation as if the days spent in the country of residence did not exist. In the case of France, the agreement continues to apply until June 30, 2023, and provides that the 25% threshold does not exist. Consequently,

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[5] Regulation (E.C.) No. 883/2004 of the European Parliament and of the Council of 29 April 2004 on the coordination of social security systems; Amended by: Regulation (E.C.) No 988/2009 of the European Parliament and of the Council of 16 September 2009.

a French resident employee of a Swiss employer participates only in the Swiss social security system through June 30, 2023. Thereafter, coverage will depend on whether the agreement with France is renewed. If not, E.U. coordination regulations will apply.

The social security rules apply equally to compensation paid to a director of a Swiss company. Such compensation is subject to Swiss social security payments.

RISKS OF REMOTE WORKING FOR THE EMPLOYER IN RELATION TO THE ALLOCATION OF TAXABLE PROFITS

As a general rule, legal entities in Switzerland are subject to unlimited taxation when their seat or effective management is found to be in Switzerland.[6] Where a permanent establishment exists, part of the company's profit can be allocated between the State or residence and the State where the permanent establishment is located, based on the separate activity of each.

Swiss tax law defines a permanent establishment as any fixed installation in which all or part of the company's activity is carried out. This definition is in line with the definition of a permanent establishment in the O.E.C.D. Model Tax Treaty, which also served as the basis for the France-Switzerland Income Tax Treaty, for example. The O.E.C.D. Model defines a permanent establishment as a fixed place of business through which an enterprise carries on all or part of its business.

Risk of Hybrid Work Arrangement

In practice, remote working could give rise to a permanent establishment at the place of residence of an employee having sufficient power to conclude contracts on behalf of the company. As an example, assume that a cross-border employee living in France works as a project manager for a Swiss company active in the field of IT. The employer grants the employee one day of telework per week, which does not meet the 25% threshold for application of French social security payment. The employee has no signing authority, but his function is to improve customer relations. To that end, he contributes indirectly to increasing the company's turnover and building customer loyalty. In this fact pattern, the Swiss company should have no responsibility for collecting French income tax or making French social security contributions with regards to the employee. Nonetheless, when the employee carries out his activity from his domicile in France, a French tax examiner may ask whether his added value could allow the French tax administration to tax part of the Swiss employer's profit by considering that the activity of the employee creates a permanent establishment in France.

During the COVID-19 pandemic, the O.E.C.D. guidance was that the home of the foreign remote worker did not constitute a P.E.[7] In the post-COVID-19 period, the conclusion might be different where the remote worker takes the lead role in negotiating contracts and does so from his or her home office. The risk is real as France has a very broad interpretation of the concept of permanent establishment. In a recent decision, the French Conseil d'Etat held that an agent may constitute a

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6 Article 50 F.D.T.A.

7 Publication April 2020.

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permanent establishment if he or she habitually plays the lead role in the conclusion of contracts and participates in their negotiation. It does not matter that final approval of the contracts are signed abroad by personnel at the head office.[8]

In sum, there is no certainty that a cross-border worker who continues to work up to 25% of the time from a home office in France will not be viewed by the French tax authorities as either a fixed place of business permanent establishment or a dependent agent permanent establishment. This would shift tax exposure to France with a potentially concomitant reduction in Swiss tax.

On the other hand, it is one thing to assert that a permanent establishment exists in France, it is another thing to measure the arm's length profits that are attributable to the permanent establishment. The key is to measure the relative materiality of one day of working in France in comparison to four days of working in Switzerland along with Swiss residents assigned to negotiating the transaction. Clearly, proportionality will be important in determining the profit share taxed in France, if a permanent establishment were to exist there.

Other points to keep in mind are that (i) the failure to declare a permanent establishment in France may result in a penalty of 80% of additional tax assessment and (ii) Switzerland and France may have different views of the profits attributable to a one-day-each-week office.

Risk of Directors Who are Cross-Border Commuters

Beyond the questions of qualification of a permanent establishment, the situation of Swiss company directors who take strategic decisions from their home in France could raise questions relating to the tax residence of the Swiss employer, if effective management of the company in France could be construed. The same risk exists for a small businessman, whose operational and strategic management is in the hands of a single person resident in France. In this case, the place of effective management could be located at the place where the person remotely works. Such enterprise would thus not be taxed at its official seat, but at the domicile of the self-employed person. These risks have not yet materialized. Other risky fact patterns are sure to be identified. However, at some point the risks become more and more far-fetched as the meaning of the word "permanent" in the term "permanent establishment" becomes more and more nebulous.

CONCLUSION

Swiss companies wishing to allow their cross-border workers to work from home on a permanent basis should carefully analyze the consequences of that decision. In principle, exposure exists for the worker and the employer as to wage taxes and social security charges being imposed unexpectedly and exposure exists for the business as to the creation of a permanent establishment and a possible shifting of the place of effective management.

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[8] CE plén. 11 December 2020 n° 420174, min. c/ Sté Conversant International Ltd.

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A.T.A.D.3 AND HOW TO DEAL WITH UNCERTAINTY IN ITS INTERPRETATION: A QUANTITATIVE APPROACH

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Tags
A.T.A.D. 3
Conceptual Model
Quantitative Advice
Risk Analysis
Uncertain Outcome
Unshell Directive

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INTRODUCTION

The European Union ('E.U.') has made significant efforts to change the current tax system, focusing on ensuring fair and effective taxation in the E.U. Important progress has been made in this area, particularly with the adoption of the Anti-Tax Avoidance Directives ("A.T.A.D.1" and "A.T.A.D.2") and the extension of the scope of the Directive on Administrative Cooperation (*e.g.*, the mandatory disclosure rules of D.A.C.6). In addition, it was recognized that legal entities with little or no substance and economic activity, commonly referred to as "shell entities," have the potential to be used for abusive tax practices.

Against this background, the European Commission (the "Commission") published a proposal for a directive to prevent the misuse of shell entities for tax purposes ("A.T.A.D.3" or the "Unshell Directive") at the end of 2021. The Unshell Directive includes rules for the identification of shell entities and provides for certain reporting obligations, automatic exchange of information, and substantive tax consequences.

Since the publication of the Commission's initial proposal, the European Parliament ("E.P.") has adopted certain amendments to the Commission's initial proposal. At the time of writing this article, the Unshell Directive is still pending before the E.U. legislative bodies. As each E.U. Member State has the right to veto tax directives, it is not yet clear whether, and in what form, the Unshell Directive will be implemented.

The mechanics of A.T.A.D.3 under the original proposal have been discussed previously in Insights.[1] In our article, we will describe the recent developments and the expected next steps. However, we mainly focus on how to deal with uncertainty in the interpretation of new tax legislation, with A.T.A.D.3 as an example, and how to measure and compare optimization opportunities using a modelling approach.

The Unshell Directive as Originally Proposed by the Commission

The Unshell Directive (i) subjects certain entities to automatic exchange of information and reporting obligations or (ii) categorizes such entities as shell entities, resulting in a number of tax disadvantages. A.T.A.D.3 is scheduled to enter into force on January 1, 2024.

Scope and Explicit Carve-Outs

The Unshell Directive is intended to apply to so-called "undertakings," broadly meaning entities that can be considered resident in a Member State for tax purposes, regardless of their legal form. This includes legal arrangements, such as

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[1] Paul Kraan, "Use it or Lose it: The Future of Shell Entities in the E.U.," *Insights* Vol. 9 No. 2 (December 2021).

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partnerships, that are considered resident for tax purposes in a Member State, but does not include permanent establishments or tax transparent entities.

The Unshell Directive contains explicit carve-outs for undertakings carrying out certain activities, such as undertakings with a transferable security admitted to trading or listed on a regulated market, regulated financial undertakings, certain purely domestic holding structures, and undertakings with at least five own full-time employees ("F.T.E.") carrying out activities which generate relevant passive income. According to the Commission, undertakings that carry out these activities are *a priori* considered to be low-risk and therefore irrelevant for the purposes of the Unshell Directive.

Gateways and Exchange of Information

The Unshell Directive is intended to affect only undertakings that lack substance and are misused for tax purposes. Three cumulative criteria – commonly referred to as "gateways" – have been proposed to filter out these types of undertakings:

- More than 75% of the undertaking's revenue is characterized as passive income (also referred to as "relevant income") in the two preceding tax years.
- More than 60% of the undertaking's relevant assets are located outside the undertaking's Member State of residence and/or at least 60% of its relevant income is earned or paid out via cross-border transactions.
- The undertaking has outsourced the administration of its day-to-day operations and decision-making on significant functions in the two preceding tax years.

If an undertaking passes the three gateways, information on the undertaking will be automatically exchanged between Member States.

Schematically, this can be visualized as follows:

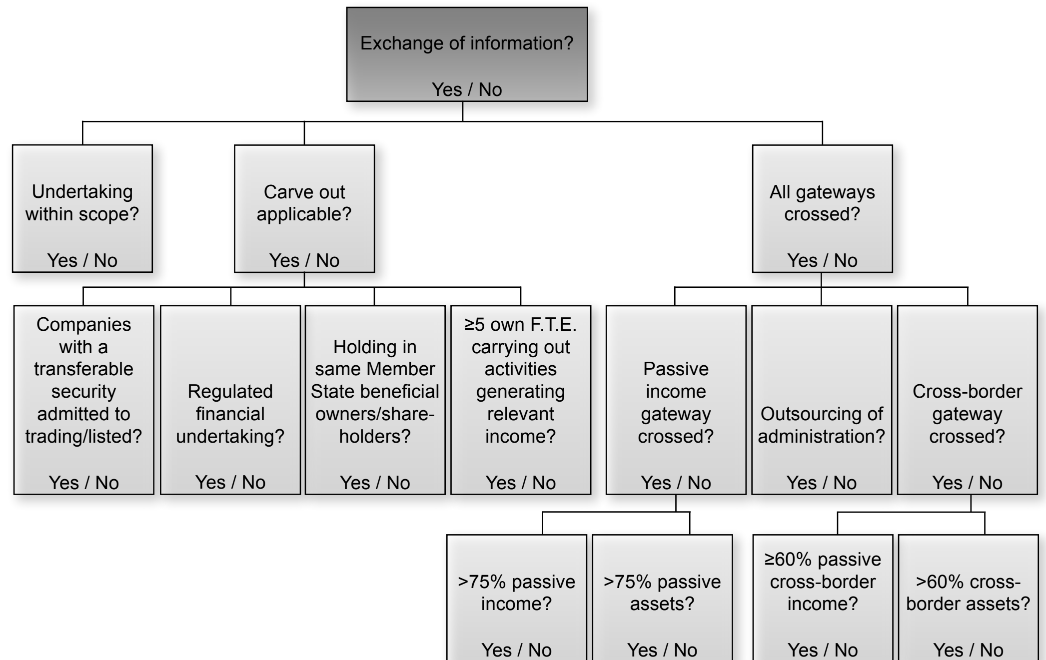

Figure 1: Schematic overview of requirements for automatic exchange of information under original Unshell Directive proposal

The schematic overview makes it clear that exchange of information can take place even if an undertaking does not qualify as a shell entity under the Unshell Directive.

Exemption Upon Request and Reporting Obligation

Undertakings passing through all gateways have the obligation to report that conclusion in annual tax returns and provide satisfactory documentary evidence that they meet certain minimum substance requirements:

- Premises are available for its exclusive use.
- At least one owned and active bank account in the E.U.
- At least one qualified director with decision-making powers in relation to its core income-generating activities who is resident close to the undertaking or, alternatively, a sufficient number of employees that are engaged in its core income-generating activities being resident close to the undertaking.

If an undertaking is able to provide sufficient and objective evidence to the relevant tax authorities that its existence does not lead to tax benefits for the group as a whole, an undertaking should be exempted from the above reporting obligation. In such case, the undertaking is not a shell entity for purposes of A.T.A.D.3, even if it does not meet the substance requirements. This can be illustrated as follows:

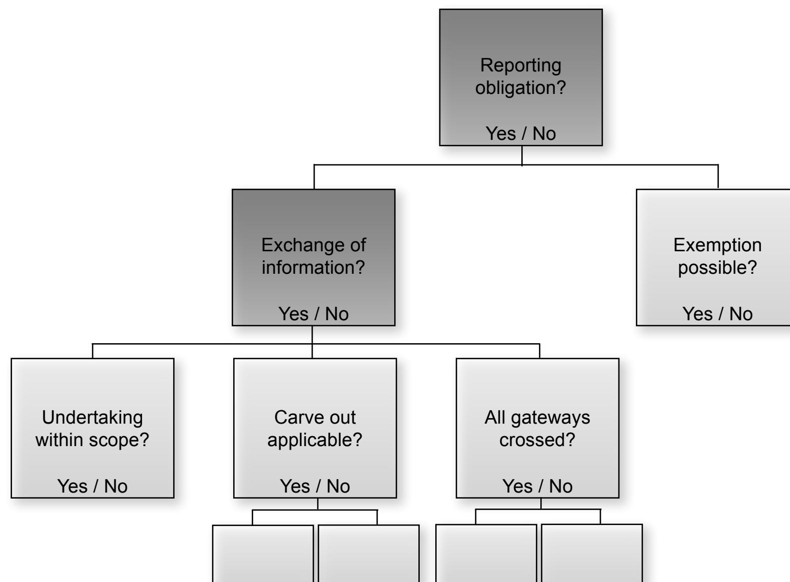

Figure 2: Schematic overview (condensed) of requirements for reporting obligations under original Unshell Directive proposal

Sufficient Substance and Rebuttal of Shell Entity Presumption

If an undertaking is not exempt from its reporting obligation, but it provides satisfactory evidence that it meets the substance requirements, it will not be considered a shell entity under the Unshell Directive. Alternatively, if no exemption is applicable and the undertaking fails to meet the three substance requirements, it will be presumed to be a shell entity for purposes of the Unshell Directive.

An undertaking nevertheless still has the opportunity to rebut the shell entity presumption. To claim such rebuttal an undertaking should provide evidence of each of the following items:

- The non-tax, commercial reasons for establishing and maintaining the undertaking, which does not require compliance with all of the substance indicators.
- The resources used by the entity to carry out its activities.
- The key decisions on the value-generating activities of the undertaking are taken in the Member State in which the undertaking claims to be resident for tax purposes.

This can be schematically depicted as follows:

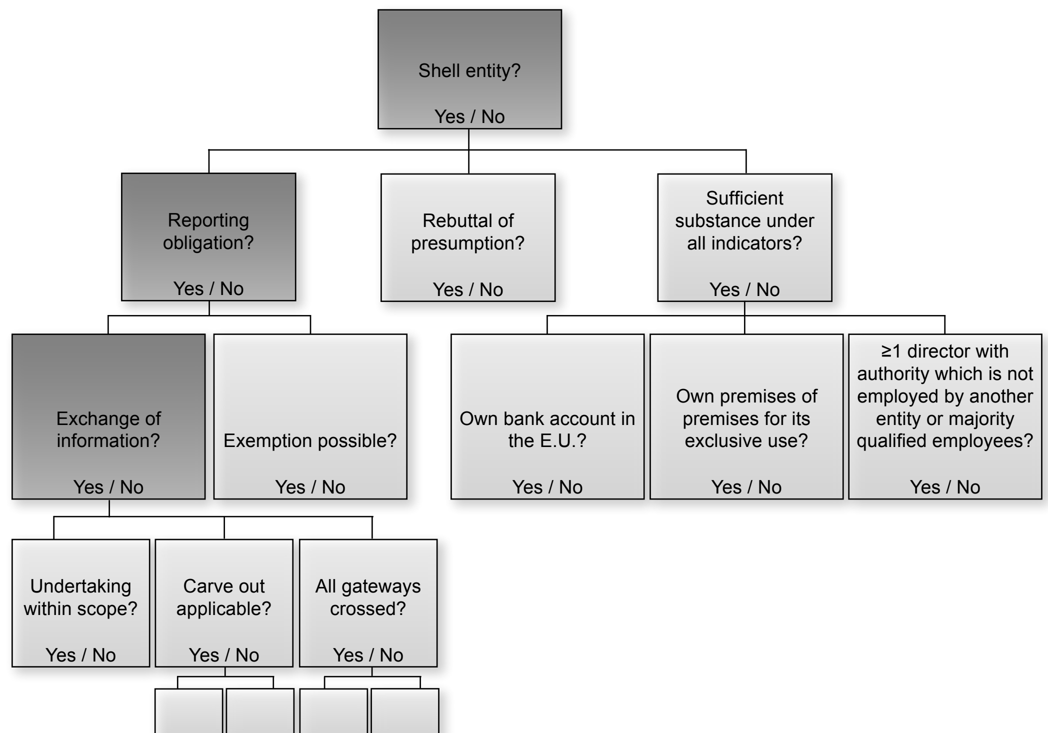

Figure 3: Schematic overview (condensed) of requirements to qualify as shell entity under original Unshell Directive proposal

Although an undertaking is thus able to rebut the presumption of being a shell entity, automatic exchange of information and the reporting obligations may still apply.

Main Tax Consequences of Being a Shell Entity

If an undertaking qualifies as a shell entity, a number of tax consequences arise for (i) the shell entity itself, (ii) the shell entity's E.U.-based shareholder, and (iii) the payer of the shell entity's income flows.[2] The tax consequences can be summarized as follows:

[2] For sake of simplicity, this article does not deal with the tax consequences in case of real estate assets or valuable movable assets.

Situation				
Residence jurisdiction shareholder?	E.U.		Non-E.U.	
Residence jurisdiction payer?	E.U.	Non-E.U.	E.U.	Non-E.U.
Combination	1	2	3	4

Consequences				
Payer				
Tax treaty / E.U. Parent-Subsidiary Directive / E.U. Interest-Royalty Directive?	Tax treaty and/or E.U. directives vis-à-vis shell entity disregarded, application of tax treaty and/or E.U. directives vis-à-vis shareholder	No direct consequences of A.T.A.D.3	Tax treaty and/or E.U. directives disregarded	No direct consequences of A.T.A.D.3
Withholding taxes?	Apply withholding tax as if the relevant income was paid directly to the shareholder, in accordance with the tax treaty between payer's jurisdiction and shareholder's jurisdiction or E.U. directives	No direct consequences of A.T.A.D.3	Apply withholding tax as if the relevant income was paid directly to the (both E.U. and non-E.U.) shareholder, in accordance with the tax treaty between payer's jurisdiction and shareholder's jurisdiction or E.U. directives	No direct consequences of A.T.A.D.3
Shell entity				
Tax treatment of the shell entity?	Shell entity remains tax resident in its jurisdiction			
Tax residence certificate?	Tax administration of shell entity's jurisdiction does not issue a tax residence certificate or issues such certificate stating that the shell is not entitled to tax treaty benefits or E.U. directives			
Shareholder				
Tax treaty / E.U. Parent-Subsidiary Directive / E.U. Interest-Royalty Directive vis-à-vis shell entity jurisdiction?	Tax treaty and/or E.U. directives disregarded		No direct consequences of A.T.A.D.3	
Taxation of income shell entity?	At shareholder level, in accordance with domestic law as if directly accrued to shareholder, minus tax paid on relevant income in shell jurisdiction		No direct consequences of A.T.A.D.3	

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Recent Developments: the Amendments to the Unshell Directive Proposed by the E.P.

On January 17, 2023, the E.P. adopted certain amendments to the Unshell Directive as proposed by the Commission. The main amendments are as follows.

Carve-Outs and Gateways

- The carve-out for undertakings with at least five F.T.E. exclusively carrying out the activities generating the relevant (passive) income has been removed
- The thresholds for the gateway tests have been reduced from 75% to 65% and from 60% to 55%.[3]
- The outsourcing gateway is only met in case of outsourcing to third parties.

The E.P.'s proposed amendments can be illustrated as follows:[4]

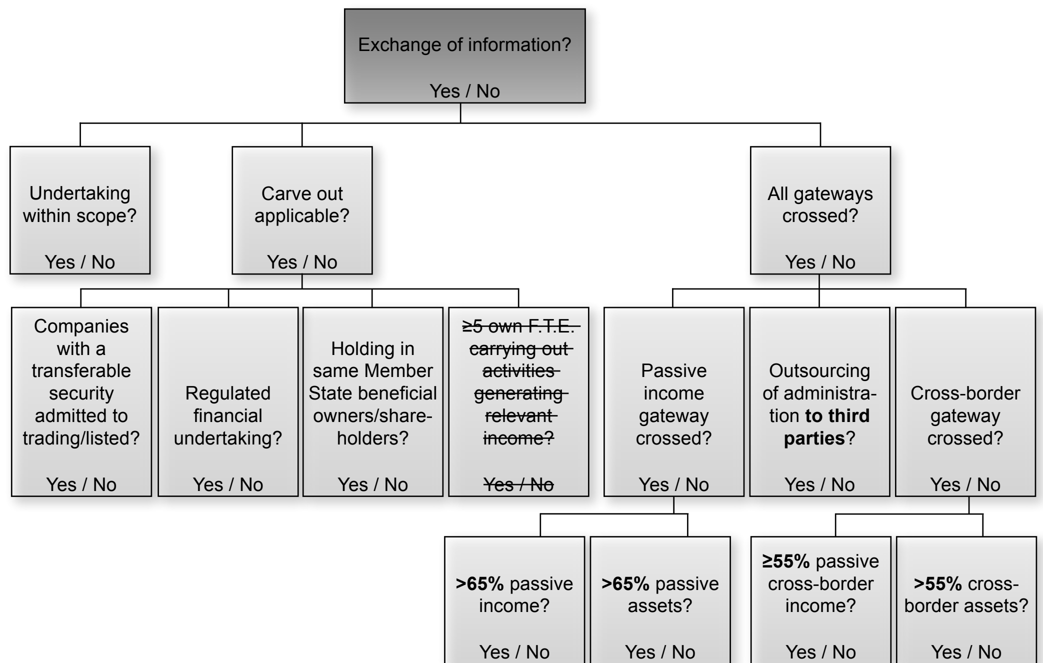

Figure 4: Schematic overview of requirements for automatic exchange of information under the E.P.'s Unshell Directive proposal

[3] Note that the original proposal included the requirement that more than 60% of its relevant assets are located outside the undertaking's Member State or at least 60% of its relevant income is earned or paid out via cross-border transactions. In the E.P.'s proposal, this has been changed to more than 55% in both cases.

