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INSIGHTS

2023: A YEAR IN REVIEW

A YEAR OF GUEST FEATURES

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EDITORS' NOTE

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

This year, 20 articles were written by 32 guest authors hailing from 16 countries.

- Four dealt with nomad employees and remote workers, including an overview of the issues, a review of O.E.C.D. guidance, one country's experience (Bulgaria), and frontier workers in Switzerland who work at home in Italy and France.
- Four dealt with special regimes to attract the wealthy individuals and highly skilled workers in each of Switzerland, Spain, France, and Italy.
- Another four dealt with concepts of economic substance in Europe, the B.V.I. (twice), Cayman, and Nevis.
- Three dealt with a combination of local tax reform (Israel), new entity classification rules (the Netherlands), and an anti-hybrid ruling (Italy).
- One each covered the C.T.A. (U.S.), crypto regulation (U.K.), application of treaty M.F.N. clauses (India), offshore capital gains (Singapore), A.T.A.D. 3 (a unique Dutch approach), trust drafting techniques (Canada/U.S.), and A.P.A. practice (Greece).

To our guest authors, we extend our heartfelt thanks. To our readers, we wish you all the best in 2024.

Happy Holidays!

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About Us

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

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Tags
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INTRODUCTION[1]

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

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

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

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

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

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

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

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CORORATE TRANSPARENCY ACT OF 2021

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

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

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

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

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

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

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

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

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DETAILS OF THE B.O. RULE

Scope of Coverage

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

Exempt Entities

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

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

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[7] 31 C.F.R. § 1010.380.

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

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

Obligation to Report

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

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

Individuals Exercising Substantial Control

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

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

Important Decisions

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

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

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

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

Substantial Control

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

- board representation;
- ownership or control of a majority of the voting power or voting rights of the reporting company;
- rights associated with any financing arrangement or interest in a company;
- control over one or more intermediary entities that separately or collectively exercise substantial control over a reporting company;
- arrangements or financial or business relationships, whether formal or informal, with other individuals or entities acting as nominees; or
- any other contract, arrangement, understanding, or relationship.

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

Ownership Interests

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

- Any equity, stock, or similar instrument; preorganization certificate or subscription; or transferable share of, or voting trust certificate or certificate of deposit for, an equity security, interest in a joint venture, or certificate of interest in a business trust in each such case, without regard to whether any such instrument is transferable, is classified as stock or anything similar, or confers voting power or voting rights
- Any capital or profit interest in an entity
- Any instrument convertible, with or without consideration, into any share or instrument described in the two preceding bulleted paragraphs (including any future on the instrument), or any warrant or right to purchase, sell, or subscribe to a share of the ownership interest, even if characterized as debt
- Any put, call, straddle, or other option or privilege of buying or selling any of the interests described in the three preceding bulleted paragraphs without being bound to do so, except to the extent that such option or privilege is created and held by a third party without the knowledge or involvement of the reporting company
- Any other instrument, contract, arrangement, understanding, relationship, or mechanism used to establish ownership

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

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

Calculation of Total Ownership Interest

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

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

Exceptions to Beneficial Owner Status

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

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

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

REPORTS

Timing

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

The final regulations adopt the following rules:

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

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Content

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

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

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

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

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

Company Applicant

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

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

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

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

[10] 31 C.F.R. §1010.380(e).

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

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

Certifications

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

INDIVIDUAL FINCEN IDENTIFIERS

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

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

LAWYERS' OBLIGATIONS

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

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[11] 31 C.F.R. §1010.380(b)(1)(ii).

[12] 31 C.F.R. §1010.380(b).

OVERALL IMPACT OF THE B.O. RULE

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

IMPACT OF THE B.O. RULE ON TRUSTS

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

NEXT STEPS

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

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

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

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TAX 101: IS CRYPTO GROWING UP?

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Tags
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C.A.R.F.
Crypto
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Intermediaries
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INTRODUCTION

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

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

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

RECOVERY OF ASSETS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

LAW, PROPERTY, SITUS

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

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

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

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

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

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

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3 [1965] AC1175.

4 [2019] EWHC 3556.

5 [1885] 30 ChD 261.

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

WHAT ABOUT TAX?

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

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

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

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

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

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

TRANSPARENCY AND REPORTING

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

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

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

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

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

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

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

CRYPTO ASSETS IN SCOPE

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

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

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

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

INTERMEDIARIES AND SERVICE PROVIDERS IN SCOPE

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

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

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

REPORTING REQUIREMENTS

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

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

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

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

DUE DILIGENCE

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

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

RESTRICTIONS ON TRANSPARENCY

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

U.K. REGULATION

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

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

WIDER TAX ISSUES AND HURDLES TO DEVELOPMENT

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

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

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

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

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

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

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Tags
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INTRODUCTION

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

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

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

TAX RESIDENCE RULES UNDER CURRENT LAW

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

Administrative problems were regularly encountered with the two rebuttable presumptions and the application of the center of life test. Individuals regularly contended that their particular facts overcame the rebuttable presumption, while the I.T.A on the other hand ignored having the individual spend less time in Israel than the refutable number of days, claiming that the individual's center of life was in Israel. Fact patterns needed to be examined on a case-by-case basis, based on specific

circumstances, facts, and evidence, often leading to inconsistent results and lack of clarity to taxpayers. Two cases demonstrate the fact finding that is required of an individual who challenges the presumption. In one case, the individual did his homework; in the other, significantly fewer facts were given and the result differed.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

TAX RESIDENCE UNDER RULES IN THE REPORT

Irrebuttable Classification as an Israeli Resident

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

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

Irrebuttable Classification as a Foreign Resident

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

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

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

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

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

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

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

The Center of Life Test

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

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CONCLUSION

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

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

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

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

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SWISS LUMP SUM TAX REGIME – BASED ON ANNUAL EXPENDITURES

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INTRODUCTION

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

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

ORDINARY TAX REGIME

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

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

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

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

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

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

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

Some Cantons provide a tax shelter (*bouclier fiscal*), according to which the Cantonal and Municipal income and wealth taxes cannot exceed a certain percentage of annual taxable income. The tax shelter is intended to eliminate the risk of confiscatory taxes for individuals having relatively low income, but significant taxable assets. To illustrate, the Cantonal and Municipal income and wealth taxes in Geneva are

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capped at 60% of the annual taxable income. On the other hand, Geneva considers a person to recognize deemed minimum income corresponding to 1% of net wealth.

FAVOURABLE LUMP SUM TAX REGIME

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

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

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

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

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

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

Application Conditions

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

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

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

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

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

Minimum Taxable Base

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

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

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

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

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bank charges paid for the management of movable assets can be deducted from the comparative calculation.

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

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

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

Examples

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

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

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

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

RESIDENCE PERMIT

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

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

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

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

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

TAX RESIDENCY AND DOUBLE TAX TREATIES

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

SWISS GIFT AND INHERITANCE TAXES

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

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

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

PRE-IMMIGRATION ESTATE TAX PLANNING

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

Trusts and Foundations

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

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

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

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

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

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

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

Corporate Structures

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

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

PRACTICAL ASPECTS

Social Security Contributions

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

Private International Law

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

CONCLUSION

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

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

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

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

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

[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:

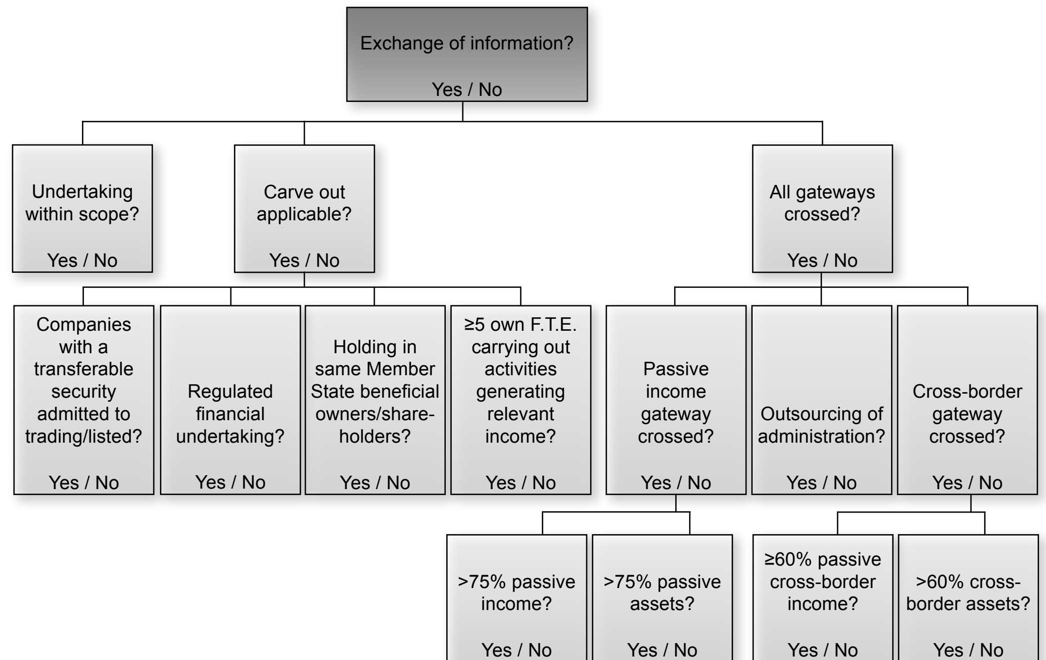

Figure 1: Schematic overview of requirements for automatic exchange of information under original Unshell Directive proposal

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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:

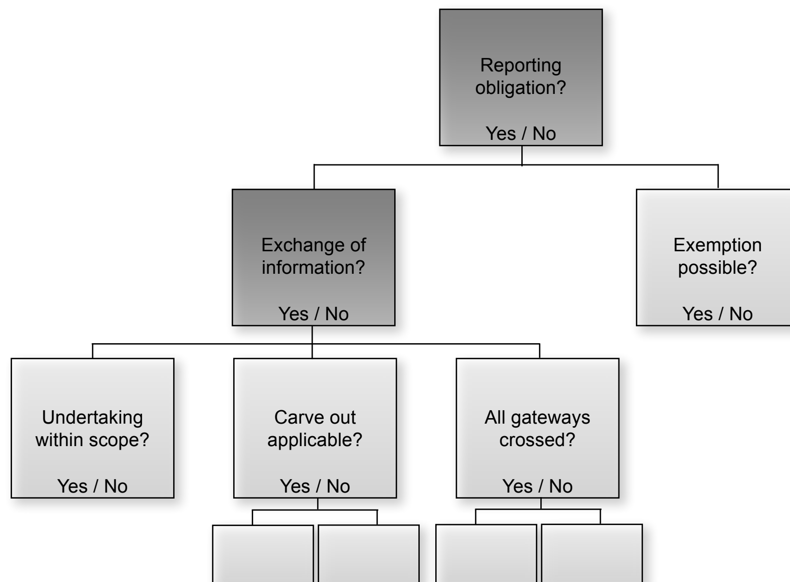

Figure 2: Schematic overview (condensed) of requirements for reporting obligations under original Unshell Directive proposal

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:

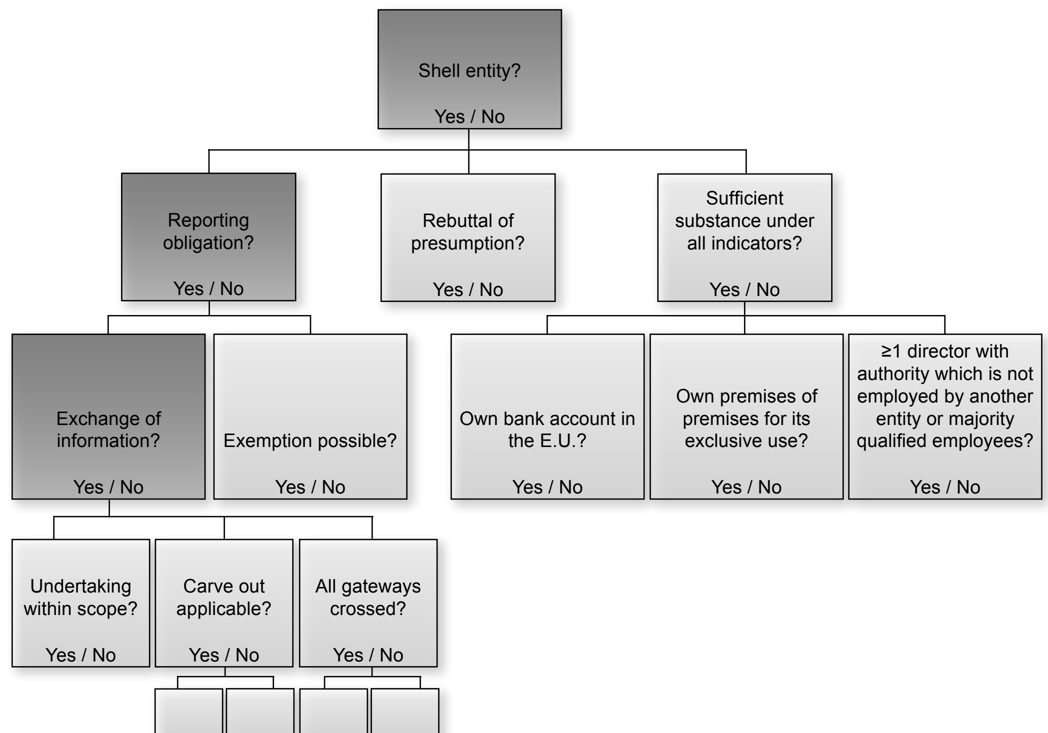

Figure 3: Schematic overview (condensed) of requirements to qualify as shell entity under original Unshell Directive proposal

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	

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]

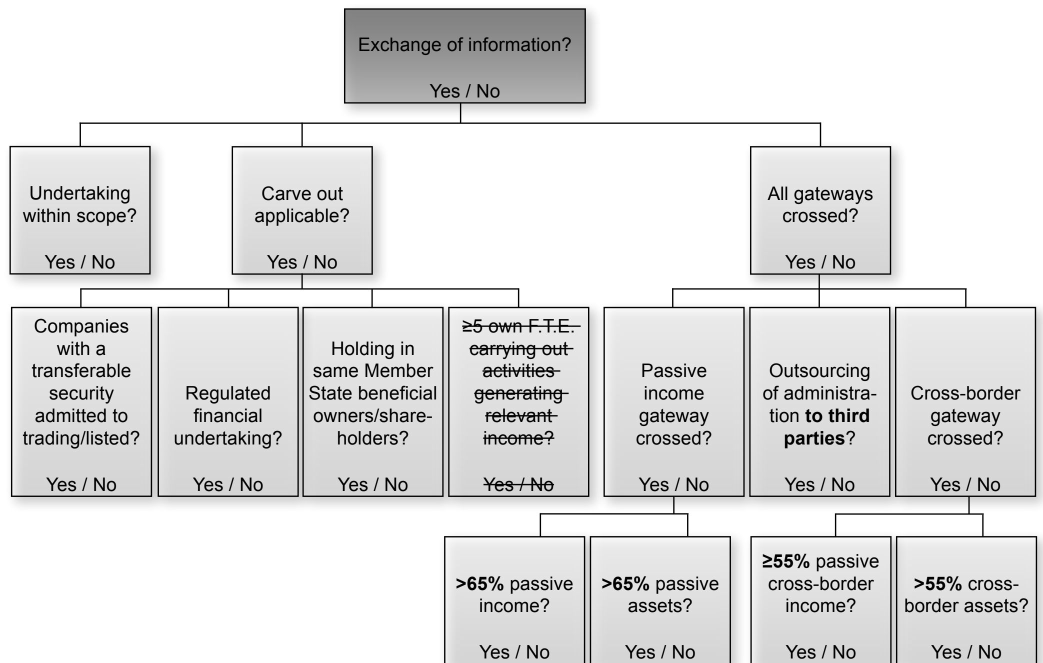

Figure 4: Schematic overview of requirements for automatic exchange of information under the E.P.'s Unshell Directive proposal

[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]