[4] Amendments highlighted in red widen the scope of the Unshell Directive, while those highlighted in green narrow the scope of the Unshell Directive.

Substance Indicators

- **Own premises**. If an undertaking shares premises with entities of the same group, this substance indicator is also met.
- **E.U. bank account**. This requirement will be met only if the relevant income is received through an E.U. bank account.
- **Qualified and authorized directors**. It is no longer required for a director to
  - be "qualified" to make decisions in relation to the undertaking's income-generating activities, to meet the relevant substance indicator;
  - actively and independently use the authorization to take decisions in relation to income-generating activities; and
  - not be an employee of a non-associated enterprise or perform the function of director of other non-associated enterprises.

Schematically, the amendments to the substance indicators can be visualized as follows:[5]

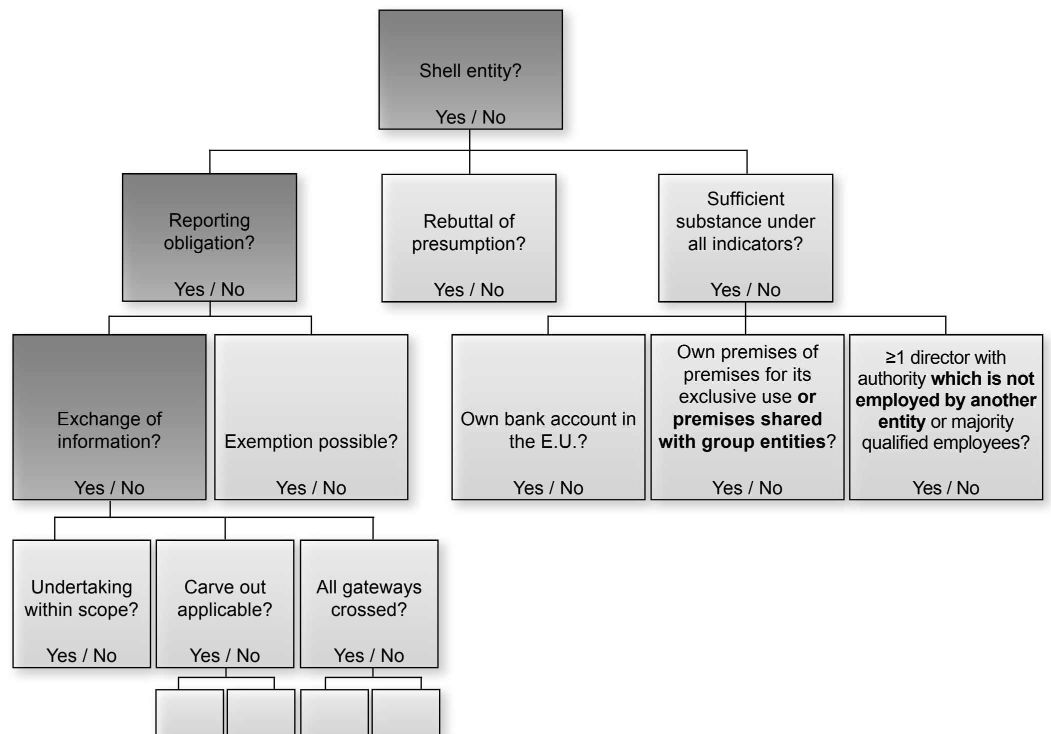

Figure 5: Schematic overview (condensed) of requirements to qualify as shell entity under the E.P.'s Unshell Directive proposal

It is interesting to note that the E.P. did not amend the entry into force date of January 1, 2024.

[5] *Id.*

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"The application of A.T.A.D.3 raises many questions for taxpayers. . ."

Next Steps

The E.P.'s proposal will be considered by the Council of the E.U. ("E.U. Council"). The E.U. Council is not obliged to adopt the E.P.'s amendments. The Member States' representatives in the E.U. Council must agree unanimously on the final text of the Unshell Directive. It appears that negotiations between the Member States are progressing slowly. The current Swedish E.U. presidency intends to put either the progress or agreement on the Unshell Directive on the agenda of the E.U. Council (Ecofin) meeting on May 16, 2023. Once finalized, the Unshell Directive will have to be implemented in the 27 Member States' domestic laws.

Applying a Statistical Approach to Tax Uncertainty

A.T.A.D.3 adds a layer of complexity to an increasingly complex tax world. While on the surface the rules under the Unshell Directive appear clear, they are nothing short of ambiguous. It also remains to be seen how consistently these rules will be implemented in the Member States' domestic laws, and how convergent the interpretation of the rules will be by each of their tax authorities and courts. Finally, certain elements of the A.T.A.D.3 analysis depend heavily on the facts and circumstances of the case, which often are not binary.

The application of A.T.A.D.3 raises many questions for taxpayers, for example:

- Is an entity affected by A.T.A.D.3? What is A.T.A.D.3's expected impact on my structure?
- Should an entity report as a shell entity in the tax return?
- Can a position be improved and is it worthwhile to do so?

These questions must be answered soon, because the answers affect the tax position of taxpayers and taxpayers want to know what they can do now to avoid being caught by the new legislation once it becomes effective. However, it is challenging to answer these questions concretely given the substantial degree of uncertainty about how the new legislation will be applied. Inevitably, this uncertainty will result in risks. In such a case, tax advisors often resort to broad and relatively vague wording when addressing the risks in their advice.[6]

The use of such language is understandable. This is commonly considered to be a nuanced, implicit expression of a level of probability. But using frequency words to express probability is problematic if the sender and recipient of the probability phrase translate such language differently. Research suggests that this is often the case.[7] In this research, the team of statisticians and a professor of science communication conducted a survey on how both laypeople and statisticians interpret Dutch probability phrases in numbers. For both research groups, the researchers found a large variability in interpretations, as shown in the graph below.

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[6] Examples of such language are "it cannot be excluded that (…)," "there is a considerable chance that (…)," and "there are good arguments that (…)."

[7] For example: Willems S., Albers C. & Smeets I. (2020), Variability in the interpretation of probability phrases used in Dutch news articles — a risk for miscommunication, JCOM: *Journal of Science Communication 19(02): A03.*

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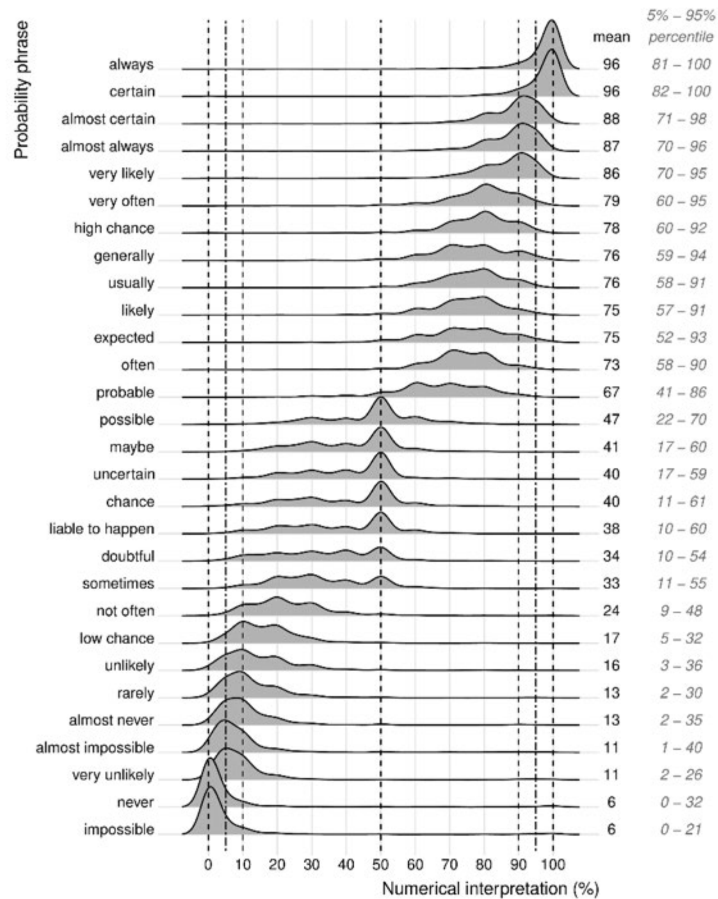

Graph 1: The distribution (density) of the interpretation of the probability and frequency phrases, as follows from the research cited in footnote 7.[8]

The above graph displays two different types of uncertainty: (i) uncertainty about the likelihood that something will happen (y-axis) and (ii) uncertainty about the *interpretation of* that likelihood (x-axis). The latter is the area where there is a risk of misunderstanding between tax advisors and clients. One way to overcome this noise in the "interpretation" of probability is to use numbers instead of words to talk about probabilities. Tax advisors would then equally use their professional knowledge and experience to assess a situation, and equally speak out about their probability estimate (albeit, perhaps, more explicitly), with the only difference being that their views are now expressed in a (range of) probability percentage(s) instead of a probability phrase that may be interpreted very differently from what they meant.[9]

Statistical Thinking Applied in the Context of A.T.A.D.3

The statistical thinking approach described above can also be applied to tax situations, when a decision is to be made while the outcome of one or more options is uncertain. Normally, the analysis starts with setting out the various choices one has,

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8 Note that the distributions are smoothed versions of histograms, which causes them to pass the boundaries of 0% and 100%.

9 A lot has been written on how to improve estimating probabilities. Discussing those techniques, such as the Fermi estimate, however, goes beyond the scope of this article.

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such as, settle or litigate a tax dispute. It can also apply to report or not report as a shell entity in the tax return. The second step is to determine what might happen if a certain choice is made. We will explain this using a basic example, based on the Unshell Directive as amended by the E.P.

Example

An E.U.-based legal entity does not fall under any of the carve-out categories and passes through the "cross-border income" and "outsourcing" gateways. The income statements for the two years under review give the following percentages of relevant income:

Relevant Income	
	Threshold >65%
Year 1	54.0%
Year 2	75.5%
Average of %	64.7%
Average	67.4%

Table 2: Percentages of relevant income based on income statements in example

Do the percentages in the table above lead to the conclusion that this entity passes the "relevant income" gateway? The text of the Unshell Directive only mentions that this gateway is passed if "more than 65% of the revenues accruing to the undertaking *in the preceding two tax years is relevant income*." In the absence of clear guidance as to how exactly the >65% threshold is to be measured (*e.g.*, whether it is sufficient to exceed the threshold in only one of the two years), this is uncertain. The taxpayer ultimately seeks advice to decide whether to report as a shell entity in its tax return.

One way to start this analysis is to structure the tax rule under review in a conceptual model, such as set out in Figures 1-5.[10] It allows for a structured, concise approach to estimating the probabilities. To do that, the professional judgment of the tax advisor is required. Let us assume that the tax advisor considers that it is "defensible" to take the position that the relevant threshold will not be exceeded, and translates this into a probability of 30%.

If we incorporate this 30% probability into the conceptual model, it becomes clear that the probability of running into automatic exchange of information is 70% and that – in the absence of any other "escape" – there is also a 70% chance of running into the reporting obligation and being qualified as a shell entity. This is very obvious and it would not normally require a conceptual model to draw such a conclusion. However, how would this probability change if the tax advisor additionally considers it "likely" (in this case converted into a 60% probability) that it can be argued that the

[10] Another way is to firstly calculate the worst-case impact of a new tax rule, as it may well be that given the amounts involved, further analysis would no longer be required.

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administration of day-to-day operations is not outsourced? This 60% probability is then included in the conceptual model, as shown in Figure 6.

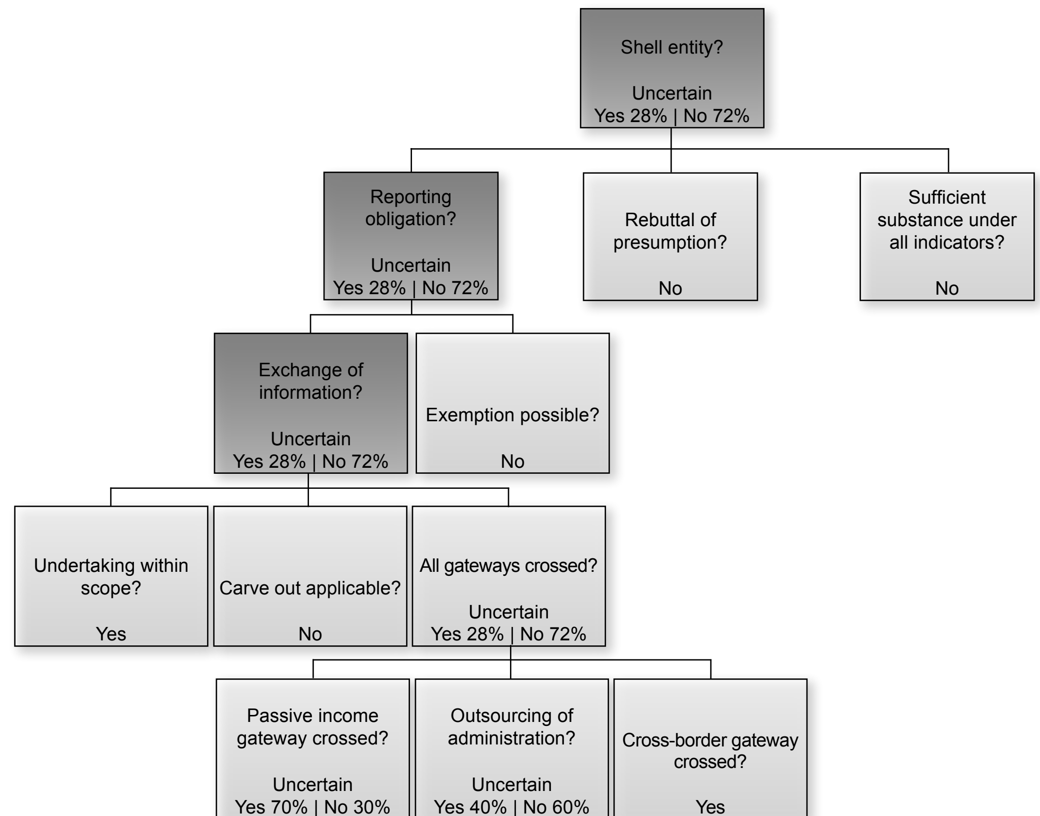

Figure 6: Schematic overview (condensed) of requirements to qualify as shell entity under Unshell Directive (E.P. proposal), including probabilities from example

Despite the fact that there are now multiple uncertain elements, the conceptual model still provides a simple overview of the relationships between the various input variables. More importantly, a closer look at the effect of these additional arguments brings a logical mathematical effect to the surface: while there now is an additional element that, by itself, carries a 60% probability that the entity will not run into any of the consequences of the Unshell Directive, the cumulative probability drops from 60% to 28% (*i.e.*, 32 percentage points). This mathematical effect is important to keep in mind when deciding which elements of the analysis to best focus on.

Based on the advisor's judgment, the (cumulative) probability that the entity qualifies as a shell entity is 28%.[11] The entity acknowledges the inherent uncertainty, but still faces a binary decision: should it include in its tax return that it is a shell entity or not? While there are two choices, there are essentially three scenarios, as shown in the table below.

[11] Namely: the 70% probability that the relevant income gateway would be crossed multiplied by the 40% probability that the entity fails to successfully claim that outsourcing did not take place.

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Shell entity or not?			
Choices			
Tax return position	No automatic exchange of information, no reporting obligation, no shell entity		Shell entity
Option	1		2
Scenarios			
Ultimate outcome	No shell entity	Shell entity	Shell entity[12]
Probability	72%	28%	100%
Scenario	1a	1b	2

Table 3: Options and scenarios in example

Some parties will choose Option 2 and pay whatever amount of additional tax is due, as they want to avoid discussions with the authorities and additional tax interest at any cost. Often, however, a client will first be interested in the value – for example, the additional tax and interest due – of making a choice. Let us assume that the maximum additional cash-out is € 1,000,000, including € 100,000 of tax interest. We could then combine the scenarios and the corresponding cash-outs, as shown in Table 4 below.

Shell entity or not?			
Choice to be made by entity			
Tax return position	No shell entity[13]		Shell entity
Option	1		2
Scenarios			
Ultimate outcome	No shell entity	Shell entity	Shell entity
Probability	72%	28%	100%
(Additional) tax due	nil	€900,000	€900,000
Tax interest	nil	€100,000	nil
Scenario	1a	1b	2

Table 4: Options and scenarios in example, including cash-out per scenario

12 Assuming that the tax authorities would not themselves take a position contrary to the position taken by the entity itself.

13 And no automatic exchange of information or reporting obligation.

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The entity would face the maximum downside if scenario 1b were to occur. However, the probability of this scenario occurring was estimated to be 28%. The probability-weighted average additional cash-out, commonly referred to as the expected value, of choosing Option 1 is therefore € 280,000.[14] Compared to Option 2, which in this example would result in a guaranteed cash-out of € 900,000, Option 1 would in principle be the rational, economic choice. That being said, it is the client's choice – it will ultimately come down to its risk appetite. The aim of using the structured, statistical approach to tax uncertainty as described above is to help the client make an informed decision by providing the client with a picture that is as objective as possible.

Comparing Optimization Alternatives

As a final note, the (expected) values attributed to the "base case"[15] choices can also serve as a benchmark against which potential optimization alternatives can be tested. For example, if an advisor sees an opportunity for an internal reorganization that would "probably" (let us say 60% probability) make a carve-out applicable to the entity, the costs associated with such internal reorganization can be compared to the reduction in expected cash-out under Option 1. The conceptual model would then look as follows:

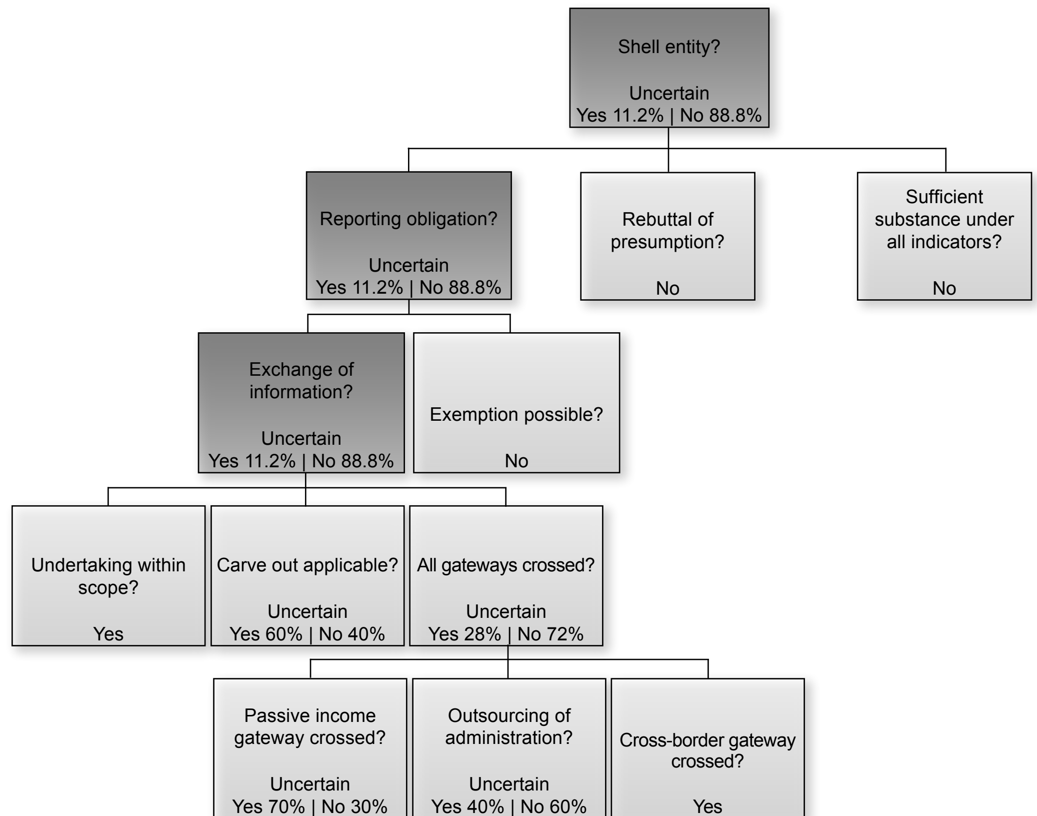

Figure 7: Schematic overview (condensed) of requirements to qualify as shell entity under Unshell Directive (E.P. proposal), including updated probabilities from example

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14 Namely: 72% multiplied nil (scenario 1a) plus 28% multiplied by EUR 1,000,000 (scenario 1b).