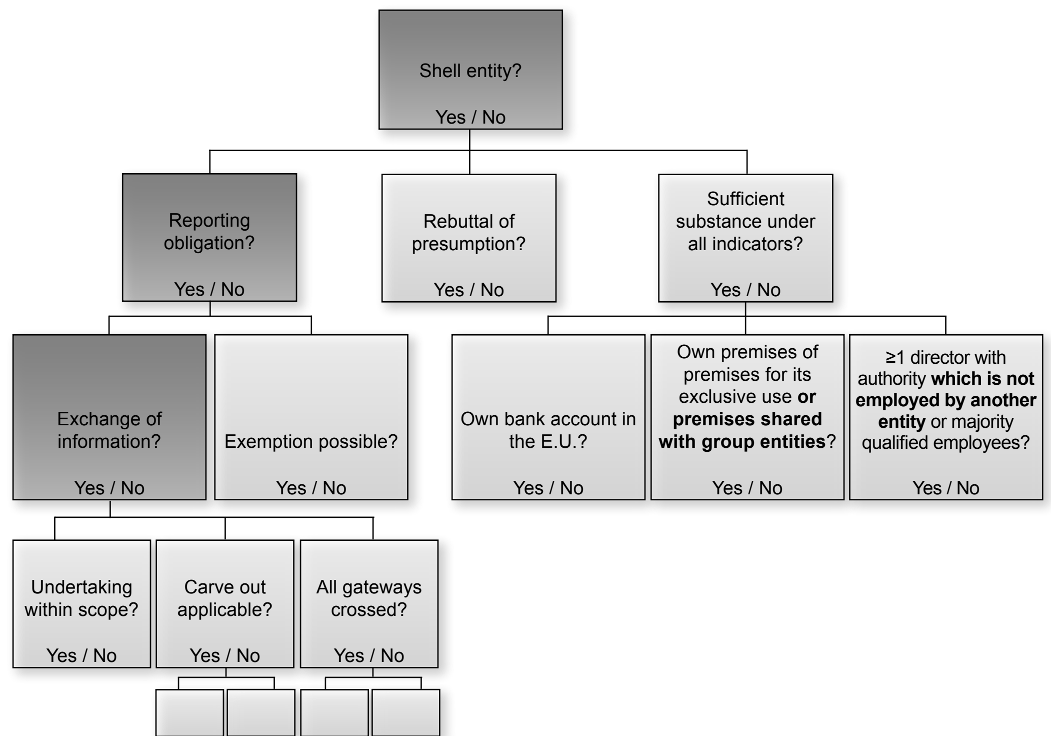

Figure 5: Schematic overview (condensed) of requirements to qualify as shell entity under the E.P.'s Unshell Directive proposal

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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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.

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

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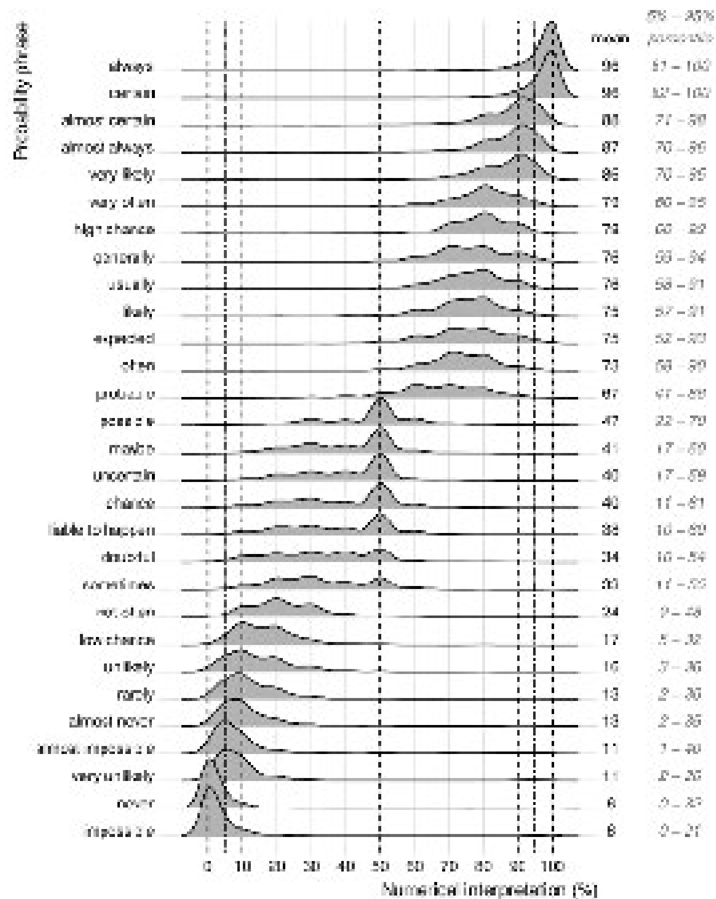
[6] Examples of such language are "it cannot be excluded that (…)," "there is a considerable chance that (…)," and "there are good arguments that (…)."

[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.*



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.

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.

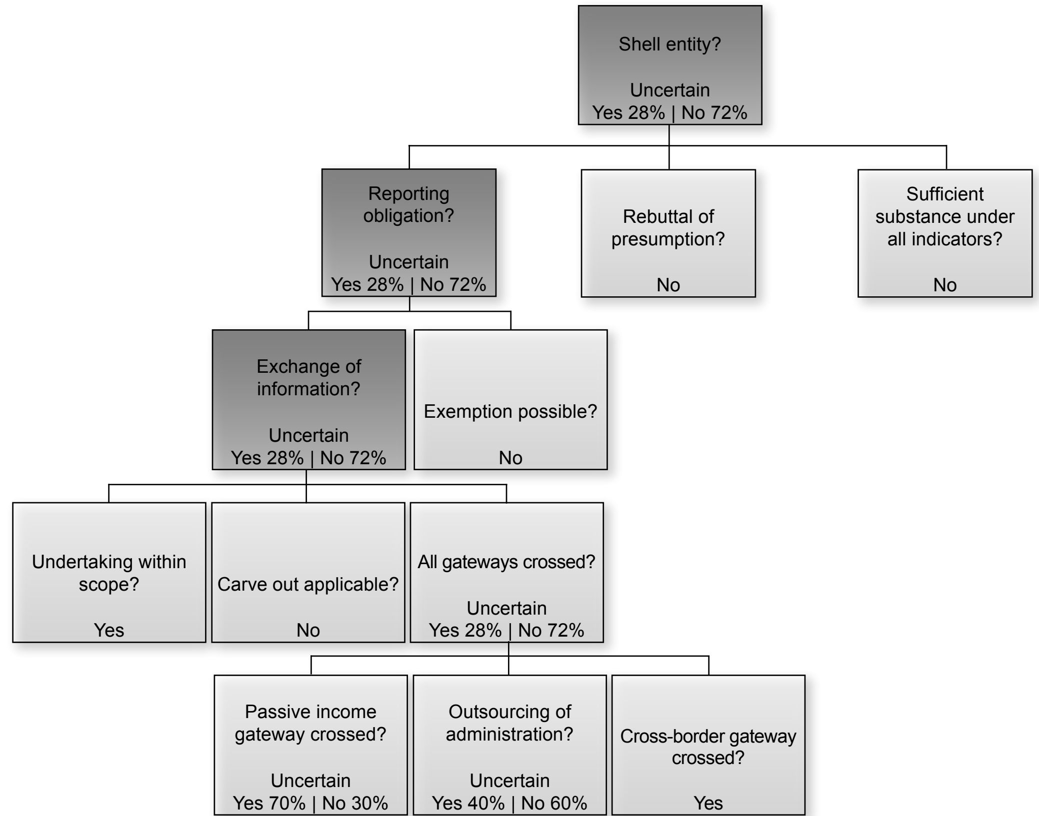

Figure 6: Schematic overview (condensed) of requirements to qualify as shell entity under Unshell Directive (E.P. proposal), including probabilities from example

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:

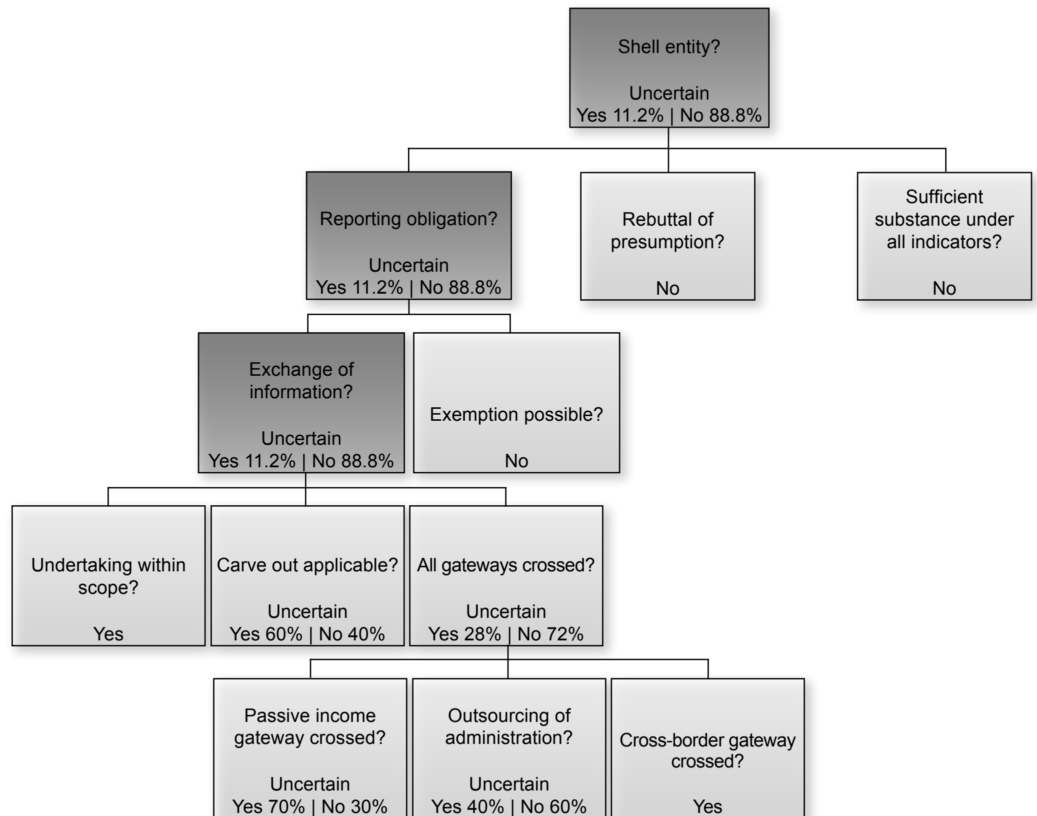

Figure 7: Schematic overview (condensed) of requirements to qualify as shell entity under Unshell Directive (E.P. proposal), including updated probabilities from example

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."

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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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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.

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

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.

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

[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

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).

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

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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.

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

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Tags
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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

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

[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.

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).

TAX ISSUES FOR REMOTE WORKERS AND THEIR SWISS EMPLOYERS

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Tags
Cross Border
Remote Worker
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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

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

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

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

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.

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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.

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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

[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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LET'S TALK ABOUT NOMAD EMPLOYEES!

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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

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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BITTERSWEET CHRISTMAS IN SPAIN – BECKHAM REGIME 2.0 AND SOLIDARITY TAX

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Tags
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Highly Qualified
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Solidarity 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

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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

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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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TELECOMMUTING: GOOD INTENTIONS, BAD OUTCOMES

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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

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

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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ECONOMIC SUBSTANCE: VIEWS FROM THE U.S., EUROPE, AND THE B.V.I., CAYMAN, AND NEVIS

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Sham Transaction

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Like concepts of beauty, the presence or absence of economic substance in the tax context often is in the eye of the beholder. As importantly, economic substance means different things to tax authorities in different jurisdictions. This article looks at the concept of economic substance in three separate localities – the U.S., the E.U., and certain Caribbean jurisdictions.

THE VIEW FROM THE U.S.

Background

U.S. tax law has a doctrine known as the economic substance doctrine. The main purpose is to prevent taxpayers from entering into artificial transactions for the principal reason of reducing tax exposure. Under the doctrine, a transaction that is purely or substantially tax motivated is disregarded.

The doctrine has been recognized in the caselaw for over 90 years. In 2020, it was codified in order to have the same standard applied in U.S. courts no matter where located. In comparison to rules in the E.U. and several Caribbean jurisdictions, it applies to transactions rather than the entities conducting transactions.

Along with the economic substance doctrine, caselaw has created other doctrines meant to achieve broadly the same effect. The various doctrines include the following:

- Economic substance doctrine
- Business purpose doctrine
- Sham transaction doctrine
- Substance over form doctrine
- Step transaction doctrine

However, the lines between these doctrines are not always clear. The result is that while these doctrines serve an important role in denying improperly earned tax benefits, it adds more uncertainty for taxpayers who may be caught by such doctrines. For example, the economic substance doctrine states that tax benefits can be denied if the transaction that gives rise to those benefits lacks economic substance independent of U.S. Federal income tax considerations, even if all facts occurred. Similarly, the business purpose doctrine states that tax benefits can be denied if the transaction was not intended to serve some useful non-tax purpose. Where both a useful non-tax purpose exists alongside overriding tax purposes, some courts have bifurcated the transaction in order to disallow the tax benefits of the overall transaction. Caselaw has not always helped in drawing clearer lines.

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Transactions Lacking Economic Substance

Commr. v. Court Holding Co.[1]

In this case, a corporation agreed to sell an apartment building with the intent of winding up once the transaction was completed. This would have resulted in two levels of tax: first, corporate income to the corporation effecting the sale, and second, income tax for shareholders as the sale proceeds were distributed. After agreement on price was reached, but before a written agreement was executed, the corporation visited a tax advisor who pointed out that a better tax result could be achieved if the apartment building were distributed to the shareholders as part of a liquidation of the corporation after which the building could be sold by the shareholders. Under the law in effect at the time, the corporation did not recognize gain when assets were distributed to shareholders as part of a liquidation. One level of tax could be eliminated. The form of the transaction was renegotiated. Following the advice of the tax advisor, the corporation approved a plan of liquidation and distributed the building to its shareholders. The shareholders effected the sale. The Supreme Court, reversing the Fifth Circuit, held that the corporation was still the true seller.

> The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress. [Citations omitted.]

Corliss v. Bowers[2]

The taxpayer transferred a portfolio of investments to a trust formed for the benefit of his wife and children. However, the taxpayer retained significant control over the trust, including powers to modify or revoke, in whole or in part, the trust deed. The taxpayer argued that he was not liable for tax on the trust income because he never received that income. The Supreme Court disagreed and pointed out that while the assets and money were sitting in a trust, the taxpayer had actual command over the property. By analogy, the court reasoned that a taxpayer would not escape tax liability merely because it was sitting in his bank account.

> [T]axation is not so much concerned with the refinements of title as it is with actual command over the property taxed – the actual benefit for which the tax is paid. If a man directed his bank to pay over income as received to a servant or friend, until further orders, no one would doubt that he could be taxed upon the amounts so paid. It is answered that in that case he would have a title, whereas here he did not. But from the point of view of taxation there would be no difference. * * * The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not.

[1] 324 U.S. 331 (1945).

[2] 281 U.S. 376 (1930).

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Commr. v. P.G. Lake, Inc.[3]

P.G. Lake was a company in the business of producing oil and gas. It owed a debt to its president. In consideration of the cancellation of its debt, Lake assigned him an oil payment right that consisted of a fixed amount and 3% of the unpaid balance that was payable out of 25% of the oil attributable to Lake's working interest. The president reported the oil payment right as long-term capital gain, taxed at favorable rates. The Supreme Court recognized that an oil payment typically produces long-term capital gain, the payment before the Court was an income payment, not a capital payment.

> The purpose of [long-term capital gains tax rates] was "to relieve the taxpayer from * * * excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions. * * * We do not see here any conversion of a capital investment. The lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income. The pay-out of these particular assigned oil payment rights could be ascertained with considerable accuracy. * * * These arrangements seem to us transparent devices. Their forms do not control. Their essence is determined not by subtleties of draftsmanship but by their total effect. [Citations omitted.]

Minnesota Tea Co. v. Helvering[4]

Minnesota Tea Co. was indebted to creditors at the time of its liquidation. As part of the liquidation, the company sold its assets at a gain. Under the law at the time, proceeds used by the corporation to pay off its debt would be taxed but not proceeds distributed to shareholders. In a strategy somewhat similar to the one used in *Court Holding Co.,* Minnesota Tea distributed all of the proceeds to its shareholders. The shareholders subsequently used one-quarter or so of the proceeds to pay off Minnesota Tea's debts. The Supreme Court recharacterized that portion as money used by the company itself to pay off debts

> Payment of indebtedness, and not distribution of dividends, was, from the beginning, the aim of the understanding with the stockholders and was the end accomplished by carrying that understanding into effect. A given result at the end of a straight path is not made a different result because reached by following a devious path. The preliminary distribution to the stockholders was a meaningless and unnecessary incident in the transmission of the fund to the creditors, all along intended to come to their hands, so transparently artificial that further discussion would be a needless waste of time. The relation of the stockholders to the matter was that of a mere conduit. * * *

Rice's Toyota World v. Commr.[5]

Rice was an automobile dealership that bought a used computer for $1.5 million from a promoter as part of a sale-and-leaseback transaction. Rice paid through a

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3 356 U.S. 260 (1958).