15 Base case is referred to here as the as is situation, *i.e.*, without any optimization effort. This is also referred to as the "zero position."

The corresponding values per scenario would be as follows:

Shell entity or not?			
Choice to be made by entity			
Tax return position	No shell entity		Shell entity
Option	1		2
Scenarios			
Ultimate outcome	No shell entity	Shell entity	
Probability	**88.8%**	**11.2%**	
(Additional) tax due	nil	€900,000	€900,000
Tax interest	nil	€100,000	nil
Scenario	1a	1b	2

Table 5: Options and scenarios in example, including cash-out per scenario and updated probabilities

"As discussions on the Unshell Directive are still ongoing, it remains to be seen whether and, if so, in what form and when the Unshell Directive will be implemented and become effective."

If the internal reorganization were implemented, the probability of qualifying as a shell entity would decrease from 28% to 11.2%. This leads to a decrease in the expected value of Option 1 of €168,000.[16] From an economic point of view, it would thus only make sense to proceed with the internal reorganization if the associated costs were lower than €168,000.[17] In this case, too, the pros and cons of a possible optimization exercise are objectified to facilitate a client's decision-making as much as possible.

CONCLUDING REMARKS

As discussions on the Unshell Directive are still ongoing, it remains to be seen whether and, if so, in what form and when the Unshell Directive will be implemented and become effective. In addition, there is likely to be considerable uncertainty in the application of the Unshell Directive, for example due to ambiguous interpretation of the rules or unclear qualification of facts and circumstances.

Where a decision has to be made while the outcome of one or more options is uncertain, it may be difficult to give concrete advice. However, it is not impossible: the aim of this article has been to present a method by which tax uncertainty can be communicated in a rational and (as far as possible) objective manner. This method expresses uncertainty (and risk) in percentages rather than words. This avoids noise in the "interpretation" of probability, which will otherwise easily come into play between the sender (*e.g.*, a tax advisor) and recipient (*e.g.*, a client) of a probability expressed in words.

[16] From €280,000 to €112,000.

[17] This is a basic example based on one year of cash-out, but the mechanics are in principle the same for a multi-year analysis (albeit that discounting the future cash flows would likely be required to make an appropriate comparison).

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In this article, we illustrated the abovementioned method using the uncertainty in the application of A.T.A.D.3. However, this approach can be used in any other tax-related decision under uncertainty, such as when choosing between several alternative investment structures or when faced with a decision to settle or litigate a tax dispute.

The approach involves the following steps:

1. Set out the various choices one has (*e.g.*, to report or not report as a shell entity in the tax return) and determine what scenarios can occur (*e.g.*, what can happen if a certain choice is made).

2. Structure the tax rule under review in a conceptual model.

3. Evaluate the case at hand and, for each option that exists for the decision at hand, assign probabilities to the elements in the conceptual model that are uncertain (if any).

4. Determine the interdependencies among the elements and calculate the total probabilities of the various scenarios associated with a choice. Once this is done, each scenario has a probability (*e.g.*, there is a 40% probability that the entity will qualify as a shell entity, even though it is not reported as such in the tax return).

5. Determine the (financial) outcome of each scenario (*e.g.*, tax cash-out and interest).

6. Compute the expected value of each option. This is the sum of the financial outcome of each scenario multiplied by the probability of each scenario.

Following the steps above provides an overview of the expected impact of making a decision. It allows for a comparison of the various options one currently has, based on a single financial metric (*i.e.*, the expected value of a choice).

However, if an alternative presents itself, for example because optimization opportunities have been identified and the question thus comes up whether to proceed with such optimization exercise, the same six steps can equally be applied. In such case, the (expected) values assigned to the "base case" choices serve as a benchmark against which potential optimization alternatives can be tested.

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FRENCH TAX RESIDENCE, INCOME TAX TREATIES AND NEWCOMERS REGIMES: WHERE DOES FRANCE STAND?

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Tags
Article 4
France
Income Tax Treaty
Newcomer Regime
Residence
Subject to Tax

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INTRODUCTION

The determination of an individual's tax residence is a delicate exercise, combining a review of factual elements in light of different sets of criteria and rules. Most jurisdictions other than the U.S. impose tax sole on the basis of residence. Hence, a definition of tax residence is required. The criteria upon which tax residence is determined by a country may differ depending on the type of tax imposed, such as personal income tax or inheritance tax. Some jurisdictions may have in place a set of objective factors. Others may rely on general principles, leaving room for interpretation and uncertainty.

French domestic tax law adopts a single definition of tax residence for personal income and inheritance taxes, relying on several alternative criteria. The test can provide different results if a person's factual circumstances change during the year. If an income tax treaty applies, the analysis is first performed under French domestic tax law. If the analysis under French law is that the individual is a resident, the matter can be looked at again under a relevant income tax treaty. The tiebreaker rule that appears in most income tax treaties is based on a commonly accepted standard.

France has in effect a network of more than 120 income tax treaties. Most of them are based on the O.E.C.D. Model Income Tax Treaty. Some cover wealth tax or inheritance tax. France has also a small number of tax treaties covering gift and inheritance taxes.

Over the past 10 years, entitlement to substantive tax treaty benefits have been challenged when the individuals claimed tax residence in a treaty partner jurisdiction while benefitting from low-tax or no-tax regimes in their new country of residence. Examples of such regimes include the Beckham regime in Spain, the Aliyah exemption in Israel, the NHR regime in Portugal, the Nondom regime in the U.K., and the Italian newcomers regime.

The challenges cover entitlement to reduced withholding taxes on investment income derived from French sources and access to the tiebreaker provision under a relevant income tax treaty. The basis of the challenge is straightforward. If those taxpayers do not pay taxes locally on their foreign income they are not subject to tax on worldwide income in the country of residence. Consequently, they should not be considered to be residents of a treaty partner jurisdiction under the residence definition of a relevant income tax treaty. They risk full taxation in France.

At first, French Courts seemed to adopt a strict position on treating individuals who benefit from a newcomer regimes in a treaty partner country. In part, the courts applied the same test to individuals that were applied to corporations. Ultimately, a

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more lenient test was applied to individuals. The current approach is to recognize the application of income tax treaties for taxpayers benefiting from a newcomer regime in a treaty partner jurisdiction, provided that they maintain substantial personal contacts in the treaty partner jurisdiction.

This article (i) provides an overview of the criteria available under French domestic tax law and the O.E.C.D. Model Income Tax Treaty regarding the criteria for being a resident and (ii) reviews relevant French case law of the past 10 years clarifying the conditions under which taxpayers benefiting locally from a favorable newcomer regime may claim the application of an available income tax treaty to determine tax residence status.

TAX RESIDENCE STATUS UNDER FRENCH DOMESTIC TAX LAW

Under French Article 4 B of the French tax code, an individual may qualify as a French tax resident under any of the tests described below.

The individual's home or a principal place of abode is in France

French case law has linked the concepts of home and principal place of abode to residence. The primary test looks to the location of an individual's home. If that is not conclusive, the secondary test looks to the principal place of abode.[1]

The term "home" relates to the place where the individual generally lives. This criterion focuses on determining the center of the taxpayer's family interests, *i.e.*, the place where the taxpayer lives with spouse and children. The French administrative Supreme Court[2] generally considers that an individual who exercises professional activity abroad and who regularly stays in France because of the presence of a spouse and minor children results in France being the center of family interests.

The individual's main professional activity is centered in France

An individual's main professional activity is centered in France if the majority of working time related to the activity is carried out in France.[3] The rule applies if even if the French activity does not produce the main part of the individual's income. Time spent in France and elsewhere is of primary importance. If the time-spent factor comparison is not conclusory, compensation for each professional activity is examined may be examined.

The center of economic interests is located in France

The term of "center of economic interests" looks to the place where (i) an individual's main investments are located, (ii) an individual manages private affairs, (iii) the center of an individual's professional life is located, or (iv) an individual derives the most income.[4] In the situation where the taxpayer has various activities or investments,

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[1] French administrative Supreme Court, 3 November 1995, n°126513, Larcher.

[2] French administrative Supreme Court, 12 March 2010, n° 311121, Gerschel – French administrative Supreme Court, 27 January 2010, n° 319897.

[3] BOI-IR-CHAMP-10 n°220.

[4] BOI-IR-CHAMP-10, n°230.

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residence is determined by identifying the center of a person's economic interest, typically the country where most of an individual's income is generated.[5]

TAX RESIDENCE STATUS UNDER INCOME TAX TREATIES

If an income tax treaty is applicable, dual residence conflicts are resolved under dual resident provision of the treaty. Typically, the dual resident provision appears in Article 4 (Residence) of an income tax treaty based on the O.E.C.D. Model Income Tax Treaty. It provides a series of tests that are applied in specific order.[6] If the first test is inconclusive, the second is applied. If the second test is inconclusive, the third test is applied, and so forth until a determination is made.

Here are the typical tests and the order of application.

Permanent Home

The term "permanent home" refers to any type of home that an individual may own, rent, or occupy. It may be a house, an apartment, or a hotel room, as long as it is reserved for the individual's personal use and is available at any time. The permanence[7] of the home is essential. Where a person has a permanent home in both jurisdictions or in neither jurisdiction, the test is inconclusive.

Note that the test under an income tax treaty differs from the test under French domestic law. The former looks to the use of the physical premises and its permanence over a period of time. The latter looks also to family and personal interests at each location.

Personal and Economic Relations / Center of Vital Interests

The "center of vital interests" is determined by a body of evidence corroborating the place where the taxpayer has the greatest number of personal, professional, and patrimonial links and the relative importance of each link at each location. Examples are (i) family ties, (ii) social relations, (iii) occupations, (iv) political, cultural and other activities, (v) source of income and (vi) and wealth.

Where the economic links with one jurisdiction are stronger but the personal links are stronger in the other, the latter jurisdiction has been viewed at times as the jurisdiction of residence, provided that some amount of income is derived in that jurisdiction. However, in a recent case,[8] a court recognized that the two factors had equal weight and one negated the other. The test was found to be inconclusive.

Habitual Abode

The essential element here is the "habitual" physical presence in each of two countries. It is not absolutely necessary to count the days although a meaningful difference between the number of days spent in each country may lead to a conclusion.

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5 French administrative Supreme Court, 27 January 2010, n°294784, Caporal.

6 French administrative Supreme Court, 29 October 2012, n°346641, Kessler.

7 Durable possession of the home: French administrative Supreme Court, 17 December 2010, n° 316144, Venekas et Ms Giannarelli spouse Venekas.

8 Administrative Court of Nice, 11 March 2021, n°1402822.

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Income tax treaties do not specify the period to be compared. The O.E.C.D. commentary states the following:

> * * * [T]he determination must cover a sufficient length of time for it to be possible to ascertain the frequency, duration and regularity of stays that are part of the settled routine of the individual's life.[9]

The habitual abode test under an income tax treaty must be distinguished from the most habitual abode in that counting the days is always necessary under French domestic tax law.

Nationality

The nationality test allocates the residence of an individual to the country of nationality. However, individuals may have two nationalities, if permitted by laws of each country. Where that occurs, or where the individual is stateless, the test based on nationality is inconclusive.

Mutual Agreement

"If all prior tests are inconclusive, the determination of residence under an income tax treaty is determined on the basis of mutual agreement by the two countries."

If all prior tests are inconclusive, the determination of residence under an income tax treaty is determined on the basis of mutual agreement by the two countries.

APPLICATION OF INCOME TAX TREATIES FOR NEWCOMERS

Where an individual qualifies as a French tax resident under French domestic law and a tax resident of another country under its domestic law, a conflict exists as to the sole place of residence of that individual. This conflict may be resolved by an income tax treaty only if the treaty is applicable to the individual. To determine whether a specific income tax treaty is relevant, both treaty partner countries must conclude that the individual is a dual resident under the relevant income tax treaty.

O.E.C.D. Model Income Tax Treaty and O.E.C.D. Commentary

Paragraph 1 of Article 4 (Resident) provides the definition of the term "resident" for purposes of an income tax treaty.

> For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof as well as a recognised pension fund of that State. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

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[9] O.E.C.D. (2017), Model Tax Convention on Income and on Capital: Condensed Version 2017, O.E.C.D. Publishing, C (4) n°19.1.

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In several paragraphs, the O.E.C.D. commentary to Paragraph 1[10] addresses what it means to be liable to tax.

> 8. Paragraph 1 provides a definition of the expression "resident of a Contracting State" for the purposes of the Convention. The definition refers to the concept of residence adopted in the domestic laws (see Preliminary remarks). As criteria for the taxation as a resident the definition mentions: domicile, residence, place of management or any other criterion of a similar nature. As far as individuals are concerned, the definition aims at covering the various forms of personal attachment to a State which, in the domestic taxation laws, form the basis of a comprehensive taxation (full liability to tax). It also covers cases where a person is deemed, according to the taxation laws of a State, to be a resident of that State and on account thereof is fully liable to tax therein (*e.g.* diplomats or other persons in government service).
>
> 8.1 In accordance with the provisions of the second sentence of paragraph 1, however, a person is not to be considered a "resident of a Contracting State" in the sense of the Convention if, although not domiciled in that State, he is considered to be a resident according to the domestic laws but is subject only to a taxation limited to the income from sources in that State or to capital situated in that State. That situation exists in some States in relation to individuals, *e.g.* in the case of foreign diplomatic and consular staff serving in their territory.
>
> * * *
>
> 8.3 The application of the second sentence, however, has inherent difficulties and limitations. It has to be interpreted in the light of its object and purpose, which is to exclude persons who are not subjected to comprehensive taxation (full liability to tax) in a State, because it might otherwise exclude from the scope of the Convention all residents of countries adopting a territorial principle in their taxation, a result which is clearly not intended.

Although comment 8.3 above seems to avoid the systematic exclusion of territorial tax systems, it could be viewed as also covering those tax systems where only newly arrived residents are subject to territorial taxation. Consequently, the O.E.C.D. commentary to Paragraph 1 could be viewed as applying to taxpayers benefiting from a newcomer regime that imposes tax only on domestic source income for a specified period of time.

Relevant French Case Law

First Stone

In the France-U.K. context, the French administrative Supreme Court ruled in 2012 in the *Regazzacci* case[11] that an individual resident in the U.K., whose foreign source

[10] The commentary is first effective as of July 17, 2008.

[11] French administrative Supreme Court, 27 July 2012, n°337656 and 337810, Regazzacci.

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income was taxable in the U.K. only at the time of remittance under a tax regime for nondomiciled individuals was indeed resident in the U.K. for the purposes of the France-U.K. Income Tax Treaty applicable at the time.

Backward Step or Double Reading

In two cases decided by the French administrative Supreme Court on November 9, 2015,[12] the court held that the France-Spain Income Tax Treaty and the France-Germany Income Tax Treaty were not applicable to two pension funds. According to the court, the purpose of an income tax treaty is the elimination of double taxation and not the allocation of taxing rights between States. Each pension fund was entirely exempt from tax in its home country. A juridical person that is exempt from tax on all income by virtue of its status or activity is not likely to be exposed to the risk of double taxation. Presumably, the fact that the individuals covered by the pension plans would be taxable on future pension payments was not considered. A third case reached the same conclusion in 2016.[13]

These decisions were interpreted as weakening the position of taxpayers benefiting from newcomer regimes. As it turned out, however, the court adopted one set of rules for individuals and another for juridical persons.

Milestone

In 2020,[14] the French administrative Supreme Court reviewed the France-China income tax Treaty and concluded that an individual was not precluded from claiming benefits under the treaty merely because he benefitted from a territorial tax system in China. The important fact was that the individual was subject to tax in China by reason of his domicile, residence, or similar personal connection. The territorial aspect of the tax regime did not mean he was not subject to tax. While the France-China income tax treaty does not generally follow the O.E.C.D. Model Income Tax Treaty, and for that reason the decision may have its limitation, the conclusion is consistent with paragraph 8.3 of the O.E.C.D. commentary discussed above. At the very least, it confirmed the view that the rule for an individual is more favorable than the rule for a juridical person.

Towards Legal Certainty

More recently, the administrative Court of Appeal of Toulouse[15] rendered a decision regarding the application of the France-Israel Income Tax Treaty that follows paragraph 8.3 of the commentary to Article 4 of the O.E.C.D. Model Income Tax Treaty.

In the case, two Israeli residents benefitted from an exemption for foreign source income under the newcomer law, commonly known as the Aliyah exemption. The individuals were entitled to French pensions, ordinarily taxed in France under French domestic law. However, Article 18 of the France-Israel Income Tax Treaty provided that these pensions were only taxable in Israel. French tax authorities denied the

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12 French administrative Supreme Court, 9 November 2015 n°371132, Sté Santader Pensionnes; and French administrative Supreme Court, 9 November 2015 n°370054, min. c/ LHV.

13 French administrative Supreme Court, 20 May 2016, n°389994 Sté Easyvista.

14 French administrative Supreme Court, 9 June 2020, n°434972.

15 Administrative Court of Appeal of Toulouse, 13 October 2022, n°20TL22832.

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exemption provided by Article 18, contending that the individuals were not residents of Israel as defined in the treaty. Article 4 of the treaty is similar to the O.E.C.D. provision. The term "resident" of a treaty partner country excludes persons who are subject to tax in the country only on income from sources in that country. The Court ruled in favor of the Israeli pensioners, reasoning as follows:

> [The exclusion for persons taxable only on income from sources in a State] is only intended to exclude from the status of resident of a State, persons who are locally subject to tax only on income from sources situated in that State for reasons other than the existence of a personal link with that State.[16]

The pensioners were Israeli residents within the meaning of the treaty and the treaty benefit for pensions stood.

CONCLUSION

It is not every day that a technical question involving interpretation of income tax treaties can be considered as clarified. The final conclusion of this debate might soon be reached in a confirmation by the French administrative Supreme Court. As explained in paragraph 8.3 of the O.E.C.D. commentary to paragraph 1 of Article 4 (Resident), an individual is considered to be a resident of a treaty partner country based on actual personal presence and ties with that country. If the ties exist and the individual is generally subject to tax in the country for income other than foreign source income, that individual is a resident of the treaty partner country, except to the extent the treaty provides otherwise. In comparison, the residence rule for juridical persons requires that income sourced in France must be subject to tax in the country of residence of that juridical person in order for a treaty benefit to be available.

As previously indicated, not all income tax treaties entered into by France are silent as to the effect of favorable tax regimes on the beneficiary's status as resident of a treaty partner jurisdiction. Paragraph 6-b of Article 4 of the France-Switzerland Income Tax Treaty essentially provides that an individual who benefits from a *forfait* ruling[17] is not considered to be a Swiss resident for purposes of the treaty.

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[16] Translation for information purposes.

[17] See Aliasghar Kanani, "Swiss Lump Sum Tax Regime – Based on Annual Expenditures," *Insights* Volume 10, Number 1 (January 2023); and Michael Fischer, "The Forfait Tax Regime in Switzerland – a Venerable Alternative," *Insights* Volume 2, No. 10 (December 2015).

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BITTERSWEET CHRISTMAS IN SPAIN – BECKHAM REGIME 2.0 AND SOLIDARITY TAX

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Tags
Beckham Regime
Digital Nomads
Ecosystem
Entrepreneurial
Highly Qualified
Remote Workers
Solidarity Tax
Spain
Start-Up
Wealth Tax

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INTRODUCTION

Last year, Christmas in Spain brought with it good news for some individuals and bad news for others. Regarding the good news:

- The special tax regime for certain immigrants (also known as the "*Beckham Regime*") was amended by introducing changes to significantly improve its scope and benefits.
- The Spanish Parliament approved the Law 28/2022 of December 21, 2022, regarding the promotion of the "start-up ecosystem" ("Start-ups Law"). The final draft was published in the Official Gazette on December 24, 2022, and the new law entered into effect on January 1, 2023. Implementation regulations are pending.

Regarding bad news:

- The Solidarity tax addressed to high net worth individuals was approved. It is an add-on wealth tax that backstops the existing Wealth tax, so that Spanish residents that previously paid no Wealth tax will be subject to the Solidarity tax. Think of it as the equivalent of a minimum tax that backstops and income tax.

This article addresses the foregoing additions to Spanish tax law. The net effect is bittersweet.

BECKHAM REGIME 2.0

Main Amendments

The basic benefit of the Beckham Regime is that qualifying individuals are subject to tax in Spain as nonresidents for six tax years, beginning with the year of arrival. The first €600,000 of Income from employment is taxed at a flat rate of 24% rather than graduated rates of up to 43%. Income in excess of €600,000 is taxed at a flat rate of 47%. Other income and assets are subject to tax at ordinary rates, but the tax base includes only income from Spain and assets located in Spain. The regime is elective.

In order to benefit from this specific tax regime, an individual must not have been a Spanish tax resident for a specified period. Prior to the change in law, the period of nonresidence in Spain was 10 years. Under the change in law, the nonresidence period is reduced to five years.

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The criteria for eligibility has been widened to cover more than employees:

- **Entrepreneurial activity.** Individuals coming to Spain to carry on an entrepreneurial activity may elect coverage under the Beckham Regime. This means that self-employed individuals may qualify, but only if the entrepreneurial activity is an innovative activity for which Spain has a special economic interest. A favorable determination from the State Administration ("ENISA") will be required. Apart from the tax benefits, an individual who qualifies under this category is entitled to obtain a work visa.

- **Highly qualified professionals.** Individuals coming to Spain to provide services to start-up companies or to carry on research, training, or innovative activities may elect coverage under the Beckham Regime.[1] To qualify, the payment must represent more than 40% of the individual's total personal income and the company must be a start-up. The definition of a "start-up company" is included in the Start-up Law. A company is considered to qualify where all the following conditions are met.

    - The company must be newly formed, or alternatively, cannot be recorded at the Mercantile Registry for a period of more than five years, in general, or for a period of more than seven years if operating in the biotech, energy, or industrial areas.

    - The company must not arise from a merger, spin-off, or change of corporate form involving entities that are not considered to be start-ups.

    - The company must not distribute, or have distributed, dividends, meaning that profits are reinvested in the business or held for future reinvestment.

    - The company must not be listed on a regulated stock exchange.

    - The principal place of business, registered office, or permanent establishment must be located in Spain.

    - At least 60% of the Company's employees must have an employment contract in Spain.

    - The company must be based on an innovative entrepreneurship project which has a scalable business model.

    Apart from the tax benefits, an individual who qualifies under this category is entitled to obtain a work visa.

- **Remote workers.** Remote workers coming to Spain may elect coverage under the Beckham Regime. Work must be carried out from home by the employee (known as a "*digital nomad*"). In the particular case of a remote work visa, the Beckham Regime is available for employees. Apart from the tax

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[1] Beyond extension of the Beckham regime, the Start-up Law provides other benefits to emerging companies and individuals. These include favorable rules on stock option schemes, special valuation rules for shares and participations awarded to employees, tax credits for investment in new companies and reduced corporate tax rates. A discussion of these benefits is beyond the scope of this article.

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benefits, an individual who qualifies under this category is entitled to obtain a work visa.

- **Managers.** Under prior law, a manager electing for tax benefits under the Beckham Regime could not own more than 25% of the share capital of the employer. The cap has been eliminated for managers coming to Spain to work for operating companies. Those who come to Spain to work for a holding company continue to be subject by the limit on the ownership of shares in the employer. A company is considered to be a holding company if its activity principally covers the management of passive assets, such as financial securities and real estate.

To sum up, income from the performance of qualified activities is taxed at a flat rate of 24% up to €600,000. Qualifying Spanish source income in excess of the ceiling is taxed at the rate of 47%. Income from sources outside of Spain is not taxed. Taxpayers that benefit from the Beckham Regime are subject to Spanish Wealth tax, but the tax base is limited to assets situated in Spain.

Beneficiary's Relatives

One of the primary advantages of the new law is that, beginning from January 1, 2023, the spouse and children under the age of 25 (or disabled of any age) of the qualifying individual are entitled to benefit from the Beckham regime. The favorable rate is capped for family members. The rate applies only to the extent the aggregate amount of income of all family members does not exceed the income of the qualifying individual. As with the qualifying individual, only Spanish source passive income is subject to tax.

Absence of Transitional Relief

The Start-up Law entered into effect on January 1, 2023, and involves significant improvements as to the scope and benefits of the Beckham regime. In this regard, a transitional regime for persons arriving in Spain prior to the effective date of the new law is not included in the Start-up Law. No indication exists that a transitional regime will be included in the regulations that may be issued by Spanish tax authorities. In comparable circumstances Spanish courts have held that once an individual establishes residence in Spain and does not qualify for benefits under the law in effect at the time, subsequent changes that lower the bar for qualification have no retroactive effect unless the legislation or implementing regulations provide relief.

SOLIDARITY TAX

Spanish Wealth tax is administered at the autonomous regional level. Some regions impose the tax, but provide relief for property located in the region. Think of a sale that is subject to V.A.T., but the rate is zero. To eliminate that practice, the government enacted a second wealth tax in addition to the existing tax that applies nationwide, but which provides relief for regional Wealth tax paid. On December 28, 2022, the final text of the Solidarity tax law was published in the Spanish Official Gazette. This second wealth tax is aimed at individuals with a net wealth exceeding €3.0 million.

Key Features

In comparison to the existing Wealth tax, the Solidarity tax cannot be managed at the level of autonomous regions. It is intended to target specific regions such as Madrid, Galicia, and Andalusia. Those regions provide Wealth tax allowances for assets physically located within the region. The new Solidarity tax applies to Spanish taxpayers having a worldwide net worth in excess of €3.7 million. It also applies to nonresident taxpayers holding assets with a value in excess of €3.0 million in regions where the Wealth tax was effectively abated by applicable allowances.

This difference of treatment between residents and nonresidents may violate European Union Law providing the right to free movement of capital between member States. It may also violate rights granted by Article 63 of the Treaty on the Functioning of the European Union, which prohibits all restrictions on the movement of capital and payments (i) between Member States and (ii) between Member States and third countries.

In broad terms, the Solidarity tax adopts most of the rules issued under the existing Wealth tax. Thus, for example, rules regarding the definition of covered taxpayers, the determination of the taxable base, and the allowance of exemptions merely refer to the Wealth tax Law.

As drafted, the Solidarity tax has a lifespan of two years. The first year is calendar year 2022 and the second year is calendar year 2023. An open question exists as to whether the government will extend the two-year period at the end of 2023.

Applicable tax rates are as follows:

Net Tax Base (up to)	Tax Burden	Remaining Tax Base (up to)	Tax Rate
€0.00	€0.00	€3,000,000.00	0.00%
€3,000,000.00	€0.00	€2,347,998.03	1.7%
€5,347,998.03	€39,915.97	€5,347,998.03	2.1%
€10,695,996.06	€152,223.93	€ Higher	3.5%

In order to avoid double taxation of assets, the Solidarity tax allows for the effective deduction of previously paid Wealth tax. That deduction implements the Government's goal of targeting Madrid and Andalusia, where a 100% Wealth tax allowance is applied for assets located in the region. As a result, the Solidarity tax effectively implements a minimum Wealth tax on a national basis.

Madrid and Andalusia have sought redress in Spanish courts to prevent the effective elimination of allowances each has granted for wealth tax purposes. The position of the two regions is that the Solidarity tax violates the rights of the Autonomous regions granted by the Spanish Constitution.

The Solidarity tax establishes an overall cap on the tax due, similar to the existing cap in the Wealth tax that takes into account the overall tax payable under the Personal Income tax and the Wealth tax. If the final amount of Solidarity tax, Personal Income tax, and Wealth tax exceed 60% of the Personal Income tax net taxable

base, the Solidarity tax payable is reduced. However, the reduction may not exceed 80% of the initial amount of Solidarity tax due.

Spanish Constitution

Several issues exist under Spanish law regarding the constitutionality of the Solidarity tax. For that reason, many advisers have urged clients to claim refunds of Solidarity tax paid.

Retroactivity

Because the Solidarity tax has effect for tax years beginning on January 1, 2022, even though it was published in the Spanish Official Gazette on December 28, 2022, it has retroactive effect. It that starting date confirmed, the Solidarity tax may be unconstitutional for taxpayers who became Spanish tax residents for 2022 and were physically present in Spain for more than 183 days prior to December 28, 2022. Retroactive legislation violates article 9.3 of the Spanish Constitution, encompassing the principle of legality.

The issue of retroactivity of tax legislation in general is pending in a case currently before the Spanish Supreme Court. It involves a specific tax approved in the Canary Islands and applicable to deposit and credit Institutions. The tax was effective prior to the date of enactment – hence it was retroactive to time before enactment. While the decision in the Canary Islands case is not binding on the Spanish Supreme Court in a matter related to the Solidarity tax, it would illustrate the views of the court.

"Several issues exist under Spanish law regarding the constitutionality of the Solidarity tax . . ."

Violation of Right to Autonomy of Regions

The taxing rights related to Wealth tax are granted at the Autonomous region level and to tax the same assets a second time, at the level of the Spanish State, may be viewed as being contrary to Article 156 of the Spanish Constitution. Under that provision, the Autonomous regions are granted financial autonomy. The aspect of the Solidarity tax providing credits for wealth tax payments to Autonomous regions in effect imposes a minimum Wealth tax on residents of regions granting allowances.

Procedural Irregularity

The Solidarity tax was enacted by means of an amendment to an existing bill before parliament. This parliamentary procedure may be contrary to the principles of good regulation granted under Article 129 of the Spanish Constitution. The relationship between the State and the Autonomous regions must be arranged through specific laws in order to protect the financial rights granted via the Spanish Constitution.

In conclusion, it is likely that the Solidarity tax might be declared unconstitutional based on the above-mentioned criteria. Therefore, many advisers recommend that clients should claim a refund immediately after paying the Solidarity tax.

Spanish Real Estate Companies

Nonresidents are subject to Wealth tax in a limited way. The tax applies to assets located in Spain. Over the years, there has been debate over whether nonresidents holding Spanish real estate assets through foreign entities should be subject to Wealth tax. Initially, the Directorate General of Taxes ("the D.G.T.") issued binding

rulings[2] stating that income tax treaties could create taxing rights for Spain, even though the Spanish domestic law did not contain a provision imposing tax. Recently, the D.G.T. changed its view. In binding rulings,[3] it stated that nonresident taxpayers holding real estate assets directly or indirectly through foreign entities were not subject to Wealth tax.

There no longer is a debate on the application of Wealth tax to nonresidents holding Spanish real estate through an envelope company. The same bill introducing the Solidarity tax amended the Wealth tax in order to grant taxing rights in this specific scenario of holding Spanish real estate assets through foreign entities. This measure applies to the Solidarity tax as Wealth tax rules are adopted in applying the Solidarity tax.

Nonetheless, each case should be evaluated based on the particular income tax treaty involved. To illustrate, the current Spain-U.S. Income Tax Treaty[4] does not include the Spanish Wealth tax within its scope. Consequently, the Spanish Wealth tax imposed on the value of Spanish real estate assets held through a foreign company does not conflict with the income tax treaty. In comparison, the Spain-Canada Income Tax Treaty[5] provides that the imposition of Wealth tax may be imposed on real estate assets that are held directly. As a result, Canadian residents holding shares of foreign or Spanish companies would not be subject to Wealth tax even when the assets of the issuing company consist primarily of Spanish real estate.

CONCLUSION

An ambiguity exists between the Beckham Regime and the Solidarity tax. Does the Beckham regime override the Solidarity tax? Under one view, the wording of the Beckham Regime refers only to its application to Personal Income tax and Wealth tax. On that basis, the Solidarity tax could be applied to worldwide assets of an individual electing the benefits of the Beckham regime. The other view is that when the Solidarity tax refers to definitions and provisions of the Wealth tax, it adopts the limits on jurisdiction to impose the tax. Consequently, if wealth is not taxed under the Wealth tax, it cannot be taxed under the Solidarity tax. As with many debates of this kind, the answer is in the eye of the beholder. In the view of the author, taxpayers electing coverage under the Beckham regime are subject to Solidarity tax. However, the Solidarity tax may be imposed only on the value of assets located in Spain, and only if those assets exceed €3.0 million. The D.G.T has recently confirmed this view in a ruling pending to be published.

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[2] Rulings V4968-16, V1452-14, and V2521-13.

[3] Rulings V1947-22, V2646-21, and V2070-21.

[4] Originally signed on February 22, 1990, revised by a protocol signed on January 14, 2013, which entered into force on November 27, 2019.

[5] Originally signed on November 23, 1976, and amended by a protocol signed on November 18, 2014.

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TAX CONSIDERATIONS FOR A U.S. HOLDER OF BARE LEGAL TITLE IN A *USUFRUCT* ARRANGEMENT

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Tags
C.F.C.
Check-the-Box Election
Code §962 Election
Foreign Tax Credit
G.I.L.T.I.
Previously Taxed Income
Subpart F

INTRODUCTION

Ask parents why they work as hard as they do, and many will answer that it is to give their children a better future. For some, this involves sending their children to foreign countries like the U.S. For others, the hope is to build something they can pass on to their children. But combine the two, and U.S. tax law presents a tricky situation.

Consider Mr. P., a French citizen and resident who is neither a resident nor citizen of the U.S. He starts a business ("OpCo") in the Netherlands in the form of a Dutch B.V. OpCo is owned entirely by HoldCo, Mr. P.'s 100%-owned holding company. HoldCo is a French S.A.S.

Mr. P. sends his only child, Ms. C., to the U.S. for schooling, after which she obtains residence in the U.S., and ultimately gains citizenship. Mr. P. plans for his daughter to inherit HoldCo, which continues to own OpCo. But transferring these entities to a U.S. person creates new challenges. The primary risk is that the transfer can trigger C.F.C. status for both foreign entities.

The Subpart F regime directed at income of C.F.C.'s is designed to prevent U.S. Shareholders benefitting from (i) certain intercompany transactions and (ii) other investment income opportunities offshore. Its companion regime, G.I.L.T.I., is meant to disincentivize U.S. owners of C.F.C.'s from keeping earnings offshore. C.F.C. status is often considered undesirable due to onerous tax and reporting obligations.

U.S. tax law provides options for mitigating some of these drawbacks. They include check-the-box ("C.T.B.") elections, which allow a C.F.C. to be treated as a flow-through entity, and Code §962 elections, which allow an individual to be taxed as corporation in connection with income that is taxable under the C.F.C. regimes of U.S. tax law. The benefits are (a) lower tax rates on Subpart F income and tested income under G.I.L.T.I. and (b) access to indirect foreign tax credits while income remains undistributed. The benefit is recaptured when an actual dividend is received from a C.F.C. The previously taxed income benefit is limited to the amount of U.S. corporate tax previously paid under the C.F.C. regimes. As a result, most or all of the dividend retains its character as dividend income received from a foreign corporation. Depending on whether the dividend is a qualified dividend under Code §1(h)(11), it will be taxed as a rate of 20% or 37%.

The following diagram summarizes the basic tax consequences of each option:

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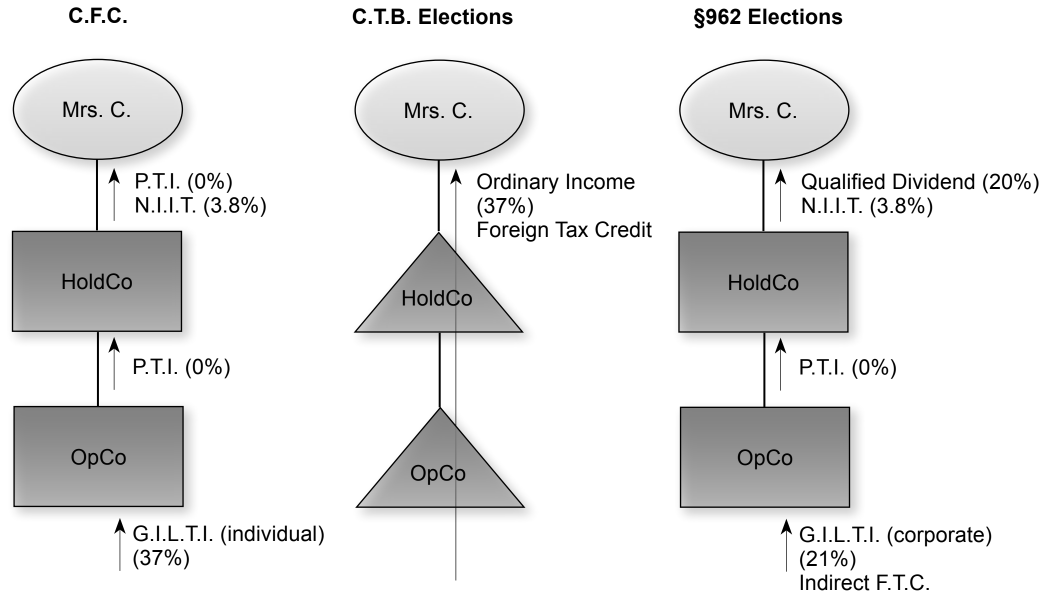

CLASSIFICATION OF FOREIGN ENTITIES

The first issue is the status of foreign entities under U.S. tax law. Foreign entities like OpCo and HoldCo that are owned entirely by non-U.S. persons such as Mr. P. and operate outside the U.S. generally do not fall into the U.S. tax net. But a transfer to a U.S. person changes things.

A foreign entity is a C.F.C. if it is a corporation in which "U.S. Shareholders" own more than 50% of the voting power or value of all issued shares outstanding.[1] For this purpose, U.S. persons are U.S. Shareholders only if they hold at least 10% of the foreign entity, measured by voting power or value.[2] When Ms. C. inherits her father's ownership in HoldCo, she will be a U.S. Shareholder with respect to HoldCo and will own more than 50% of the outstanding shares of HoldCo if the value of the bare legal title exceeds the value of the income interest. In addition, Ms. C is considered an owner of HoldCo's shares in OpCo because U.S. law applies indirect ownership rules and rules under which ownership by one entity or person may be attributed to a U.S. taxpayer for purposes of determining whether that U.S. taxpayer is a U.S. Shareholder and whether the particular foreign corporation is a C.F.C. [3]Those rules will cause OpCo to be a C.F.C. and Ms. C to be its U.S. Shareholder.

OpCo and HoldCo must be corporations under U.S. law for them to be C.F.C.'s. U.S. law classifies a foreign entity based on the number of its shareholders or members entity and the extent of their liability. A foreign entity is a corporation if all shareholders or members have limited liability for the debts and other obligations of the entity.[4] The general understanding is that shareholders of a Dutch B.V. or a French S.A.S.

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[1] Code §957(a). All references to the Code and. refer to the Internal Revenue Code of 1986 as currently in effect. All references to Treas. Reg refer to associated regulations issued by the I.R.S.

[2] Code §951(b).

[3] Code §958.

[4] Treas. Reg. §301.7701-3(b)(2)(i)(B).

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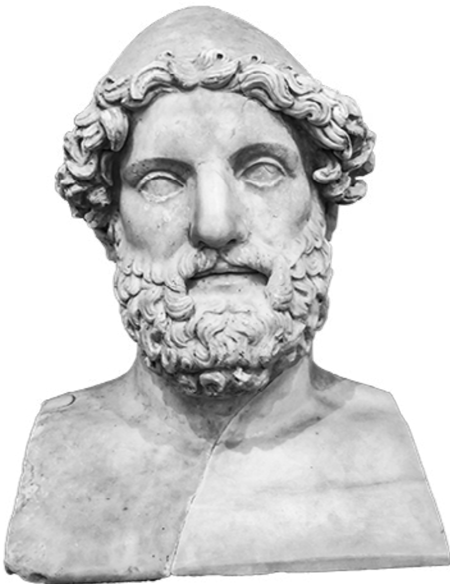
are not personally liable for the debts and other obligations of the underlying entity. B.V.'s and S.A.S.'s are therefore corporations for U.S. purposes. This, combined with Ms. C.'s U.S. Shareholder status, means that HoldCo and OpCo will become C.F.C.'s when their shares pass to Ms. C.

The discussion in the foregoing paragraph are addressed to default classifications, meaning that no action is taken to change the classification for income tax purposes in the U.S. A C.T.B. election is available for certain entities, which allow them to change their entity classification for U.S. tax purposes. Foreign entities that are not eligible to change their classifications tend to be limited to those entities that can issue shares that are publicly traded on an exchange. Examples are S.A.'s, P.L.C.'s, A.G.'s, and N.V.'s.[5]

C.F.C. ISSUES

C.F.C. status results in several unfavorable consequences for U.S. Shareholders. U.S. persons that are shareholders in a foreign corporation that is not a C.F.C. are not taxed on the corporation's earnings until dividends are received.[6] For an individual, the tax rate on dividends is capped at 20% when the dividend is a qualified dividend. To be qualified, a dividend must be distributed by a U.S. corporation or a corporation that is eligible for benefits granted under a comprehensive income tax treaty with the U.S.[7] In additions, the I.R.S. must determine that the treaty is satisfactory[8] and an exchange of information program must be in effect. Finally, the foreign corporation cannot be a P.F.I.C. in the year a dividend is paid or the preceding year and cannot be a surrogate corporation under the anti-inversion rules.[9] Individual U.S. shareholders are also subject to net income investment tax ("N.I.I.T."), a 3.8% tax on passive income.[10] The I.R.S. position is that N.I.I.T. cannot be offset by a tax treaty or by foreign tax credits.[11] The position was upheld by the U.S. Tax Court.[12]

U.S. Shareholders of a C.F.C. no longer benefit from deferral in a material way. They are taxed on most or all of the earnings of a C.F.C. in the same year as earned by the C.F.C., even if not distributed in the form of a dividend. Income tax is imposed under one of two regimes: Subpart F or G.I.L.T.I. The Subpart F regime applies to (i) certain intercompany transactions between the C.F.C. and a related party[13] and (ii) passive income earned by the C.F.C. from financial investments and the like.[14]



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5 For a complete list, see Treas. Reg. §301.7701-2(b)(8).