4 302 U.S. 609 (1938).

5 752 F.2d 89 (4th Cir. 1985).

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recourse note in the amount of $250,000 payable over three years and two nonrecourse notes payable over eight years. Rice leased the computer back to the promoter under an eight-year nonrecourse lease which allowed Rice to earn annual cash-on-cash income of $10,000. The Fourth Circuit found the transaction to be a sham under a two-prong test. First, under the subjective tax, Rice's only motive was obtaining tax benefits. Second, under the objective test, there was no reasonable possibility of generating a profit.

> The business purpose inquiry simply concerns the motives of the taxpayer in entering the transaction. The record in this case contains ample evidence to support the tax court's finding that Rice's sole motivation for purchasing and leasing back the computer under the financing arrangement used was to achieve the large tax deductions that the transaction provided in the early years of the lease.
>
> * * * [T]he record supports the court's subsidiary finding that Rice did not seriously evaluate whether the computer would have sufficient residual value at the end of the eight year lease to Finalco to enable Rice to earn a profit on its purchase and seller-financed leaseback. Under the purchase and lease agreements with Finalco, Rice was obligated to pay (and did pay) $280,000 to Finalco in the form of principal and interest on the recourse note. Finalco's rental payments provided Rice with a return on the investment of $10,000 annually after payment of Rice's principal and interest obligations under the nonrecourse notes. At the time of the lease, Rice could therefore be certain of receiving a $50,000 return since Finalco had subleased the computer for five years, but Rice could recover the additional $230,000 of its investment only if it could re-lease the computer after five years or realize a substantial amount by its sale. * * *
>
> Residual value of the computer (either in selling or re-leasing) should therefore have been the crucial point of inquiry for a person with a business purpose of making a profit on this transaction. However, Rice's principal officer knew virtually nothing about computers, and relied almost exclusively on the representations of a Finalco salesperson regarding expected residual value. * * *
>
> The second prong of the sham inquiry, the economic substance inquiry, requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits. * * * The record contains estimates of residual value made by several experts that range from a low of $18,000 to a high of $375,000. Although Rice's experts presented a range of predicted residual values with a high end sufficient to earn Rice a profit, the tax court found the Commissioner's experts to be more credible and to have used more reliable forecasting techniques.

The Merrill Lynch Transactions

Merrill Lynch developed a financial product to create capital losses that U.S. corporations could use to offset capital gains from other transactions. Under the financial product, the U.S. corporation would form a partnership with a foreign partner not subject to U.S. tax. The two partners would capitalize the partnership with cash

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contributions, primarily from the foreign partner, who would consequently become the majority partner. The partnership would purchase high-grade, floating-rate private placement notes ("P.P.N.'s") that included put options enabling the partnership to sell the P.P.N.'s back to the issuer at par.

In exchange for selling the P.P.N.'s, the partnership would receive consideration consisting of 80% cash and 20% indexed installment notes. The gain from the sales would be reported using the installment method under Code §453. Additionally, since the floating-rate notes were categorized as contingent consideration because the total amount to be received could not be determined at the time of sale, gain recognition would be accelerated but offset by deferred loss. This is because in installment sales with contingent consideration, basis is allocated equally to all years in which payment can be received.[6] A taxpayer recognizes gain if a payment in a particular year exceeds the allocated basis for the year. A payment that is less than the basis for that year is a recovery of basis. Losses are only allowed in the final year of payment.

"Since the foreign partner held the majority interest, it would be allocated the bulk of the gain in the first year."

In a simplified example from one court case involving these transactions,[7] a seller sells a property with basis and current value of $1 million in exchange for $500,000 cash and an indefinite five-year instrument. Because there are five years in which payment could be received, the $1 million in basis is allocated $200,000 to each year. In the first year, the seller receives $500,000 in cash, of which $200,000 is recovery of basis and $300,000 is gain. This leaves $800,000 in basis to be recovered. In the second year, the notes are sold for $500,000, producing a loss of $300,000 due to the remaining $800,000 of basis.

Since the foreign partner held the majority interest, it would be allocated the bulk of the gain in the first year. That gain would not be categorized as effectively connected income in the hands of the foreign partner. Consequently, no U.S. tax was imposed. The loss from the second-year sale of notes would be allocated to the U.S. partner, and was used to offset capital gains from an unrelated transaction.

In a series of lawsuits, courts struck down the transactions as a sham. There was no reason for the companies to get involved other than to produce a tax loss. Courts disregarded the existence of either the partnership[8] or the transaction.[9]

Andantech L.L.C. et al. v. Commr.

Like the Merrill Lynch transactions, this case[10] involved a manipulation of timing. Comdisco was a lessor, dealer, and remarketer of IBM computer equipment. It engaged in a sale-leaseback transaction with a partnership formed by two non-U.S. individuals. Comdisco then subleased the equipment to end users of the equipment. The partnership sold the right to receive rental payments, causing an acceleration of the rental income. Since the partners were both non-U.S. individuals, the income went untaxed. At that point, when the revenue stream was already disposed of, a

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6 Temp. Treas. Reg. §15A.453-1(c)(3)(i).

7 *ASA Investerings Partnership v. Commr.*, 201 F.3d 505.

8 *Saba Partnership v. Commr.,* T.C. Memo. 2003-31; Boca Investerings Partnership v. U.S., 314 F.3d 625.

9 *ACM Partnership v. Commr.*, 157 F.3d 231.

10 331 F.3d 972 (D.C. Cir. 2003).

U.S. corporation became a 98% partner and received its proportionate share of the depreciation deductions. There was no rental income to offset these deductions because the gain from the rental income had already been recognized.

The D.C. Circuit Court applied the sham-transaction doctrine and disregarded the partnership. The foreign partners' participation was disregarded under the step-transaction doctrine because they always intended to withdraw from the partnership. The sale-leaseback transactions were held to lack economic substance and a non-tax business purpose.

> [T]he intent of the [foreign partners] was not to run the business as a partnership or otherwise, but to assist with a transaction for which they * * * would be well compensated. Their contribution of cash was comparatively minimal and borrowed, and they withdrew almost all of it from the company after only three months, exactly as outlined in the June proposal. [The foreign partners] had only been made aware of the deal and offered their participation after an earlier pair of potential European partners backed out, and had a maximum of two weeks to consider the deal before the formation of the partnership. This, too, illustrates the lack of intent to actually enter into the partnership for a purpose other than to facilitate the proposed tax-beneficial transaction. The terms of the deal offered further evidence of the intent of the participants. For example, Andantech hired a Dutch business manager to run Andantech, but with a contract of only two and a half months, coinciding precisely with the timeline described in the proposal memo for the income-stripping transaction, and the time period in which the transaction, in fact, occurred.

Transactions Where the Taxpayer Prevailed

Frank Lyon Co. v. U.S.[11]

A state bank wanted to build a new headquarters building, but banking regulations prevented financing the new building with a conventional mortgage. Consequently, the bank entered into a sale-leaseback transaction. The bank sold the building to Frank Lyon, which financed its purchase with a mortgage and then leased the building back to the bank.

The I.R.S. argued that the sale-leaseback should be disregarded. In its view, the bank remained the true owner, and Frank Lyon should not have been allowed any depreciation deductions.

> * * * Although the rent agreed to be paid by the bank equaled the amounts due from the petitioner to its mortgagee, the sale-and-leaseback transaction is not a simple sham by which petitioner was but a conduit used to forward the mortgage payments made under the guise of rent paid by the bank to petitioner, on to the mortgagee, but the construction loan and mortgage note obligations on which petitioner paid interest are its obligations alone, and, accordingly, it is entitled to claim deductions therefor under §163(a) of the Internal Revenue Code of 1954. * * *

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[11] 435 U.S. 561 (1978).

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While it is clear that none of the parties to the sale-and-leaseback agreements is the owner of the building in any simple sense, it is equally clear that petitioner is the one whose capital was invested in the building and is therefore the party entitled to claim depreciation for the consumption of that capital under §167 of the Code. * * *

Where, as here, there is a genuine multiple-party transaction with economic substance that is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features to which meaningless labels are attached, the Government should honor the allocations of rights and duties effectuated by the parties; so long as the lessee retains significant and genuine attributes of the traditional lesser status, the form of the transaction adopted by the parties governs for tax purposes. [Citations omitted.]

Twenty-First Securities Transactions

Two U.S. corporations were approached by Twenty-First Securities Corporation, a promoter, for a series of transactions. The promoter identified American Depositary Receipts ("A.D.R.'s") of public European companies that had announced dividend distributions. The promoter arranged for an intermediary to borrow A.D.R.'s owned by tax-exempt entities that were not able to claim a foreign tax credit on the 15% dividend withholding tax. The intermediary sold the A.D.R.'s short to the corporation-taxpayer for fair market value plus 85% of the expected dividends. The stock lender received cash equal to 102% of the fair market value.

This purchase carried a settlement date before the record date for the dividends, meaning the corporation received the dividends. The A.D.R.'s would then be sold immediately with a settlement date after the dividend-record date. The second sale price was lower because it did not include the dividends, creating a loss for the corporation. And unlike the stock lender, the corporation could claim a foreign tax credit for the dividend withholding tax.

The I.R.S. lost their attempts to recharacterize the transactions.[12] In *Compaq Computer Corp. v. Commr.*,[13] the Fifth Circuit held that the transaction was a genuine multi-party transaction, made at arm's length, that had business and regulatory motives behind it, rather than only tax avoidance.

The mere fact that a tax benefit existed did not make the transaction a sham. The transaction had a reasonable possibility or profit along with a real risk of loss. Notably, Compaq made profits on a pre-tax basis, as the gross dividend income before the foreign withholding taxes exceeded the capital loss. The I.R.S. argued that the economic benefit should have been measured on a cash basis, excluding foreign tax credits. The court rejected this argument. It was inconsistent with the I.R.S.'s acceptance that the issuing corporation's withholding and satisfaction of Compaq's foreign tax liability created additional income for Compaq. The argument was also internally inconsistent because the I.R.S. wanted to treat the withholding tax as a cost but not the foreign tax credit as a benefit.

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[12] *IES Industries Inc. v. U.S.,* 253 F.3d 350 (8th Cir. 2001).

[13] 277 F.3d 778 (5th Cir. 2001).

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The benefit stemming from the foreign tax credit in this transaction is no longer possible due to Code §901(k)(1)(A)(i), which disallows the foreign tax credit for withholding on dividends if the recipient of the dividend holds the stock for fewer than 16 days in the 31-day period beginning 15 days before the ex-dividend date.

Palmer v. Commr.

A chiropractic school found its ability to obtain grants limited because of its status as a profit-making corporation.[14] The school consequently decided to become a not-for-profit entity. To effect this conversion while maximizing the tax benefit, the corporation's shareholders formed a charitable foundation and contributed their shares to the foundation. This resulted in a deduction for charitable contributions. The foundation then caused the dissolution of the corporation. This allowed the school assets to be distributed in a liquidation distribution that was tax-free at the level of the corporation under the law at the time and not taxed at the level of the not for profit foundation. The I.R.S. unsuccessfully argued that the steps should be collapsed because the taxpayer in the lawsuit controlled the foundation and knew that the corporation was to be liquidated after its contribution to the foundation.

The case raised the question of whether a taxpayer must choose the form of transaction that yielded the highest tax liability. Problematically for the I.R.S., the vote in favor of the liquidation had not yet taken place. There was no requirement that the foundation go through with the plan.

The Tax Court ruled that an expectation of an event is not enough to rearrange the order of steps chosen by the taxpayer. The I.R.S. would eventually acquiesce in Revenue Ruling 78-197.

Code: §7701(o)

Reasons for the Enactment of §7701(o)

The report from the Joint Committee on Taxation reveals the reasons behind the creation of Code §7701(o).[15] The case law, as illustrated by the cases described above and others, indicated a lack of consistency in the approach to the economic substance doctrine. No uniformity existed regarding the type of non-tax economic benefit a taxpayer must establish in order to demonstrate that a transaction has economic substance. Some courts denied tax benefits on the grounds that a stated business benefit of a particular structure was not, in fact, obtained by that structure. Other courts denied tax benefits on the grounds that the subject transactions lacked profit potential. Still others applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but these factors were insignificant when compared to the tax benefits. Also, courts differed on whether financial accounting benefits arising from tax savings qualified as a non-tax business purpose.

Several cases involved transactions structured to allocate income for Federal tax purposes to a tax-indifferent party, with a corresponding deduction, or favorable basis result, to a taxable person. The income allocated to the tax-indifferent party for tax purposes was structured to exceed any actual economic income to be received by the tax-indifferent party to the transaction.

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[14] 62 T.C. 284 (1974).

[15] JCX-18-10.

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Codification of the Economic Substance Doctrine

To help create a more unified doctrine, Congress enacted a statutory version of the economic substance doctrine. The codified rule provides that a two-prong test must be met in order for a transaction to have economic substance. The provision provides that, in the case of any transaction to which the economic substance doctrine is relevant, a transaction is treated as having economic substance only if

- the transaction changes in a meaningful way the taxpayer's economic position, apart from Federal income tax effects; and
- the taxpayer has a substantial purpose for entering into such a transaction apart from Federal income tax effects.

Under the second prong of the test, a taxpayer's non-Federal-income-tax purpose for entering into a transaction must be substantial. The provision does not mandate a minimum return. Rather, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

State or local income tax effect which is related to a Federal income tax effect will be treated in the same manner as a Federal income tax effect. Achieving a financial accounting benefit will not be treated as a purpose for entering into a transaction if the origin of the financial accounting benefit is a reduction of Federal income tax. Fees and other transactions are taken into account as expenses in determining pre-tax profit, and foreign taxes are to be treated as expenses per the Regulations.

"Under the second prong of the test, a taxpayer's non-Federal-income-tax purpose for entering into a transaction must be substantial."

The determination of whether the economic substance doctrine is relevant to a transaction is made in the same manner as if Code §7701(o) was not enacted.

Basic Business Transactions

The J.C.T. report states that the provision is not intended to alter the tax treatment of certain basic business transactions that are respected under longstanding judicial and administrative practice merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Illustrative examples of such transactions given by the J.C.T. report include the following:

- The choice between capitalizing a business enterprise with debt or equity.
- A U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment.
- The choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under Subchapter C of the Code.
- The choice to utilize a related-party entity in a transaction, provided that the arm's-length standard of §482 and other applicable concepts are satisfied.

As under present law, whether a particular transaction meets the requirements for specific treatment under any of these provisions is a question of facts and circumstances. Additionally, the fact that a transaction meets the requirements for specific treatment under any provision of the Code is not determinative of whether a transaction or series of transactions of which it is a part has economic substance.

Code §6662 Penalty

A 40% penalty applies under Code §6662(b)(6) where any portion of an underpayment is attributable to one or more undisclosed, non-economic substance transactions. The penalty calls for strict liability, and reasonable-cause arguments are not relevant. Reliance on the opinion of counsel is irrelevant, also. If the non-economic substance transaction is disclosed, the penalty is reduced to 20%. The disclosure is generally made on Form 8275 (Disclosure Statement). However, if a taxpayer takes a position that a Regulation itself is invalid, the appropriate form is Form 8275-R *(Regulation Disclosure Statement)*.

Notice 2010-62

The I.R.S. has issued Notice 2010-62, which advises taxpayers of the following:

- The law will be applied literally.
- Once it is determined that economic substance is relevant, both prongs of the legislative economic substance test must be met.
- Application of existing caselaw that applies only one leg of the two-pronged test will be challenged.
- The I.R.S. will not issue a Private Letter Ruling or determination letter regarding whether the economic substance doctrine is relevant to any transaction or whether any transaction complies with the requirements of §7701(o).
- The I.R.S. will continue to analyze when the economic substance doctrine will apply in the same fashion as under prior law.
- If authorities under prior law concluded that the economic substance doctrine was not relevant in determining whether certain tax benefits are allowable, the I.R.S. will continue to take that position.
- The I.R.S. anticipates that caselaw will continue to develop. This may be a euphemism that existing caselaw will be challenged.
- The I.R.S. does not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply.

Recent L.B.&I. Guidance

Previously, approval by the Director of Field Operations was required before the codified economic substance doctrine could be formally asserted. This reflected congressional concerns about overzealous I.R.S. examiners. But in 2022, the L.B.&I. (Large Business & International) Division issued a memorandum that removes the requirement to obtain executive approval before asserting the codified economic substance doctrine. Taxpayers are at greater risk of running afoul of the economic substance doctrine.