6 Immediate taxation also arises when a foreign corporation is a P.F.I.C. and a U.S. shareholder makes a Q.E.F. election. This article does not address issues regarding P.F.I.C.'s.

7 Code §1(h)(11).

8 For a list of satisfactory treaties, see Notice 2011-64.

9 Code §§1(h)(11)(C)(iii)(I) and (II).

10 Code §1411(a)(1).

11 Treas. Reg. §1.1411-1(e).

12 See also *Toulouse v. Commr.,* 157 T.C. 49 (2021).

13 Code §954(d), applicable to foreign base company sales income, and (e), applicable to foreign base company services income.

14 Code §954(c), applicable to foreign personal holding company income.

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Subject to minor exceptions,[15] G.I.L.T.I. applies to most of what is not caught by Subpart F.

Since OpCo earns its income from running a standalone business, its income most likely is covered by the G.I.L.T.I. provisions. When OpCo recognizes income, Ms. C. will treat the income as "tested income" that is included in her income tax return for the same year. She will pay U.S. tax computed at ordinary income rates that top out at 37%. As an individual filing a tax return on Form 1040, she is not entitled to claim a foreign tax credit for Dutch corporate income taxes imposed on OpCo in the absence of an election made in Ms. C's U.S. income tax return to be taxed under the Subpart F and G.I.L.T.I. provisions as if she were a corporation, rather than an individual. This is discussed below.

Alternatively, Ms. C may seek relief under the high tax exception to both C.F.C. provisions if the effective rate of French tax exceeds 90% of the U.S. corporate tax rate. The effective rate of tax is computed by restating the income of OpCo to comply with U.S. tax accounting rules and dividing the actual French tax paid or incurred by the restated net income before foreign income taxes.[16] The effective rate of tax must be at least 18.9% in order to claim the benefit of the high tax exception.

If a U.S. Shareholder is taxed on a C.F.C.'s Subpart F income or G.I.L.T.I., dividends to upper-tier entities and eventually to the U.S. Shareholder are considered previously taxed income ("P.T.I.") and are exempt from a second round of income tax.[17] Therefore, while HoldCo's dividends from OpCo would ordinarily be Subpart F income to HoldCo and taxed to Ms. C. as such, the P.T.I. rule spares her from a second level of tax. Similarly, and as a general rule, HoldCo's distribution of that income to Ms. C. does not trigger more income tax for her.

In addition to this increased tax burden, U.S. Shareholders face heavy annual reporting obligations. The full extent of these requirements depends on a shareholder's level of ownership and involvement in a C.F.C. Since Ms. C. will become a majority owner, her requirements will be on the heavier side. Acting as an officer or director of HoldCo or OpCo would further increase her reporting burden.

***Usufruct* Arrangements**

A common planning tool in many civil law jurisdictions is a *usufruct* arrangement, under which ownership rights over a piece of property is divided between an income interest and an ownership interest.[18] Broadly, one person, known as the *usufruct*uary, retains the right to the use of the property or the income from the use of the property, while another person holds the bare legal title to the property. A typical arrangement involves a parent, who is a *usufruct*uary, and a child, who is the bare owner, with the child receiving full ownership of the shares at the conclusion of the parent's lifetime. The local tax benefit is a significant reduction in inheritance taxes.

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15 Code §951A(b)(1), applicable to net deemed tangible income return, and (c)(2)(A), applicable to specified income excluded from tested income.

16 Code §954(b)(4); Treas. Reg. §1.954-1(d)(4).

17 Code §959(a).

18 See Fanny Karaman and Stanley C. Ruchelman, "Usufruct, Bare Ownership, and U.S. Estate Tax: an Unlucky Trio," *Insights* Vol. 3. No. 8, (September 2016), and Fanny Karaman and Beate Erwin, "Basis Planning in the Usufruct and Bare Ownership Context," *Insights* Vol. 4 No. 3, (March 2017).

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"In addition to issues at the time of inheritance, a usufruct arrangement between a parent resident in a civil law jurisdiction and a child resident in the U.S. brings its own set of issues for the child during the lifetime of the parent."

With one exception,[19] *usufruct* arrangements are not commonly available in the U.S. Certainly, tax law provisions that focus on *usufruct* arrangements are few, if any. [20]The I.R.S. sometimes analogizes *usufruct*s to life estates.[21] In a life estate, the life tenant enjoys use of a property during his or her lifetime, but the *usufruct*uary may be obligated to preserve the underlying property to a greater or lesser extent, as agreed. At the life tenant's passing, ownership of the property passes to the remainderman. At that point, the life interest and the remainder interest are merged into full tile. The *usufruct*uary corresponds to the life tenant, and bare legal owner corresponds to the holder of the remainder interest.

While *usufruct* arrangements provide inheritance tax benefits in civil law jurisdictions, the desired benefit is not available under U.S. estate tax rules applicable to U.S. persons planning an estate or for non-U.S. persons owning U.S. situs property. The value of the bare legal ownership at the time of the life tenant's demise is included in the taxable estate where the life tenant owned the property before the remainder interest was given away.[22]

In addition to issues at the time of inheritance, a *usufruct* arrangement between a parent resident in a civil law jurisdiction and a child resident in the U.S. brings its own set of issues for the child during the lifetime of the parent. As in our example with Mr. P and his daughter, Ms. C, the arrangement can provide issues for Ms. C where the *usufruct* relates to shares of stock in a foreign corporation owned by Mr. P. Ms. C's ownership of bare legal title in HoldCo can cause HoldCo and OpCo to be treated as C.F.C.'s. If so, Ms. C is affected by the Subpart F and G.I.L.T.I. regimes. Both companies are C.F.C.'s but the *usufruct*uary, Mr. P, is the only person having an interest in the income of the companies.

In P.L.R. 8748043, the I.R.S. considered whether certain U.S. persons should include Subpart F income in respect of several Dutch controlled foreign corporations ("C.F.C.'s") in which bare legal title was held by bequest. The C.F.C.'s stock was subject to a *usufruct* created for the benefit of a nonresident alien. The I.R.S. concluded that the corporations were C.F.C.'s, but the U.S. persons were not required to include any Subpart F income. The I.R.S. reasoned as follows:

> Since the *usufruct*uary has a 100 percent interest in the income of the corporation . . ., it logically follows that the *usufruct*uary should be treated as the owner of the corporate stock during such time for purposes of subpart F and, by analogy, the foreign personal holding company provisions.

Several years later, Field Service Advice ("F.S.A.") 199952014 looked to P.L.R. 8748043 to reach a similar conclusion regarding the concept of ownership of shares for purposes of Code §958. In a somewhat different context involving a nongrantor trust for which certain persons held life interests and others held remainder interests, the issue presented was whether the remaindermen could be allocated a portion of the Subpart F income of a C.F.C. owned by the trust. The F.S.A. concluded that only

[19] Louisiana.

[20] One example seems to appear in Treas. Reg. §1.1014-2(b)(2).

[21] *E.g.*, Rev. Rul. 66-86; P.L.R. 201032021.

[22] Code § 2036.

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the income beneficiaries would be deemed to have an interest in the income of the trust by reason of the application of Code §958.

> * * * [W]e conclude that for purposes of section 958(a)(2) and Treas. Reg. [§]1.958-1(c)(2), where a foreign non-grantor trust provides for distribution of all of the trust's net income to one or more named individuals in specified proportions, or (as here), where the trust provides that all its net income should be distributed to a single named individual, the trust's income beneficiaries should be treated as proportionately owning stock owned, or considered as owned, by the trust. Under these circumstances and for this purpose, remainder beneficiaries, whether vested or contingent, should not be taken into account.
>
> Our conclusion supports the purpose of subpart F, which is to avoid the deferral of certain classes of income earned by CFCs by requiring such amounts to be annually included in income by the United States shareholders thereof. Our conclusion also is generally consistent with PLR 8748043 (September 1, 1987), which dealt with the subpart F consequences of an interest in a Netherlands *usufruct* and * * * concluded that the *usufruct*uary should be considered as owning foreign corporate stock subject to a *usufruct* interest. The ruling specifically noted that the facts therein supported the conclusion that the *usufruct* was not an arrangement to decrease artificially a United States person's proportionate interest in the foreign corporation.

Consequently, a *usufruct* arrangement in which Ms. C holds bare legal title is unlikely to result in an inclusion of income generated by HoldCo and OpCo during the lifetime of Mr. P because she has no right to any income generated by those companies.

The foregoing conclusion may not prevent HoldCo or OpCo from being a C.F.C. for reporting purposes. Depending on the value of Ms. C's bare legal ownership, she may meet the reporting thresholds for filing Form 5471 *(Information Return of U.S. Persons With Respect To Certain Foreign Corporations*). If she is treated as owning more than 50% of the value of the shares in each foreign corporation, she would be a U.S. Shareholder and the two companies would be C.F.C.'s. Ms. C would have reporting obligations of a Category 4 filer with regard to Form 5471.

In addition to income tax filing, Ms. C may have an F.B.A.R. filing obligation for the financial accounts owned by each of HoldCo and OpCo. Under the F.B.A.R. regulations issued by the Financial Crimes Enforcement Network ("FinCEN"),[23] a bureau of the U.S. Treasury Department, each U.S. person having a financial interest in a bank, securities, or other financial account in a foreign country is required to report that financial interest to FinCEN when the aggregate value of all foreign financial accounts exceeds $10,000 at any time during the calendar year. Reporting is effected by filing FinCEN Form 114 *(Report of Foreign Bank and Financial Accounts (FBAR))*. A U.S. person has a financial interest in a foreign financial account where (i) the owner of record or the holder of legal title is a corporation and (ii) the U.S. person owns directly or indirectly more than 50% of the total value of the shares. If Ms. C. fits within this definition, she may be treated as a holder of a financial interest.

[23] 31 C.F.R. § 1010.350.

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C.T.B. ELECTIONS

Only foreign entities that are corporations are at risk of C.F.C. status. Removing corporate status eliminates C.F.C. status. While this results in the recognition of income by Ms. C on her share of the income and gains recognized by HoldCo and OpCo, two benefits will be realized. The first relates to the period during which Mr. remains alive. As long as income is viewed to be allocated to Mr. P and the allocation has substantial economic effect,[24] no income will be realized by Ms. C. The second benefit relates to the period after the conclusion of Mr. P's lifetime. All income and gains that are realized by Ms. C will have the same character in her hands as it would if she received the income directly. To the extent the income consists of qualified dividends and the gains are treated as long-term capital gains, the U.S. Federal income tax will be capped at 20%, plus N.I.I.T.

C.T.B. elections allow U.S. taxpayers to change the U.S. tax treatment of a foreign entity by filing Form 8832 *(Entity Classification Election)*. Checking the box to be a partnership or a disregarded entity means that HoldCo and OpCo will not become C.F.C.'s in the hands of Ms. C. The result is that Ms. C. will be treated as directly realizing HoldCo and OpCo's income when and as realized by those companies. Taxpayers can file C.T.B. elections by submitting Form 8832 to the I.R.S. The effective date of the election can be as early as 75 days before the date of filing the election. The election is made by registered mail addressed to the I.R.S. Service Center, Ogden, UT 84201-0023. If the I.R.S. does not confirm receipt of the election, the instructions advise contacting the I.R.S. Service center with the receipt for the earlier registered mailing.

Timing of C.T.B. Affects Gain Recognition

The timing of the election is important. When a corporation elects to be taxed as a flow-through entity, it is deemed to have been liquidated the day prior to the effective date of the election.[25] Its assets are considered distributed to its owner(s), who are deemed to contribute them back to a new flow-through entity.

This deemed liquidation results in gain recognition by the owners as of the day immediately preceding the date of the deemed liquidation.[26] In situations like Ms. C.'s, it is generally preferable to have the deemed liquidation take place during the lifetime of the foreign parent. The gain is recognized only for U.S. tax purposes and is taxable only to U.S. tax residents where, as here, all the assets are situated abroad. Having the gain flow through to Mr. P. while he is still the owner means there will be no tax owed on the deemed liquidation, as he is not a U.S. resident. Typically, foreign law will not recognize the liquidation, but that conclusion must be confirmed by competent foreign counsel.

In addition to the immediate potential income tax on any gain resulting from a C.T.B. election, U.S. tax counsel must consider the future U.S. estate tax exposure at the conclusion of Mr. P's lifetime. If Mr. P., OPCO, or HoldCo own U.S-situs assets such as shares in a U.S. corporation at the conclusion of Mr. P's lifetime, those U.S. assets will be will be subject to U.S. estate tax in the absence of an applicable estate

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[24] Code §704(b)(2). Treas. Reg. §1.704-1(b)(2).

[25] Treas. Reg. §301.7701-3(g)(1)(ii).

[26] Treas. Reg. §301.7701-3(g)(3)(i).

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tax treaty providind otherwise.[27] In determining the base against which U.S. estate tax is imposed, the value of U.S. situs assets can be reduced for a *pro rata* portion of global expenses, debts, and losses based on the portion of the total value of the worldwide estate that is situated in the U.S.[28] In addition, the executor must file a true and accurate U.S. estate tax return that lists all of the gross estate situated outside of the U.S.[29]

Ordinarily, the estate of a foreign individual is subject to estate tax at graduated rates imposed on U.S. situs assets in excess of $60,000. That exemption is provided by a credit of $13,000 against U.S. estate tax. The tax on the first $1.0 million of a taxable estate is $345,800. Thereafter, a flat 40% tax applies. In these circumstances, tax advisers typically recommend that U.S. assets should be held through a separate foreign corporation. This allows the basis in foreign assets held in a foreign corporation to be stepped up immediately before the date of death. The C.T.B. election for the second foreign corporation owning U.S. assets would be made shortly after the date of death. While the U.S. heir would recognize a *pro rata* amount of Subpart F income[30] or G.I.L.T.I. income arising from the check the box election, in most instances the income tax would be less than the estate tax. Where possible, U.S. situs investment assets should be of a kind that can be rolled over with regularity, thereby limiting the ultimate income tax for the U.S. heir.

However, the rules are somewhat different for Mr. P. Because he is a resident of France, the estate tax treaty between the U.S. and France[31] will apply to determine the U.S. estate tax exposure for Mr. P.'s estate. The Estate Tax Treaty provides two main benefits to the estate of a resident of France who owned U.S. situs assets at the conclusion of life.

- The scope of U.S. estate tax is limited to (i) real property in the U.S.,[32] (i) business property held through a permanent establishment or a fixed base for providing professional services in the U.S.,[33] and (iii) tangible movable property in the U.S.[34] All other property is exempt from U.S. estate tax except for French residents who are U.S. citizens or who have their domicile in the U.S.[35]
- The U.S. will allow a unified credit to the estate of a French decedent on a *pro rata* basis that looks to the portion of the value of the decedent's worldwide assets that that are situated in the U.S.[36]

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27 Code §2511.

28 Code §2106(a)(1).

29 Code §2106(b).

30 Code §951(a)(2)(A).

31 Convention Between the United States of America and the French Republic for the Avoidance of Double Taxation and the Prevention OF Fiscal Evasion With Respect to Taxes on Estates, Inheritances, and Gifts ("the Estate Tax Treaty"). It entered into force on October 1, 1980 and was amended by a protocol that entered into force on December 21, 2006..

32 Article 5 of the Estate Tax Treaty.

33 *Id.*, Article 6.

34 *Id.*, Article 7.

35 *Id.*, Article 8.

36 Paragraph (3)(a) of Article 12 of the Estate Tax Treaty

The unified credit is $12.92 million for 2023. The portion of that credit that will be allowed to the estate of Mr. P will be based on the value of U.S. situs assets owned or deemed owned by Mr. P directly or through HoldCo or OpCo once a C.T.B. election is made. Note that while the unified credit increases annually with inflation, it is scheduled to be reduced to an amount that eliminates the tax on $5.0 million in 2026.

Effect of a C-T-B Election on U.S. Heir

Checking the box to treat HoldCo and Opco as flow-through entities can cause substantial changes in the taxation of Ms. C. One key difference is that income is to be taxed as if it flows directly to the owner instead of to a company that is a C.F.C. Both the G.I.L.T.I. and Subpart F provisions result in ordinary income for Ms. C when and as she recognizes income. However, if the income of HoldCo and OpCo arise from qualified dividends or long-term capital gains, the tax rate in the U.S. at the Federal level will be capped at 20%, plus 3.8% N.I.I.T.

In addition, French and Dutch taxes paid by the two companies should be available as a foreign tax credit that reduces U.S. income tax. For an individual, foreign income taxes paid by a foreign corporation reduce earnings, but they cannot be claimed as credits.

CODE §962 ELECTIONS

C.T.B. elections are not the only tax planning alternative in the context of a C.F.C. U.S. tax law provides that an individual who is a U.S. Shareholder with regard to a C.F.C. can make an election to be taxed as a corporation for purposes of computing tax under Subpart F and G.I.L.T.I.[37] This is commonly known as a Code §962 election. There are three main consequences to making the election: (i) G.I.L.T.I. is taxed at a lower tax rate, (ii) an indirect foreign tax credit becomes available, and (iii) actual distributions to the U.S. Shareholder become taxable.

"... French and Dutch taxes paid by the two companies should be available as a foreign tax credit that reduces U.S. income tax."

Foreign Tax Credit Computation Under G.I.L.T.I.

As a deemed corporate taxpayer under Code §962, Ms. C. pays the corporate rate of 21% on her G.I.L.T.I. inclusion resulting from OpCo's income and is entitled to a 50% deduction,[38] effectively cutting her G.I.L.T.I. rate in half to 10.5%. This is preferable to the top graduated rate for an individual, currently set at 37%. When a C.F.C. owned by an individual retains its earnings for use in the business, the rate reduction has a material benefit arising from the lower effective tax rate that is due without the receipt of funds from the C.F.C.

The benefit is enhanced if OpCo pays Dutch tax on its earnings under the indirect foreign tax credit provisions of Subpart F[39] and G.I.L.T.I.[40]

Corporations that are U.S. Shareholders of a C.F.C. may claim an indirect foreign tax credit for foreign taxes paid by that C.F.C. The credit may reduce or eliminate Ms. C.'s U.S. tax under both provision. However, the foreign tax credit benefit in

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37 Code §962.

38 Code §250.

39 Code §960(a).

40 Code §960(d).

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the context of G.I.L.T.I. limited. A corporation that is a U.S. Shareholder can claim a foreign tax credit only for 80% of foreign income taxes paid by a C.F.C. on its tested income.[41] As with indirect foreign tax credits under Subpart F, the amount claimed as a foreign tax credit must be grossed-up when computing the G.I.L.T.I. inclusion.[42] The increased amount then increases the benefit of the 50% deduction discussed above.

When computing the foreign tax credit limitation, a special basket is provided for G.I.L.T.I. inclusions and the foreign income taxes on those inclusions. Unused foreign tax credits cannot be carried to another year. If not used in the year they arise, they are lost. In comparison, the direct foreign tax credit that is available once a C.T.B. election can be carried back and forward as provided under the rules of Code §904 – one year back and 10 years forward.[43]

Tax Treatment Upon Receipt of Dividends

A Code §962 election enabling Ms. C to compute tax as a corporation alters the way in which actual distributions are taxed. The dividend from OpCo to HoldCo continues to be treated as P.T.I. if the underlying earnings of OpCo were taxed previously in the hands of Ms. C under Subpart F or G.I.L.T.I. The rules change when a dividend form HoldCo is received by Ms. C. The Code §962 election denies full P.T.I. treatment for the distribution.[44] The portion of the dividend that is treated as P.T.I. is limited to the U.S. income tax that was previously paid on Subpart F income or tested income under G.I.L.T.I. While the actual dividend remains foreign source income received from a foreign corporation – which may or may not be a qualified dividend depending on the ability of the foreign corporation to obtain benefits under an income tax treaty – the amount that is taxable reduced, more or less as if the dividend flowed through a U.S. holding company that paid U.S. tax (reduced by allowable foreign tax credits), after which it distributed a dividend to its shareholder.

CONCLUSION

There is no one solution for all taxpayers. A taxpayer seeking a more precise answer must evaluate the paths in order to identify the path that results in the most attractive after-tax position, with the best likelihood of success, at the most reasonable cost to operate.

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[41] Code §960(d)(1).

[42] Code §78.

[43] Code §904(c).

[44] Treas. Reg. §1.962-3(a).

LOST IN TRANSLATION: TREATMENT OF FOREIGN-LAW DEMERGERS UNDER U.S. FEDERAL TAX LAW

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Tags
C.F.C.
Demerger
Distribution
Division
G.I.L.T.I.
Redemption
Section 355
Spin-off
Split-off
Split-up
Subpart F

INTRODUCTION

At a certain point in the life of a corporation that operates more than one business, management may wish to separate the different businesses into two or more separate corporate entities. Reasons may vary, but they often include resolving operating conflicts, creating a locally based more-effective style of management, improving borrowing capacity, complying with regulatory restrictions, and reducing exposure to liability.