THE VIEW FROM THE EUROPEAN UNION

Background

Over the last decade, the international tax framework for holding companies operating in the European Union (the "E.U.") has grown increasingly complex. This complexity arises, *inter alia*, from the proliferation of anti-abuse rules designed to curb aggressive tax planning and ensure fair taxation. As a result, non-E.U. investors face a genuine challenge in navigating the fine line between legitimate tax planning, which may or may not be earmarked as aggressive, and abusive tax avoidance.

This section of the article aims to serve as a practical guideline to prevent E.U. holding structures from being classified as abusive leading to the potential denial of tax benefits.

We will first explore the advantages and restrictions associated with E.U. holding structures. Subsequently, we will delve into the primary abuse of rights within the E.U., drawing lessons from the so-called "Danish Cases" of the Court of Justice of the European Union (the "C.J.E.U."). Then, we will discuss the forthcoming substance requirements within the E.U. under the proposed Unshell Directive, also known as the third Anti-Tax Avoidance Directive ("A.T.A.D. 3"). Finally, we will review the similarities and differences between the Organization for Economic Co-operation and Development's ("O.E.C.D.") approach, specifically under the Principal Purpose Test (the "P.P.T."), and the E.U.'s approach under the general anti-abuse rules ("G.A.A.R.") found in the Parent-Subsidiary Directive (the "P.S.D.") and the A.T.A.D, as well as the general abuse principle recognized in the C.J.E.U.'s Danish Cases.

Tax Advantages and Restrictions for Holding Structures in the E.U.

Holding structures established or operating within the E.U. benefit from tax advantages under the applicable Double Tax Treaties ("D.T.T.") and national laws of E.U. Member States. In addition, they benefit from the following:

- Protection under E.U. primary law, namely the fundamental freedoms guaranteed by the Treaty on the Functioning of the European Union (the "T.F.E.U."), *i.e.*, the free movement of goods, services, persons, and capital.
- Potential advantages under E.U. secondary law, mainly the P.S.D. and the Interest and Royalties Directive (the "I.R.D."), which provide, *inter alia*, for no withholding tax ("W.H.T.") on dividend or interest payments made within the E.U. under specific circumstances.

Note, however, that the E.U. restricts or denies tax benefits for holding structures deemed abusive under the following:

- The general anti-abuse principle contained in E.U. primary law, as recognized in the C.J.E.U.'s "Danish Cases" that we will analyze below.
- Several anti-abuse provisions found in E.U. secondary law, including the following:
    - The Merger Directive (2009/133/CE) includes a Specific-Anti-Abuse Rule ("S.A.A.R.") under Article 15.
    - The P.S.D. (2011/96/E.U.) includes a S.A.A.R. under Article 1, §§ 2-4.

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- The I.R.D. (2003/49/E.C.) includes a S.A.A.R. under Article 5.
- The A.T.A.D. (2016/1164/E.U.) includes a G.A.A.R. under Article 6.

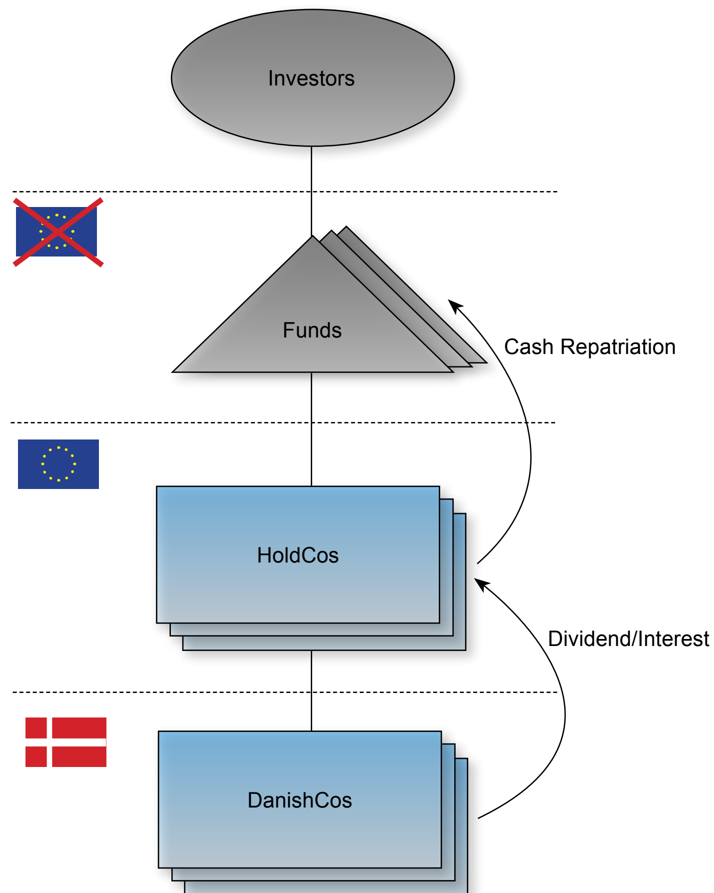
- Other relevant initiatives, such as the following:
  - The Directive on Administrative Cooperation ("D.A.C.") (2011/16/E.U.), which promotes cooperation among E.U. tax authorities to combat tax evasion and avoidance.
  - The E.U. Council's List of Noncooperative Tax Jurisdictions, which identifies jurisdictions that do not meet E.U. standards of tax transparency and cooperation.

Abuse of Rights in the E.U.: Lessons From the "Danish Cases"

In February 2019, the Grand Chamber of the C.J.E.U. delivered two landmark judgments, known as the "Danish Cases," addressing the issue of directive shopping under the P.S.D. and the I.R.D.

Since then, tax authorities in several Member States – including Belgium, France, Italy, the Netherlands, Spain, and Denmark – have relied on the Danish Cases to tackle cases of alleged directive shopping.

Background



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The main question in the Danish Cases was whether dividend and interest payments made by Danish operating companies to parent companies in other E.U. Member States such as Luxembourg, Cyprus, and Sweden were eligible for the W.H.T. exemption in Denmark when the income was fully or partially passed to non-E.U. ultimate parent companies and private equity funds located outside the E.U. in places such as Bermuda and the United States

The taxpayers applied the Danish W.H.T. exemption based on the P.S.D. and the I.R.D. However, the Danish tax authorities denied the W.H.T. exemption claiming that the E.U. parent companies were not the beneficial owners ("B.O.'s") of the payments but mere conduit companies. The case eventually ended up before the Danish High Court, which sought an answer from the C.J.E.U. regarding a preliminary question

General Anti-Abuse Principle

The Danish Cases raised the issue of how the prohibition of abuse of rights should be interpreted and applied under E.U. law. Specifically, the Danish courts asked the C.J.E.U. whether a Member State needed to implement a domestic anti-abuse provision to address abusive practices related to the P.S.D. and I.R.D.

This question was particularly relevant at the time because Denmark had not yet incorporated the P.S.D.'s anti-abuse provision into its national law. Therefore, the critical question was whether Denmark could deny tax benefits to a taxpayer under an anti-abuse provision that had not yet been implemented into national law.

Under the caselaw applicable at the time, a Member State could not apply a specific rule found in a directive if that Member State did not implement the directive into its national law. For example, in the *Kofoed* case (C-321/05), the C.J.E.U. considered that the anti-avoidance provision of the Merger Directive (20019/133/EC) reflected the general Community law principle that abuse of rights are prohibited, but required, that the transposition of an anti-avoidance rule be derived from the domestic general legal context to be in line with the principle of legal certainty. Therefore, and as expected, Advocate General Kokott followed the same conclusion in her opinion on the Danish Cases.

However, the C.J.E.U. disregarded the Advocate General's position and ruled that the E.U. principle regarding abuse of rights applies to prevent fraud or abuse even if domestic legislation has not been enacted. In other words, the C.J.E.U. ruled that Denmark had an obligation to counter abusive practices, even in the absence of a domestic G.A.A.R. in its national law or tax treaties. By doing so, the C.J.E.U. elevated the prohibition of abuse of rights to the rank of a general principle of E.U. primary law.

Note, however, that this principle applies only to rights derived from E.U. primary or secondary legislation, but not to rights based solely on domestic law or tax treaty laws of Member States.