The corporate division can take many forms.[1] In most cases, demergers are structured based on the requirements of the corporate law in the country of the demerged corporation. Typically, a demerger that follows the corporate law provisions would also be exempt from tax in the relevant country.

If any of the shareholders is a U.S. individual or corporation, U.S. Federal tax considerations should be taken into account to prevent unexpected U.S. tax for a U.S. investor.

DEMERGERS UNDER U.S. FEDERAL TAX LAW - OVERVIEW

Under the Code,[2] a corporation must recognize gain on the disposition of appreciated property,[3] whether such disposition is made by way of a sale,[4] a distribution[5] or otherwise, including a constructive disposition.

However, if certain conditions are met under Code §355,[6] a corporation may distribute shares of stock in a subsidiary corporation to shareholders as part of a demerger

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1. See, for example, the Directive (E.U.) 2019/2121 of the European parliament and of the council of 27 November 2019 (came into force on January 31, 2023), that allows for a complete demerger, a partial demerger, and a demerger by separation. The E.U. Directive harmonizes the legal framework for cross-border conversions, mergers, and demergers of E.U. companies.
2. The Internal Revenue Code of 1986, as amended.
3. Appreciated property is property the fair market value of which exceeds its adjusted basis in the hand of the corporation.
4. Code §§61(a) and 1001(a).
5. Code §§301, 311, and 317.
6. A discussion on the requirements of Code §355 and the regulations promulgated thereunder is beyond the scope of this article.

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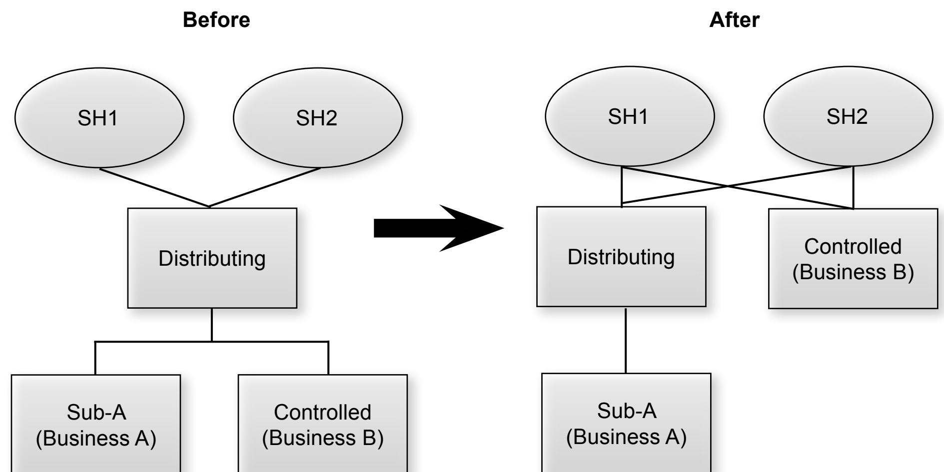
without having to recognize gain or loss. Where applicable, Code §355 eliminates U.S. tax for both the corporation and its shareholders.[7]

Code §355 may apply regardless of the way in which the demerger is structured, provided all its requirements are met. Typically, a demerger would be structured either as a spin-off, a split-off or a split-up.

A spin-off is the generic label of a transaction that results in all shareholders of the demerging corporation (will be referred to as "Distributing") receiving stock in a demerged corporation (will be referred to as "Controlled").[8]



A spin-off can be structured as a distribution of Controlled by Distributing to Distributing's shareholders. However, even if structured differently, in substance, the shareholders receive a distribution in kind from Distributing, comprised of the stock of Controlled. Based on the principles of the "substance over form" doctrine, a spin-off transaction is typically characterized under U.S. Federal tax law as a distribution of the Controlled stock from Distributing to Distributing's shareholders.

A split-off is the generic label for a transaction that results in some of the shareholders relinquishing their Distributing stock and receiving controlled stock, while the other shareholders keep their original Distributing shares. The ownership percentage in Distributing increases for the remaining shareholders.

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7 However, gain will be recognized on the distribution of any property other than stock and securities of the controlled corporation that qualify under Code §355. See, Code §355(a)(3) and (4).

8 Usually, such distribution would be made on a *pro-rata* basis. In rare circumstances a spin-off can be non *pro-rata*, see P.L.R 8825058; Ginsburg, Levin and Rocap, *Mergers, Acquisitions and Buyouts*, at 1001.1.

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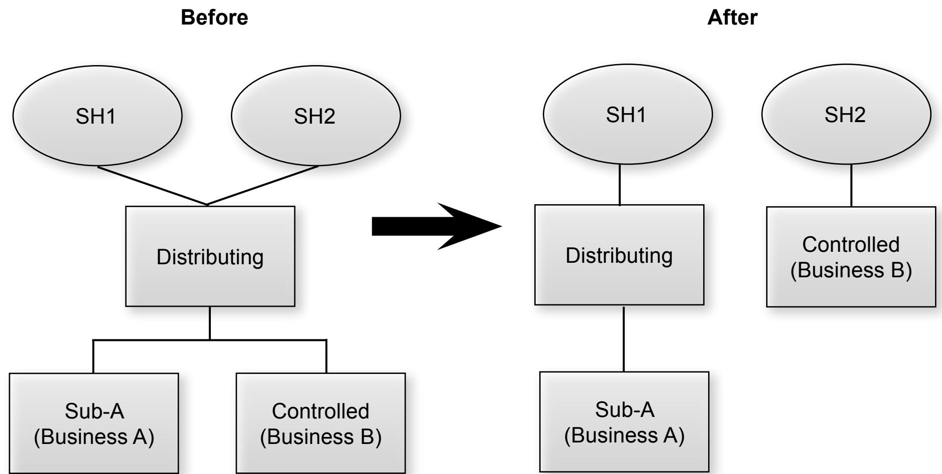
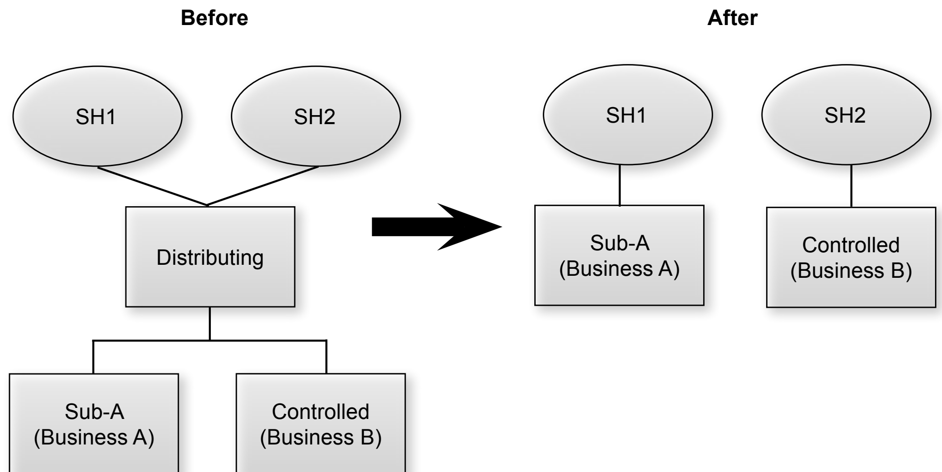


In the split-off scenario, Distributing's exchanges Controlled stock in return for its own stock from some of its Shareholders. This type of transaction is effectively a redemption of the Distributing shares by shareholder 2.[9]

A split-up is the generic label of a transaction that results in Distributing being split into two new corporations and going out of existence.



A split-up scenario is economically equivalent to the liquidation of Distributing.

TAX CONSEQUENCES OF A BAD DEMERGER – THE STRUCTURE MATTERS

As mentioned above, whether the demerger is structured as a spin-off, a split-off or a split-up, no gain is expected to be recognized by the demerged corporation or its shareholders if the requirements of Code §355 are met.

9 Code §317(b).

“In a bad spin-off, which is usually characterized as a distribution, dividend income will generally be recognized by the shareholders receiving the distribution, to the extent of the distributing corporation’s earnings and profits.”

However, to the extent that the requirements of Code §355 are not met (referred to as a “bad” transaction), the characterization of the transaction either as (1) a distribution of property in the case of a spin-off, or (2) a redemption of stock in the case of a split-off, or (3) a liquidation of the demerged corporation in the case of a split-up makes a great difference, because each type of transaction entails different tax implications.

In a bad spin-off, which is usually characterized as a distribution, dividend income will generally be recognized by the shareholders receiving the distribution, to the extent of the distributing corporation’s earnings and profits.[10] Any distribution amount exceeding the earnings and profits, if any, will be treated as a return of basis to the extent of the adjusted basis in the corporation’s shares,[11] with any remaining amount treated as a capital gain.[12] In addition, the distributing corporation will be required to recognize gain on the distribution of appreciated property as if such property were sold.[13] The amount of gain will be equal to the excess of the fair market value of the appreciated property over its adjusted basis.[14] This recognition of gain by the corporation will increase the corporation’s earnings and profits, thereby increasing dividend treatment for the shareholder.

In a bad split-off, which is typically characterized as a redemption, further analysis will be required to determine whether the redemption (i) is essentially equivalent to a dividend or rather (ii) should be treated as a sale of stock.[15] If the redemption is treated as a dividend, the above consequences will apply. If the redemption is characterized as a sale or exchange, the participating shareholders will be treated as if they sold the redeemed shares and will recognize gain or loss on such deemed sale. The demerged corporation will be treated as if it distributed property to the redeeming shareholder in exchange for the shares redeemed.[16] To the extent the property distributed was appreciated property, the corporation will be required to recognize gain equal to the excess of the fair market value of the appreciated property over its adjusted basis.

Lastly, in a bad split-up which is typically structured as a liquidation, the liquidating corporation will be treated as selling its property in exchange for its stock.[17] The liquidating corporation is generally required to recognize gain on the deemed sale of any appreciated property and the shareholders are required to recognize gain on the deemed sale of their stock in the liquidating corporation. An exception may apply if more than 80% of the shares in the liquidating corporation are owned by another corporation.[18]

While gain is expected to be recognized in each of the above scenarios, significantly different tax consequences are expected when it comes to a demerger of a foreign

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[10] Code §301(c)(1).

[11] Code §301(c)(2).

[12] Code §301(c)(3).

[13] Code §311(b).

[14] Code §1001(a).

[15] Code §302.

[16] Code §302(a).

[17] Code §331.

[18] Code §332.

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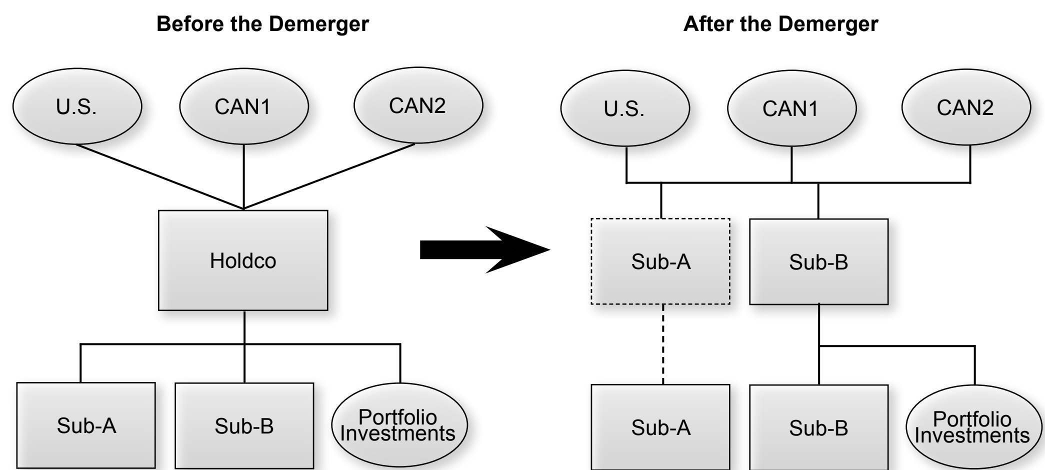
corporation in which one or more of its shareholders is a U.S. individual or corporation. We will illustrate some of these differences in the two examples that follow.

EXAMPLE A – U.S. TAX IMPLICATIONS OF A BAD SPIN-OFF OF A FOREIGN CORPORATION

Assume a Canadian holding company ("Holdco") owned by three shareholders in equal shares. Holdco operates two different lines of business, "A" and "B, through two Canadian subsidiaries, Sub-A and Sub-B, respectively. In addition, Holdco owns some portfolio investments. Two of the shareholders of Holdco are Canadian residents and the other is a U.S. resident ("U.S. Resident"). The shareholders decide to demerge Holdco by transferring Sub-A to a separate newly formed corporation ("Newco") by way of a tax-free "Butterfly Transaction"[19] under Canadian law.[20]



The Butterfly Transaction does not involve any actual distribution of stock. Instead, property (here, the Sub-A stock) is transferred by Holdco to Newco in exchange for Newco shares.[21] Nevertheless, the economic substance of the above Butterfly Transaction seems to be equivalent to a distribution of the Sub-A stock by Holdco to its shareholders, followed by a contribution of the Sub-A stock to Newco. The I.R.S. ruled on several occasions that a Butterfly Transaction may be treated as a distribution

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19 Several anti-abuse rules apply in Canada to prevent tax free treatment for a Butterfly in the context of identified aggressive tax planning. Whether the transaction described in the text qualifies as a good butterfly requires advice of competent Canadian tax counsel. In the diagram, it is assumed that the anti-abuse rules under Canadian tax law are not applicable to the facts.

20 The transaction gets its name because all assets must be divided evenly, subject to slight variations. When diagrammed, the split resembles the image of a butterfly image.

21 The steps constituting a "Butterfly Transaction" generally include the following: (1) Newco is formed by the shareholders, (2) the shareholders contribute Holdco stock to Newco, (3) Holdco transfers the subject property to Newco in exchange for Newco shares, and (4) the shares owned by each corporation are redeemed.

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followed by a contribution, and further confirmed that the Butterfly Transaction may qualify as a "good spin-off" provided all the requirements under Code §355 are met.[22]

In light of previous letter rulings, it is expected that the demerger in the example above will be characterized as a distribution, followed by a contribution, for U.S. federal tax purposes. However, the demerger might not meet all the stringent requirements of Code §355. In that case, the demerger will be treated as a taxable distribution of Sub-A stock by Holdco to Holdco's shareholders, followed by contribution of the Sub-A stock by the shareholders to Newco.[23]

If the demerger is a bad spinoff, U.S. Resident is expected to recognize dividend income. The amount of income to be included is equal to the fair market value of the Sub-A shares that U.S. Resident deemed received.[24] In addition, U.S. Resident will be treated as if he or she contributed shares in Sub-A to Newco. While such contribution is generally expected to be subject to non-recognition under Code §351, U.S. Resident will be required to enter a gain recognition agreement with the IR.S. under Code §367(a) if he or she owns 5% or more of Newco and wishes to defer gain recognition.[25]

The Canadian shareholders are non-U.S. citizens and non-U.S. residents. Therefore, they are not subject to tax in the U.S. Federal tax on their deemed dividend income.[26]

Holdco is a foreign corporation and, as such, capital gain derived by it is generally not subject to U.S. Federal tax.[27] Therefore, even though Holdco is viewed as if it recognized gain on the distribution, no tax liability is expected for it under U.S. Federal income tax law.

EXAMPLE B – U.S. TAX IMPLICATIONS OF A BAD SPLIT-OFF OF A FOREIGN CORPORATION

Assume the same set of facts as in example A, above. However, in this case, the shareholders decide to split the ownership in Holdco so that each shareholder owns

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22 See, for example, P.L.R. 200505009 and P.L.R. 200212012.

23 We analyzed this transaction as a distribution of the Sub-A stock followed by the contribution of the Sub-A stock to Newco, based on the above-mentioned private letter rulings. However, an alternative approach would suggest that the transaction should be viewed as if Holdco contributed the Sub-A stock to a new company formed by Holdco, followed by a distribution of the new company shares to Holdco's shareholders. See, I.R.S. Rev. Rul. 77-191.

24 A dividend-received deduction might have been allowed to essentially offset the dividend income, if U.S. Resident owned the Holdco stock indirectly through a U.S. corporation, provided the requirements under Code §245A were met.

25 Treas. Reg. §1.367(a)-3(b)(1).

26 Nonresident aliens are only taxable in the U.S. on dividend income if the dividend is from sources within the U.S. Code §871(a)(1)(A). Dividend income arises from U.S. sources if it is distributed by a U.S. corporation. Dividends from a foreign corporation may also be U.S. source in certain circumstances specified in the Code. See, Code §861(a)(2). However, no income or withholding tax is due if the foreign corporation is subject to branch profits tax. See Code §84(e)(3)(A).

27 Code §882(b).

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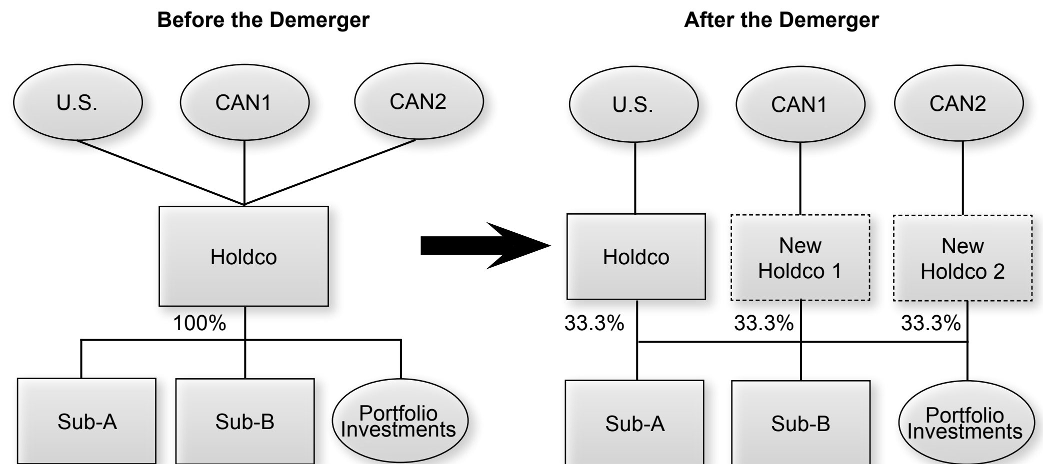
Holdco's assets through its own holding company. A new holding company is formed by each of the Canadian shareholders and one-third of each of Holdco's assets is transferred to each new holding company.



If the demerger does not meet the requirements of Code §355, the demerger is expected to be treated as a redemption of the Holdco stock by the Canadian shareholders. Since the redemption in this case is not substantially equivalent to a dividend,[28] it is expected to be treated as a distribution of property by Holdco in exchange for the Canadian shareholders' Holdco stock under code §302(a).

In comparison to Example A, in this case U.S. Resident receives no dividend income, either directly or indirectly.[29]

The Canadian shareholders are viewed as if they sold their Holdco Stock but, since they are neither U.S. citizens nor U.S. residents, they are not taxable under U.S. Federal tax law on capital gains.[30]

Similarly, Holdco is treated as if it distributed 66.67% of its assets to the new holding companies. Under Code §311(b), gain must be recognized by Holdco as if it sold the assets for fair market value. However, as mentioned, Holdco is also not subject to U.S. Federal tax.

Although it seems as if none of the parties to the transaction incurred any U.S. Federal tax liability on the demerger, this is actually not the case for U.S. Resident.

Pursuant to the demerger, Holdco will become a Controlled Foreign Corporation ("C.F.C.") and U.S. Resident is expected to become a "U.S. Shareholder" of the C.F.C. In a nutshell, a C.F.C. is any foreign corporation in which shares representing more than 50% of the voting power of all shares or more than 50% of the value

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[28] A complete termination of the shareholders' interest in the corporation is not essentially equivalent to a dividend. See Code §§ 302(a) & (b)(3).

[29] U.S. Resident did not receive any actual distribution. In addition, U.S. Resident did not receive any constructive dividend. Economically, he or she indirectly owned 33.3% of Holdco's assets both before and after the demerger.

[30] Code §872(a).

of all shares are owned by five or fewer U.S. Shareholders. A U.S. Shareholder is defined in Code §951(b) as a U.S. person[31] who owns or who is considered as owning shares representing 10% or more of the total voting power of all shares of the corporation or 10% or more of the value of all shares of the corporation.

U.S. Resident owns 10% or more of all the shares of Holdco, ranging from 33.33% to 100% during the year. Pursuant to the demerger in Example B, U.S. Resident becomes the owner of 100% of Holdco stock. Consequently, Holdco is expected to meet the definition of a C.F.C. under Code §957 immediately following the demerger.

"Gain from sale of stock and other passive assets is generally treated as Subpart F Income."

As a U.S. Shareholder who owns shares of a C.F.C., U.S. Resident will be taxable on his or her share of Holdco's income that is "Subpart F Income" as defined in Code §952 ("Subpart F Income"). U.S. Resident will also be required to include in gross income some or all of the tested tax income under the G.I.L.T.I. regime as provided in Code §951A(b).

This change in Holdco's status when it becomes a C.F.C., is expected to result in U.S. Resident being subject to tax on the demerger. Although U.S. Resident does not become a U.S. shareholder in a C.F.C. until after the demerger is completed,[32] tax liability under the C.F.C. regime extends to any Subpart F Income and tested income under G.I.L.T.I. income that Holdco earns from the beginning of its taxable year,[33] including income earned before or on the demerger. For that purpose, the taxable income of the C.F.C. is determined based on U.S. Federal tax principles.[34]

As mentioned above, U.S. tax law provides that Holdco must recognize all gain realized on the demerger.[35] Gain from sale of stock and other passive assets is generally treated as Subpart F Income.[36] Therefore, Holdco is expected to incur Subpart-F Income as a result of the demerger.

At the end of the taxable year, U.S. Resident will be required to include in taxable income his or her *pro-rata* share of Holdco's Subpart-F Income for the entire year. The *pro rata* share of the Subpart F Income will be reduced to reflect only the portion of the year during which Holdco was a C.F.C.[37] For example, if Holdco is a

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[31] A "United States person" is defined in Code §957(c) which further refers to Code §7701(a)(30) with certain modifications. With respect to individuals, a "United States Person" means a U.S. citizen or resident. See Code §7701(b) for the definition of a U.S. resident.

[32] See, Treas. Reg. §1.951-1(f), which provides that for purposes of Code §§951 through 964, the holding period of an asset (including stock of a C.F.C.) is determined by excluding the day on which such asset is acquired and including the day on which such asset is disposed of.

[33] Pursuant to Code §951(a), any U.S. Shareholder who owns stock in a C.F.C. on the last day of the taxable year in which the corporation is a C.F.C. must include in that year's gross income his or her *pro-rata* share of the C.F.C.'s Subpart-F income.

[34] Code §964(a) and Treas. Reg. §1.952-2(a)(1).

[35] The amount of such gain is expected to be the excess of the fair market value of the deemed distributed property over Holdco's adjusted basis in such property.

[36] Code §954 provides that net gains from the sale of shares of stock of a corporation are considered to be Foreign Personal Holding Company Income, a subcategory of Subpart F Income.

[37] Treas. Reg. §1.951-1.

calendar-year taxpayer, the amount of deemed gain recognized by Holdco is $1M, and the demerger is effectuated on June 30th, U.S. Resident's *pro-rata* share of Holdco's Subpart F income is expected to be $500K. U.S. Resident would have to include the $500K in his or her taxable year for the fiscal year.

It follows that, although not apparent at the outset, U.S. Resident will end up paying U.S. Federal taxes on Holdco's deemed gain pursuant to the demerger in Example-B.[38]

CONCLUSION

Regardless of how a demerger is structured, any disposition of appreciated property by the demerged corporation is treated as a taxable transaction under U.S. Federal tax law, unless the demerger meets the requirements of §355 of the Code.

Even where the demerged corporation is a non-U.S. corporation and it has only non-U.S. operations, a shareholder who is a U.S. citizen or a U.S. resident might end up being subject to U.S. Federal tax in certain circumstances.

Therefore, in structuring a demerger of a non-U.S. corporation with at least one U.S. shareholder, U.S. Federal tax considerations must be taken into account and careful consideration should be given to every step of the plan. Those who fail to consider the Code §355 rules thinking they are passive participants in a demerger do so at their peril.

[38] For a deep dive into the computation of amounts included in income by a U.S. Shareholder acquiring or disposing of shares in a C.F.C., see Stanley C. Ruchelman and Neha Rastogi, "Peeling the Onion to Allocate Subpart F Income – This Will Make You Cry," *Insights* Vol. 6 No. 5 (May 2019).

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ALL EYES ON THE I.C.-D.I.S.C. PART ONE: THE EXPORT GIFT THAT KEEPS ON GIVING

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Tags
Export Receivables
I.C.-D.I.S.C.
International Sales
Producer's Loans
Roth I.R.A.

INTRODUCTION

Regardless of their political affiliations, presidential administrations and members of Congress share the goal of maintaining U.S. competitiveness on the global market. We often hear statements directed toward strengthening the U.S. manufacturing sector and bringing production activity back to the U.S. These words would be futile without implementing initiatives favoring U.S. business interests.

Providing tax incentives is one mechanism in which the government can act upon these objectives.[1] Well-known examples include:

- **The F.D.I.I. Deduction:** Corporations may claim deductions under the Foreign Derived Intangible Income rules of §250 of the Internal Revenue Code of 1986 as currently in effect (the "Code"). F.D.I.I. derived by a U.S. corporation is eligible for a deduction of 37.5% for tax years beginning before 2026 and 21.875% thereafter. At the U.S. corporate income tax rate of 21%, the deductions have the effect of reducing the tax rate on F.D.I.I. to 13.125% for tax years beginning before 2026 and 16.406% for tax years beginning after 2025.
- **The Q.B.I. Deduction:** For partnerships and L.L.C.'s owned by individuals, the Qualified Business Income ("Q.B.I.") deduction of Code §199A provides a deduction for partners and members of partnership or L.L.C. employing many employees or having significant investment in capital assets.[2] For partners or members of L.L.C.'s that do not fit the profile, caps are place on the benefit.

An often-overlooked incentive is the Interest Charge Domestic International Sales Corporation ("I.C.-D.I.S.C.") regime, a long-lived descendent of the (i) the original Domestic International Sales Corporation ("D.I.S.C.) regime, in effect between 1972

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[1] The extent to which a tax incentive to promote exports may violate trade agreements is beyond the scope of this article. For articles on illegal tax subsidiaries see Beate Erwin and Christine Long, "E.U. State Aid – the Saga Continues," *Insights* Vol. 3 No. 6 (June 2016); Beate Erwin and Kenneth Lobo, "Treasury Attacks European Commission on State Aid – What Next?," *Insights* Vol 3 No. 8 (September 2016); and Fanny Karaman, Stanley C. Ruchelman and Astrid Champion, "European State Aid and W.T.O. Subsidies," *Insights* Vol. 3 No. 9 (October 2016). For the dispute between European jurisdictions and the U.S. over the D.I.S.C. rules, see Block, 6360 T.M., *Export Tax Incentives*, Section I, Prior Export Tax Incentives Under the Code.

[2] See Fanny Karaman and Nina Krauthamer, "The Devil in the Detail: Choosing a U.S. Business structure Post-Tax Reform," *Insights* Vol 6 No. 6 (June 2019) and Fanny Karaman and Nina Krauthamer, "Qualified Business Income – are You Eligible for a 20% Deduction?," *Insights* Vol. 5 No. 2 (October 2018).

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and 1984, (ii) the Foreign Sales Corporations ("F.S.C."),[3] in effect between 1985 and 2000, a successor of the D.I.S.C., (iii) the Extraterritorial Income ("E.T.I.") regime was adopted in 2000 and remained in effect until its repeal in 2004, which provided an exclusion for the portion of gross income consisting of extraterritorial income. The common thread of all the foregoing predecessors of the was their complexity. The lone exception was the I.C.-D.I.S.C., an attractive tax planning tool for smaller companies without fully staffed tax departments. For privately held companies operating as an L.L.C. treated as a pass-through entity, the goal is not the deferral of tax over an indefinite period of time. Rather, the benefit is an immediate and permanent tax rate reduction.

This article is the first of a two-part series. Part I highlights the technical aspects of the I.C.-D.I.S.C. and how certain taxpayers can benefit when structuring export activities. Part II will identify issues that frequently arise during I.R.S. examinations.

HISTORICAL CONTEXT

As originally enacted in 1971, a D.I.S.C. was simply a domestic corporation that made an election to be treated as a D.I.S.C. If it met all the requirements under the law, the D.I.S.C. was exempt from U.S. corporate income tax. Its function, which could take place "only on paper" accompanied by journal entries, was to serve as a buy-sell distributor or a commission sales agent. Either way, the U.S. exporter reduced its income, while the D.I.S.C. paid no U.S. tax as its paper profits grew.

At that point, the goal of the U.S. exporter was to access the proceeds of profits building up in the D.I.S.C. in order to use the cash in the export business, without triggering a loss of deferral. Methods were available – the D.I.S.C. could finance export promotion expenses, purchase export receivables from the related exporter, or make a producer's loan to finance the production of export property. Each method had its own set of rules designed to provide the appearance of substance, when none existed but for the paperwork. More importantly, as profits remained in the D.I.S.C. and sales remained relatively flat, it became harder to utilize the resulting proceeds in ways that met rules established by the I.R.S. Failing to meet those rules resulted in loss of D.I.S.C. status and recapture of the D.I.S.C. deferred tax over a period of time.

In 1985 when the F.S.C. regime was adopted in lieu of the D.I.S.C. regime, one limited category of D.I.S.C.'s was allowed to continue in existence. Under the 1985 regime, Small D.I.S.C.'s that agreed to pay an interest charge on the amount of tax deferred were allowed to continue on in the form of an I.C.-D.I.S.C. To be categorized as a Small D.I.S.C., the amount of D.I.S.C. profits that could be deferred was capped at $10 million. D.I.S.C. export profits exceeding that amount were deemed to be distributed immediately and were not eligible for deferral. The interest charge on deferred profits was imposed at a rate that was announced annually by the I.R.S.

As explained in the next portion of this article, deferral of tax is not the goal of the L.L.C. exporting from the U.S. The benefit is the permanent rate reduction for the portion of export profits allocated to the I.C.-D.I.S.C. under a special set of transfer pricing rules.

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[3] Code §922 through 927 in effect between 1984 and 2000).

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TAX BENEFIT OF AN I.C.-D.I.S.C.

The export commission payment paid by the U.S. exporter or the amount by which its export sales margin is reduced by the sale to the I.C.-D.I.S.C. generates an immediate and permanent tax saving for the partners or members of the business. To illustrate, the maximum tax rate for ordinary income realized by individuals is 37%. In addition, self employed individuals must pay 12.4% self-employment tax on self-employment income up to a ceiling that increases each year with inflation. In 2023, the ceiling is $160,200 of self-employment income. Finally, self-employed individuals must pay a 2.9% Medicare tax. Because there is no cap on the tax base for the Medicare tax, the maximum effective tax rate for the partners or members of the business is 39.9%, disregarding self-employment tax.

“The amount of net profits generated by the I.C.-D.I.S.C. under special transfer pricing rules applicable to I.C.-D.I.S.C.’s and exporting companies are not subject to tax at the I.C.-D.I.S.C. level.”

The amount of net profits generated by the I.C.-D.I.S.C. under special transfer pricing rules applicable to I.C.-D.I.S.C.’s and exporting companies are not subject to tax at the I.C.-D.I.S.C. level. When the I.C.-D.I.S.C. distributes its net profits to the shareholder group – here comprised of members of the related business – the shareholder will be treated as having received a qualified dividend taxed at a maximum rate of 20%. To that tax, a 3.8% add-on for net investment income tax (“N.I.I.T.”) likely will apply. Assuming that each partner or member generates self-employment income from the business and disregarding the 12.4% self-employment tax on the first $160,200, each dollar of export commission paid to the I.C.-D.I.S.C. or margin on exports allocated to the I.C.-D.I.S.C. is taxed at the lower combined rate of 23.8% rather than 39.9%. This creates a net effective tax reduction of 16.1 percentage points, yielding a 40% reduction of Federal income tax. For most entrepreneurs, a 40% tax reduction for doing nothing would seem to be more attractive than a deferral opportunity that is constantly subject to risk of early recapture.

TECHNICAL ASPECTS OF THE I.C.-D.I.S.C.

The technical details of operating an I.C.-D.I.S.C. are as follows. As mentioned above, they must be meticulously followed in order for the members of an L.L.C. operating an export business to benefit from the tax rate reduction.

Requirements

An entity must meet the following conditions to qualify as an I.C.-D.I.S.C.:

- It must incorporated under the law of one of the states of the United States. [4]
- At least 95% of the gross receipts during the taxable year must qualify as export receipts.[5]
  - Qualified export receipts consist primarily of revenues from the sale of export property.[6]
  - Export property must be property produced in the U.S. by a person other than the I.C.-D.I.S.C. for sale outside the U.S.

[4] Code §992(a)(1).

[5] Code §992(a)(1)(A).

[6] Code §993(a)(1).

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- Not more than 50% of the value of the property may be attributed to articles imported into the U.S.[7]
- Export property does not include intellectual property or property leased to another member of a control group in which it belongs. [8]

- At least 95% of the total adjusted bases maintained by the I.C.-D.I.S.C. in its assets at the close of the taxable year must consist of qualified export assets. Qualified export assets generally include
  - export property,
  - assets used in connection with the sale of export property,
  - accounts receivable from sale of export property,
  - working capital,
  - producer's loans, and
  - other related assets.[9]
- It must have only one class of shares, with a stated value of at least $2,500 on each day during the taxable year.[10]
- It must make an effective election to be treated as a D.I.S.C.[11]
  - An election shall be made during the 90-day period before the beginning of the tax year with the consent of all shareholders.[12]
  - If the entity fails to make a timely election, it can request an extension to file with the I.R.S. by demonstrating it acted reasonably and in good faith, and the grant of relief will not prejudice the government's interest. [13]

Failure of an entity to qualify as an I.C.-D.I.S.C. will subject the commission payment to double tax: a corporate tax when received by the I.C.-D.I.S.C. and second level of tax when distributed.

The I.C.-D.I.S.C. is not required to follow the arm's length principle under Code §482.[14] If Code §482 were applicable, all profits of the I.C.-D.I.S.C. would be reallocated to the exporting company.

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[7] Code §993(c)(1).

[8] Code §993(c)(2).

[9] Code §993(b).

[10] Code §992(a)(1)(C).

[11] Code §992(a)(1)(D).

[12] Code §992(b)(1).

[13] Treas. Reg. §301.9100-3(a).

[14] Code §994(a).

The I.C.-D.I.S.C. does not need employees, equipment, or office space. It need not engage in any specific activity. In reality, the company is not fixed in reality. It exists merely on paper. And yes, the Code permits this.

Structuring

Any type of entity or individual may hold ownership interests in an I.C.-D.I.S.C. A pass-through entity such as an L.L.C., may hold the ownership interest in an I.C.-D.I.S.C., which is a domestic corporation for which an election is made. The shareholders of the I.C.-D.I.S.C. may be the exporting company or L.L.C. or the exporter's owners. If the I.C.-D.I.S.C. has many individual owners, ownership interests could be held in a partnership or second L.L.C.

Classifications of I.C.-D.I.S.C.'s

There are two types of I.C.-D.I.S.C.'s – a buy-sell I.C.-D.I.S.C. and a commission I.C.-D.I.S.C. A buy-sell I.C.-D.I.S.C. purchases export property from the exporting company and is required to take title. It then serves as principal in a sale or lease of the export property to customers outside the U.S.

A commission I.C.-D.I.S.C. is used more frequently since it can achieve the same tax benefits without taking title to the property and without being involved in the sale to customers overseas. The I.C.-D.I.S.C. is treated as an agent even though the exporting company conducts all the activity of selling the products outside of the U.S., acting pursuant to an agency agreement that must be in place and honored by the exporting company and the I.C.-D.I.S.C. The exporting company pays the I.C.-D.I.S.C. a commission as compensation for its services. Again, arm's length transfer pricing rules are not applicable if certain statutory transfer pricing rules are elected. This is discussed below.

The I.C.-D.I.S.C. then distributes the cash to its owners. If the exporting company requires cash and is the owner of the I.C.-D.I.S.C., the distribution will be paid directly to the company. If the I.C.-D.I.S.C. is owned by the same persons that own the exporting company, the distribution will be paid to them after which the proceeds will be contributed to the company. The latter ownership works better if each member in the ownership group owns both companies in the same percentage.

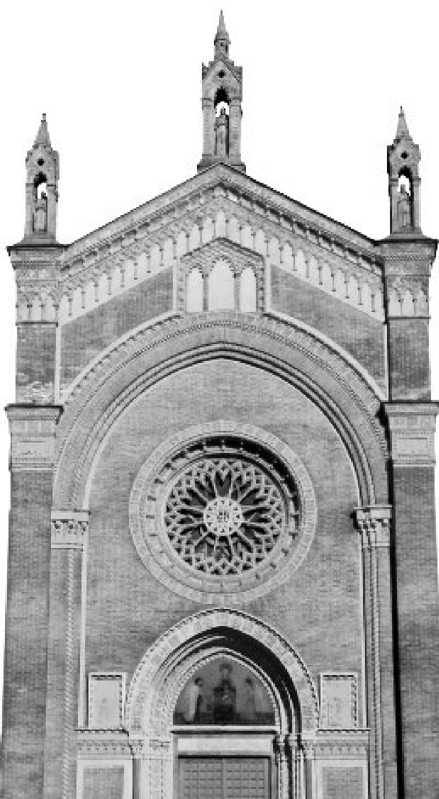
Since the commission I.C.-D.I.S.C. is most commonly used, the following section analyzes the effects of using such structure.

Operation and Tax Effects of a Commission I.C.-D.I.S.C.

Commission Payment

The exporting company pays a commission to the I.C.-D.I.S.C. based on foreign sales of export property. The deduction is disallowed to the extent it causes the export company to report a loss for the taxable year.[15] Hence, the commission agreement should contain a no-loss cap on commission payments.

The commission is computed using one of three methods:



[15] Code §1.994-1(e)(1).

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- The 4% of export gross receipts method
- The 50% of combined taxable income
- The arm's length taxable income method determined under Code§482, which is almost never used[16]

The method can be selected on a transaction-by-transaction basis.[17] In general, a taxpayer selects the method which produces the highest commission on a given transaction, thereby generating the highest tax benefit. Of the three methods available, the 4% of export gross profits method is the easiest to compute and the 50% method is used for exports of higher net margin items.

Under the 4% method, the commission is 4% of the qualified export receipts plus 10% of the export promotion expenses ("E.P.E.") attributable to such receipts.[18] E.P.E. are expenses incurred to advance the sale of export property for use outside the U.S.[19] In general, only expenses related to the I.C.-D.I.S.C.'s employees or property qualify as E.P.E. In most cases, the I.C.-D.I.S.C. will have neither resulting in zero E.P.E.

Under the 50% method, the commission is 50% of the combined taxable income of the I.C.-D.I.S.C. and the export company attributable to qualified export receipts plus 10% of the E.P.E. attributable to such receipts.[20]

I.C.-D.I.S.C. Distributions

A shareholder of an I.C.-D.I.S.C. can receive actual dividends or constructive dividends. An actual dividend occurs when the I.C.-D.I.S.C. distributes cash or other property to the shareholder. A constructive dividend is an amount deemed distributed to the shareholder for which deferral is not permitted. Constructive dividends include interest on a producer's loan,[21] gains from certain appreciated assets transferred to an I.C.-D.I.S.C.,[22] and taxable income attributable to qualified export receipts that exceed $10.0 million.[23] A constructive dividend is treated as a qualified dividend that benefits from long-term capital gains tax rates.[24] If a shareholder is a taxable C-corporation, the deemed distribution also includes 1/17th of the I.C.-D.I.S.C.'s taxable income that is not otherwise deemed distributed under other provisions.[25]

For more sophisticated companies that can manage the I.C.-D.I.S.C. process with accuracy throughout the year, the I.C.-D.I.S.C. would funnel cash proceeds to the exporting company in ways that will not put the I.C.-D.I.S.C. election at risk, commissions are paid near the end of the fiscal year, and the corresponding distribution

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16 Code §994(a).

17 Treas. Reg. §1.994-1(b).

18 Code §994(a)(1).

19 Treas. Reg. §1.994-1(f).

20 Code §994(a)(2).

21 Code §995(b)(1)(A).

22 Code §995(b)(1)(B).

23 Code §995(b)(1)(E).

24 Code §995(b)(1), initial sentence; Code §1(h)(11)(B)(i)(I).

25 Code §995(b)(1)(F)(i).

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follows soon after, usually within a day. For less sophisticated companies, the funds generated from the commission can be distributed to the shareholders immediately and rechanneled to the exporting company.

Interest Charge

The I.C.-D.I.S.C. may defer distributing taxable income attributable to qualified export receipts but not more than $10 million. However, the shareholder will be charged interest in connection with the deferred amount.[26] The interest charge is imposed on a hypothetical tax liability using ordinary tax rates as opposed to the qualified dividend rate.[27] The interest rate is set at the one-year Treasury bill rate.[28]

For the exporting company that is privately held, deferral is usually not the major goal in setting up an I.C.-D.I.S.C. Absolute tax reduction is likely the play.

ADDITIONAL BENEFITS

For privately held companies that are more interested in deferring tax on up to $10.0 million of export gross receipts, methods are available to channel funds back to the exporting company without putting the I.C.-D.I.S.C. election at risk.

Producer's Loans

As noted, the interest charge on deferred distributions is equal to the one-year Treasury bill rate, which is a relatively low rate. Prior to the interest-charge amendment in the 1980's, D.I.S.C.'s would defer distributions and extend a producer's loan" to the exporting company. If properly structured, producer's loans allow the exporting company to invest earnings in export operations without triggering recognition of the deferred tax liability for the shareholder of the D.I.S.C. This can still be done with an I.C.-D.I.S.C., but subject to the interest charge. The exporting company deducts the interest expense, and the receipt of interest by the I.C.-D.I.S.C. is not subject to tax at the level of the I.C.-D.I.S.C. The interest income gives rise to a constructive dividend from the I.C.-D.I.S.C. that is included in the shareholder's taxable income for that tax year.[29] In substance, the producer's loan is a source of cheap credit for the exporter. For an export company operating as an L.L.C. owned by individuals, the interest expense on the producer's loan reduces ordinary income of the business and increases qualified dividend income for the I.C.-D.I.S.C. shareholders.

A loan must meet several criteria in order to be treated as a producer's loan:

- When added to the unpaid balance of all other producer's loans, the new loan does not cause the outstanding balance of all existing loans to exceed the accumulated I.C.-D.I.S.C. income as of the beginning of the month in which the loan is made.
- The loan is evidenced by a note with a maturity date of not more than five years from the date of the loan.

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[26] Code §995(f).

[27] Code §995(f)(2)(A)(ii).

[28] Code §995(f)(1)(B).

[29] Code §995(b)(1)(A)).

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- The loan is made to a person engaged in a business involving manufacturing, production, growing, or extraction of export property in the U.S.
- The loan is designated as a producer's loan.[30]

The interest rate must comply with arm's length principles. The loan can be made to any party, not just the exporting company, provided all tests listed above are met. Loans to other parties effectively allow an I.C.-D.I.S.C. to meet the asset qualification test when its qualified export income is in decline from year to year.

Accounts Receivable Factoring

Accounts receivable factoring is another tax saving consideration for those exporting companies favoring a path towards deferral. Accounts receivable factoring allows a company to sell its export accounts receivable to another party at a discount in exchange for immediate cash.

An exporting company can sell its account receivables at an arm's length discount to the I.C.-D.I.S.C. and deduct the loss. The income earned by the I.C.-D.I.S.C. is recognized as qualified interest income and is tax-exempt.[31] The distributions to shareholders are qualified dividends. This arrangement similarly allows the export company to reduce income taxed at ordinary tax rates in exchange for the receipt of a qualified dividend taxed at favorable long-term capital gains tax rates.

Roth I.R.A. Contributions

Tax exempt entities such as Roth I.R.A.'s may hold shares in an I.C.-D.I.S.C., although, any distribution will be treated as unrelated trade or business income taxed at ordinary income rates.[32] A Roth I.R.A is an individual retirement account to which contributions are made from after-tax income. However, investment income and gains grow on a tax-free basis. Distributions from a Roth I.R.A. account that are made after reaching retirement age are also tax-free. The Code places certain restrictions on Roth I.R.A. contributions.[33] However, the contribution limits do not apply to distributions made from an I.C.-D.I.S.C. Thus, the I.C.-D.I.S.C. can distribute its earnings, subject to tax at ordinary tax rates, to the shareholder that is a Roth I.R.A. and grow those earnings tax-free.

The I.R.S. challenged the use of these arrangements under the substance-over-form doctrine, but Federal circuit courts of appeals have ruled in favor taxpayers.[34]

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[30] Code §993(d)(1).

[31] See Rev. Rul. 75-430 (accounts receivable resulting from the sale of export property are qualified export assets and the discount is a qualified export receipt).

[32] Code §995(g).

[33] Code §408A(c)(2) and (3). For 2023, the maximum contribution limit is $6,500 annually, or $7,500 age 50 or older. Also, for 2023, the taxpayer's modified adjusted gross income must be under $153,000 for single filers and $228,000 if married filing jointly.

[34] See *Summa Holdings, Inc. v. Commr.,* 848 F.3d 779 (6th Cir. 2017) (utilizing the I.C.-D.I.S.C. to make payments to the Roth I.R.A.'s was valid under the I.R.C.); *Benenson v. Commr.*, 887 F.3d 511 (1st Cir. 2018) (since they payments were valid, the shareholders were not liable for excise taxes for excess contributions to the Roth I.R.A.'s) ; and *Benenson Jr. v. Commr.*, 910 F.3d 690 (2d Cir. 2018) (sine they payments were valid, the shareholders were not liable for tax deficiencies).

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The family of cases involved an export company ("ExportCo") owned by a husband, wife, and a family trust, of which the couple's two children were the beneficiaries. Two Roth I.R.A.'s were established for the children. The Roth I.R.A.'s purchased shares in ExportCo's I.C.-D.I.S.C., and then transferred the shares to a HoldCo. ExportCo paid commission to the I.C.-D.I.S.C, which distributed the commission to the HoldCo. HoldCo paid tax on the dividends and distributed the balance to its shareholders, the two Roth I.R.A.'s. The tax benefit was not tax rate arbitrage since Code §995(g) negates the possibility. Instead, the arrangement generated income for the Roth I.R.A.'s that simply were not taxed.

The I.R.S. applied the substance-over-form doctrine and asserted that (i) the payments from ExportCo to the I.C.-D.I.S.C. were not commissions but dividend distributions to ExportCo shareholders, and (ii) the distributions from HoldCo to the Roth I.R.A.'s were not dividends but contributions to the Roth I.R.A.'s in excess of the contribution limits.

In each of the three cases, the U.S. Tax Court ruled in favor of the I.R.S. finding it appropriate to recharacterize the transaction under the substance-over-form doctrine. However, the three U.S. Federal Circuit Courts reversed and held for the taxpayers in three separate decisions. Each reasoned that the Roth I.R.A. and D.I.S.C. provisions are designed to allow for favorable tax treatment. The substance-over-form doctrine does not give the I.R.S. a warrant to search through the Code and correct whatever oversights and mishaps Congress happens to make. Since the transactions did not violate the plain intent of the relevant statutes, the doctrine did not apply.

"The substance-over-form doctrine does not give the I.R.S. a warrant to search through the Code and correct whatever oversights and mishaps Congress happens to make."

INTERPLAY WITH F.D.I.I.

In 2018, the T.C.J.A. introduced an additional export friendly provision – a deduction for F.D.I.I. F.D.I.I. is the portion of a U.S. corporation's intangible income derived from serving foreign markets determined under a formulaic method. In general, Code §250 allows a U.S. corporation to deduct 37.5% of its F.D.I.I. (21.87% for tax years beginning after December 31, 2025) resulting in an effective tax rate of 13.125% on eligible income. The F.D.I.I. deduction is not available to individuals operating an export business through a partnership or L.L.C.

Where the export company is a C-corporation, it could potentially claim the F.D.I.I. deduction in addition to the I.C.-D.I.S.C. commission deduction. While the two regimes have varying scopes of applicable transactions, many transactions qualify under both sets of rules. In a situation where a transaction qualifies for I.C.-D.I.S.C. benefits and the F.D.I.I. deduction, the Code does not prohibit the use of both regimes. However, in so doing, there is a circular effect in which both sets of provisions impact the other. The I.C.-D.I.S.C. commission reduces the F.D.I.I. deduction, and the F.D.I.I. deduction reduces the net profits of the I.C.-D.I.S.C.[35] While the maximum benefit under either regime is reduced, the net benefit could be increased by using both. The taxpayer may also be better off using one set of rules and not the other for a given transaction. Tax modeling should be adopted on a case-by-case basis to determine the respective benefits.

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[35] See Code §250(b)(3)(A)(ii) and Treas. Reg. §1.994-1(c)(6)(iii), respectively.

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FOREIGN SHAREHOLDERS

In the case of a foreign shareholder, Code §996(g) treats distributions from an I.C.-D.I.S.C. as income that is effectively connected with the conduct of a trade or business through a U.S. permanent establishment. Many foreign shareholders have contended that a deemed permanent establishment provided under U.S. law cannot override the definition of an actual permanent establishment provided in an income tax treaty that is in force and effect between the U.S. and a foreign country. If the treaty takes precedence, and no permanent establishment exists, the withholding tax rate for dividends should be applicable rather than the U.S. tax rate on effectively connected income and possibly branch profits tax

In November 2022, the Office of Chief Counsel issued advice to I.R.S. personnel regarding this matter.[36] According to the advice, Code §996(g) requires foreign shareholders to treat I.C.-D.I.S.C. distributions as income items that are deemed to be attributable to a permanent establishment. According to the advice, U.S. tax treaties should be applied in a manner that is consistent with the Code wherever possible. Taxpayer arguments that focus on the later-in-time rule – if there is a conflict between domestic law and a treaty, the one that is later in time controls – codified in Code §7852(d) does not apply. The I.R.S. also indicated this interpretation is based on congressional intent.[37]

While the advice is not binding precedent on a court, it signals foreign shareholders of an I.C.-D.I.S.C. will face challenges by the I.R.S. if contending that I.C.-D.I.S.C. distributions do not give rise to effectively connected income and business profits attributable to the deemed existence of a permanent establishment. More importantly, the likelihood of success is low in light of deference that is ordinarily given to legislative history.

CONCLUSION

The I.C.-D.I.S.C. is an underrated tool that can provide substantial tax benefits to export companies operating as L.L.C.'s that are owned by individuals. It is a company having operations only on paper that has been designed intentionally to generate tax benefits. In other words, it is an anomaly in today's tax world that is hyper-focused on substance. Utilization is relatively simple, but the requirements must be strictly followed to avoid undesired tax consequences. The compliance challenge will be addressed in Part II of this series.

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[36] AM 2022-005 - Section 996 - Rules for Allocation in the Case of Distributions and Losses.

[37] H.R. Rep. 98-861, at 977 (1984) ("The provision that clarifies present law to make it clear that a resident of a treaty partner country cannot avoid tax (under sec. 996(g)) on D.I.S.C. distributions is effective on June 22, 1984.").

TAXPAYER F.B.A.R. VICTORIES

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Bittner v. U.S
F.B.A.R.
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Form BE-12
Nonwillful Penalties
Wrzesinski v. U.S.

The Bank Secrecy Act ("B.S.A.") requires U. S. persons with certain financial interests in foreign accounts to file an annual report known as an "F.B.A.R.," which is embodied in FinCEN Form 114 (Report of Foreign Bank and Financial Accounts). Two February decisions provided welcomed news to F.B.A.R. non-filers.

Penalties Assessed Per Report

In a 5-4 split decision, the U.S. Supreme Court held in *Bittner v. U.S.*[1] that non-willful F.B.A.R. violations apply on a per-report basis, not a per-account basis, significantly reducing potential penalties.

The petitioner was a dual citizen of Romania and the U.S. He returned to Romania in the 1990's where he launched a successful business career. Like many dual citizens, he was unaware that the U.S. required its citizens to report their overseas financial accounts even while living abroad. After returning to the U.S. in 2011, he learned of his reporting obligations and prepared the required F.B.A.R. forms. Upon review, the government asserted the reports neglected to address more than 25 of his accounts.

Section 5314 of the B.S.A. requires individuals to file reports related to foreign accounts. Section 5312 authorizes the Secretary of the Treasury to impose a penalty of up to $10,000 for violations of §5314. The government assessed a $2.72 million penalty for nonwillfully failing 272 time to report accounts over a five-year period (on average, 54.4 accounts x $10,000 each x 5 years = $2.72 million). The petitioner challenged the government's assessment arguing the penalty should apply per report, not per account.

Initially, the U.S. Federal District Court ruled for the petitioner,[2] but the Fifth Circuit Court of Appeals reversed[3] and upheld the government's assessment creating a split among the U.S. Federal Circuit Courts of Appeal.[4] The Supreme Court granted certiorari in order to resolve the conflict, and held in favor of the petitioner.

The Court observed that the nonwillful penalties under 31 U. S. C. § §5321 do not speak in terms of accounts. The government insisted that since Congress explicitly authorized per-account penalties for some willful violations, the Court should infer that Congress meant to do so for analogous nonwillful violations. The Court rejected

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1 143 S. Ct. 713 (2023).

2 469 F. Supp. 3d 709, 724–726 (ED Tex. 2020).

3 19 F. 4th 734, (5th Cir. 2021).

4 U.S. v. Boyd,. , 991 F. 3d 1077 (CA9 2021).

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the argument and stated that if Congress intended to subject nonwillful violations to penalties on a per-account basis, it should have explicitly done so like it had with similar provisions. The Court further observed that previously issued guidance repeatedly seemed to inform the public that the failure to file a report represents a single violation exposing a nonwillful violator to one $10,000 penalty. In particular, the Court stated in n.5:

> Our point is not that the administrative guidance is controlling. Nor is it that the government's guidance documents have consistently endorsed Mr. Bittner's reading of the law. It is simply that, when the government (or any litigant) speaks out of both sides of its mouth, no one should be surprised if its latest utterance isn't the most convincing one. This is no new principle in the law any more than it is in life. In Skidmore, this Court noted that the persuasiveness of an agency's interpretation of the law may be undermined by its inconsistency "with earlier [agency] pronouncements." 323 U. S., at 140.

Accordingly, the Court concluded that the B.S.A. applies a per- penalty for nonwillful F.B.A.R. violations report, not a per-account penalty.

Tax Treaty Offers "Escape Hatch"

A recent decision in the U.S. District Court for the Southern District of California rejected a longstanding I.R.S. position that green card holders who are tax resident in the U.S. and a tax treaty partner jurisdiction are U.S. persons for F.B.A.R. purposes regardless of the treaty. In *Aroeste v. U.S.*,[5] the court held that dual residence tiebreaker rules within U.S. income tax treaties apply to F.B.A.R. filing requirements.

The plaintiff was a green card holder in the U.S., but his permanent home and tax residence was in Mexico. Consequently, the plaintiff asserted he was a resident of Mexico under the Mexico-U.S. Income Tax Treaty (the "Treaty") and was therefore not considered a U.S. person required to file an F.B.A.R. The I.R.S. argued that the plaintiff's status under the Treaty was irrelevant for F.B.A.R. purposes because tax treaties only address income and excise taxes.

The court ultimately held that tax residency under the Treaty is relevant and provided a five-step process under which tax treaties could offer an "escape hatch" for dual-resident taxpayers excluding them from F.B.A.R. filing requirements:

- Under 26 U.S.C. §7701(b)(6), anyone allowed to permanently reside within the U.S. by virtue of U.S. immigration laws is a "lawful permanent resident" for tax purposes unless an applicable tax treaty allows that person to be treated as a resident of a foreign country for tax purposes, only.
- Under 26 U.S.C. §7701(b)(1)(A)(i), any "lawful permanent resident" is a "resident alien."
- Under 31 C.F.R. §1010.350(b)(2), any "resident alien" is a "resident of the United States."

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[5] Case No. 22-cv-682-AJB-KSC (S.D. Cal. 2023), reported unofficially at 131 AFTR 2d 2023-623.

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- Under 31 C.F.R. §1010.350(b), Any "resident of the United States" is a "United States person" required to file an F.B.A.R.
- Therefore, any person allowed to permanently reside in the U.S. by virtue of U.S. immigration laws must file an F.B.A.R. unless that person is entitled to be treated as a resident of a foreign country under a tax treaty.

Having recited the above, the Court held that the Treaty overrode the regulatory definition of the term "resident of the U.S."

> The question is whether the Treaty provides [Mr. Aroeste] an escape hatch. Because the United States and Mexico indisputably have a tax treaty, Mr. Aroeste would not be a lawful permanent resident within the meaning of 26 U.S.C. section 7701(b)(6) if he commenced to be treated as a resident of Mexico under the Treaty (with the additional caveats enumerated in the statute); which might in turn have ultimately excused him from the requirement to file FBARs as a "United States person." The Court therefore concludes a determination of Mr. Aroeste's tax residency under the Treaty is directly relevant to—indeed it is outcome determinative of—the issue of whether he was required to file the FBARs at issue in this lawsuit.

Green card holders in similar positions should take note. The decision is appealable to the 9th Circuit Court of Appeals and is sure to bring about further developments.

U.S. CONCEDES ON GIFT TAX ISSUE

In 2022, a U.S. resident, who received an $830,000 gift from his Polish mother after she won the Polish lottery, filed suit against the U.S. challenging foreign gift tax penalties for failure to report the monetary gifts on Form 3520.[6] He argued the penalties should be abated since he relied on advice from his accountant that he did not have to report the gifts, and therefore had reasonable cause for his failure to file. On March 7, 2023, the Department of Justice filed a "status report in lieu of answer" conceding the issues and noted the I.R.S. will refund the penalties.

U.S. individuals are required to report gifts from foreign persons that exceed $100,000 in a given year. Failure to do so results in a 5% penalty of the amount of the gift for each delinquent month, with a maximum penalty of 25%.[7] The penalty shall not apply if the individual shows that the failure to report is due to reasonable cause and not due to willful neglect.[8]

Courts have held that reasonable reliance on a tax professional can meet the reasonable cause requirement.[9] The I.R.S.'s concession in this case reaffirms this position and will hopefully facilitate additional relief to taxpayer's who have reasonable cause for failing to report foreign gifts.

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6 *Wrzesinski v. United States*; No. 2:22-cv-03568.

7 Code §6039F(c)(1)(B).

8 Code §6039F(c)(2).

9 *United States v. Boyle*, 469 U.S. 241 (1985); *Neonatology Associates PA v. Commr.*, 115 T.C. 43 (2000), aff'd 299 F.3d 221 (3d Cir. 2002).

BE-12 REPORT: DUE MAY 31 (MAIL OR FAX) OR JUNE 30 (EFILE)

The BE-12 Benchmark Survey of Foreign Direct Investment in the U.S., conducted every five years by the Department of Commerce's Bureau of Economic Analysis, is due on May 31 for those filing by mail or fax, or June 30 for those filing electronically.

Extensions can be easily obtained through the B.E.A. secure e-file system at www.bea.gov/efile.

Background

The Benchmark Survey of Foreign Direct Investment in the U.S. is part of routine efforts by the U.S. government to secure current economic data on the operations of U.S. affiliates of foreign enterprises. This includes, in particular, foreign investment in U.S. real estate for non-personal use.

Key Q&A's

1. *Who must file a BE-12 report?*

   The BE-12 report is required for each U.S. business enterprise (including real estate held for nonpersonal use) if a foreign person or entity owned or controlled, directly or indirectly, 10% or more of the voting interest in the business enterprise at the end of the business enterprise's fiscal year that ended in 2022.

2. *What is a business enterprise?*

   A business enterprise includes any commercial activity, including any ownership in real estate. However, an enterprise that holds residential real estate exclusively for personal use and not to make profits is excepted from reporting requirements. Personal-use property includes a primary residence in the U.S. that the owner leases while he or she is outside the U.S. but intends to reoccupy. All other situations where real estate is rented out, including all situations where the real estate is not a primary residence, do not qualify as personal use and are therefore subject to the filing requirement.

3. *Who is a foreign person?*

   Foreign person means any individual or entity that is resident outside the U.S. or subject to the jurisdiction of a country other than the U.S. An individual is a foreign resident if he or she resides, or expects to reside, outside of the U.S. for one year or more.

   However, there is an exception for individuals who reside outside their country of citizenship for one year or more if

   - the individual owns or is employed by a business enterprise;
   - the individual is a citizen of the country where the enterprise is located;

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- the individual is residing in another country for the purpose of furthering the enterprise's business; and
- the individual intends to return to his or her country of citizenship within a reasonable period of time.

Such individuals will be considered residents of their country of citizenship.

4. *Are there exceptions to filing?*

A U.S. business enterprise described in (1) is not required to complete a survey if

- it is a private fund;
- it does not own, directly or indirectly, an operating company (a business enterprise that is not a private fund or holding company) in which its foreign parent owns at least 10%; and
- if the foreign parent owns the business enterprise indirectly through another U.S. business enterprise, there are no U.S. operating companies between the foreign parent and the business enterprise in question.

If the B.E.A. has contacted an enterprise about filing, but the enterprise is not required to complete the survey for any reason, it must complete a form informing the B.E.A. of the exemption. No action is required for enterprises that are not required to file and have not been contacted by the B.E.A.

Additionally, the 10% ownership threshold discussed in Q&A 1 is met only if the foreign owner holds at least 10% of the voting power in the U.S. business. Thus, for example, a limited partnership with a U.S. general partner and foreign limited partner will typically not be required to file a BE-12 report, because limited partners do not have a say in running the partnership and are generally considered to hold 0% of the voting interests.

5. *By when must the report be filed?*

As mentioned above, the 2022 BE-12 report is due on May 31, 2023, if filing by mail or fax, or June 30, 2023, if filing electronically.

6. *Are extensions available?*

Yes, provided that the extension is requested no later than May 31. The extension is approved automatically at www.bea.gov/efile.

7. *What is the information used for?*

Survey data may be used by the U.S. government only for statistical and analytical purposes.

8. *Is the information kept confidential?*

Yes. This report is authorized under the International Investment and Trade in Services Survey Act of 1977 (Pub. L. No. 94-472). Confidentiality is protected by law. The B.E.A. is prohibited from granting another agency access to the data for tax, investigative, or regulatory purposes.

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9. *Is there a penalty for failure to file?*

Technically yes, but it is rarely imposed.

10. *Can Ruchelman P.L.L.C. assist a reporting person in completing the forms?*

Yes. Our team of Galia Antebi (antebi@ruchelaw.com) and Wooyoung Lee (lee@ruchelaw.com) can assist in identifying the required information and filling out required forms. Contact them by e-mail or by telephoning the firm at +1 212 755 3333.

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Special features include an annual examination of the use of holding companies in European tax planning and a look at the year in review.

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