Criteria to Assess Abuse

To determine the existence of an abuse, the C.J.E.U. reiterated the two-pronged tests provided in the *Emsland Stärke* Case (C-110/99), where it held the following:

> [A] finding of an abuse requires, first, a combination of objective circumstances in which, despite formal observance of the conditions laid down by the [E.U.] rules, the purpose of those rules has not been achieved [and, second] a subjective element consisting in the intention to obtain an advantage from the [E.U.] rules by creating artificially the conditions laid down for obtaining it.

In other words, the E.U. G.A.A.R. incorporates an objective component (*i.e.*, causing the purpose of the applicable rule to be defeated) and a subjective one (*i.e.*, the intention to artificially obtain an advantage).

Even if the subjective and objective elements of the abuse concept can sometimes be difficult to distinguish in cases such as *Cadbury Schweppes* (C-196/04), which involved a wholly artificial arrangement, it is important to note that these two components remain separate.

In the Danish Cases, the Court held that the following elements are suggestive of abuse, even if they must be considered jointly with all of the other facts and circumstances:

- Dividends are passed on to companies that would not have benefited from the advantages granted by the P.S.D. or the I.R.D. without the interposition of the intermediary holding company.
- The intermediary holding company makes little or insignificant taxable profit in the Member State where it is established, as payments that are received are primarily forwarded to a non-E.U. companies.
- The sole activity of the intermediate holding company is to receive dividends and pay them to the B.O. or another entity. This activity, however, must be assessed based on all the relevant facts regarding management, financial statements, costs incurred, staff, premises, and equipment.

Beneficial Ownership

Since the I.R.D. limits the eligibility for the interest W.H.T. exemption to the B.O. of the income, the Danish court requested the C.J.E.U. to provide guidance on the meaning of the term “B.O.” and on the relevance of the O.E.C.D.’s Model Tax Convention (“Model Treaty”) and its commentaries for its interpretation.

The situation was different for the benefits granted under the P.S.D., as this directive does not include a B.O. test. Consequently, the issues surrounding the P.S.D. cases focused on the interpretation of the term “B.O.” within the D.T.T.’s between Denmark and the jurisdictions of the E.U.-parent companies.

In both instances, the C.J.E.U. ruled that the concept of B.O. should focus on the actual recipient of the income, regardless of the person formally identified as such.

Practically speaking, a recipient will be deemed to be the B.O. where it receives the income for its own benefit. In contrast, a person is not a B.O. where it acts as an intermediary, such as an agent, trustee, or authorized signatory for someone else. In this respect, it is crucial for the recipient to be able to determine the use of the income freely.

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Advocate General Kokott proposed interpreting the B.O. concept autonomously under E.U. law, without regard to the commentaries on the O.E.C.D.'s Model Treaty She suggested that non-E.U. countries would otherwise have a say in the interpretation of the I.R.D. Nevertheless, the C.J.E.U. decided to adopt a more dynamic approach and stuck with the O.E.C.D.'s Model Treaty and its commentaries for interpreting the B.O. concept.

In a nutshell, the C.J.E.U. indicated that, in accordance with the O.E.C.D. commentaries on B.O., the fact that there is a legal or contractual obligation to pass on the dividend or, in fact, that dividends are passed on, should serve as an indication of abuse. Interestingly, the C.J.E.U. reproduced the O.E.C.D. commentary language, linking B.O. to a person that has the ability to use and enjoy those dividends.

Requirement of a Tax Advantage

The C.J.E.U. also reiterated the idea that a tax advantage is a *sine qua non* condition for abuse under E.U. law. In other words, there is no abuse if, in lieu of paying dividends directly to the B.O., a company decides to interpose an intermediate company without, however, benefiting from any tax advantage.

Burden of Proof

The C.J.E.U. diverged from Advocate General Kokott's opinion regarding the burden of proof in cases involving the B.O. receiving dividends and the denial of benefits under E.U. secondary law.

For the Court, national tax authorities are not required to automatically identify the B.O. but can request information from taxpayers to assess whether an abuse exists. If a taxpayer refuses to provide the requested information, benefits may be denied.

This does not mean, however, that there is a shift in the burden of proof from national tax authorities to taxpayers. The authorities still bear the responsibility of investigating potential abuse and must provide reasoning for the denial of benefits. However, this investigation can occur in certain cases, typically within the context of a tax audit, for which taxpayers are required to furnish the requested information.

Upcoming Substance Requirements – A.T.A.D. 3/Unshell Directive

On the legislative front, one of the tax developments in the E.U. is the Proposal for a Council Directive laying down rules to prevent misuse of shell entities for tax purposes. Introduced by the European Commission in December 2021, the Directive is commonly referred to as A.T.A.D. 3 or the Unshell Directive.

In the Explanatory Memorandum of the draft Proposal, the Commission explains the purpose of the directive:

> While important progress has been made in [the area of ensuring fair and effective taxation] in the last years, especially with the adoption of the Anti-Tax Avoidance Directive (A.T.A.D.) and the expansion of scope of the Directive on Administrative Cooperation (D.A.C.), legal entities with no minimal substance and economic activity continue to pose a risk of being used for improper tax purposes, such as tax evasion and avoidance, as confirmed by recent massive media revelations.

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In fact, within the E.U., legal personality is granted by Member States based on purely formal requirements such as minimum capital or minimum number of shareholders and without any review or checks of the economic activity of the entity. Therefore, it is relatively easy for non-E.U. investors to interpose an E.U. entity to enjoy advantageous tax treatment under D.T.T.'s, E.U. primary law such as the fundamental freedoms or secondary law such as the P.S.D. and the I.R.D., and national laws of Member States.

To combat inappropriate use of shell companies, the draft Proposal proposes rules to identify shell entities in the E.U., allow for the exchange information among Member States about identified shell entities, and deny E.U. tax benefits to identified shell entities. Purportedly, the goal is not to make shell entities disappear, but to avoid their abusive use for tax purposes.

If adopted and implemented, undertakings deemed as lacking minimal substance would be denied treaty benefits and benefits under E.U. primary and secondary law, particularly under the P.S.D. and I.R.D.

First Step: Is the Entity in Scope?

All E.U. entities are in scope, except entities with listed securities such as publicly traded stocks or bonds and regulated entities. In the initial proposal by the Commission, entities with at least five full times employees are also out of scope. However, this exclusion was removed by the European Parliament.

Note that, in contrast with the O.E.C.D.'s Pillar 1 and 2 initiatives, the A.T.A.D. 3/ Unshell Directive is not limited to large M.N.E.'s.

Second Step: Is the Entity at Risk?

The proposed Directive sets elements to identify undertakings that are at risk for lack of substance and potential misuse for tax purposes. It initially specifies the criteria that should lead to the obligation for taxpayers to report their substance on their tax returns. To be "at risk," an entity must meet three criteria:

- More than 65% of its income or assets are categorized as passive
- More than 55% of its activities or assets relate to cross-border transactions
- Administration and management are outsourced to a third-party

If an entity is at risk, it must report in its annual tax return whether

- premises are available for its exclusive use (shared use by entities of the same group also counts),
- at least one E.U. bank account is active, and
- at least one qualified director or the majority of the full-time employees live close to the undertaking and are involved in the decision-making process.

The current Proposal suggests that Member States impose a penalty of at least 2% of the entity's turnover for incorrect reporting or failing to report. In the event of a false declaration, an additional penalty of at least 4% of the entity's revenue would be imposed.

National tax authorities must assess each year whether an entity or undertaking is a shell based on the information furnished by the company. A presumed shell entity can present proof to show it has genuine economic activity and sufficient nexus with the Member State of which it claims to be a tax resident. Even if an entity is not a shell under the A.T.A.D. 3/Unshell Directive, it may still be still be considered a shell under national law.

Third Step: What if the Entity is a Shell?

Shell entities are not eligible for tax benefits under the network of D.T.T.'s in force and effect of the Member State in which tax residence is claimed. Also, it is not considered to be resident of that State for purposes of claiming benefits of certain European Directives, such as the P.S.D. and the I.R.D.

Similarities in the O.E.C.D. and E.U. Approaches to Abusive Tax Structures

Comparing the indicia used by the O.E.C.D. and the E.U. to determine the existence of abuse, certain factors are similar under both sets of rules.

Legal (Non-Tax) Reasons and Political Advantages

In the *Centros* Case (C-212/97), the C.J.E.U. acknowledged that the choice of an individual to incorporate a company in a Member State cannot be the sole reason for a corporate structure to be deemed abusive so that tax benefits are denied under E.U. law. The court stated:

> Choosing to incorporate in a Member State] whose rules of company law seem to him the least restrictive * * * cannot, in itself, constitute an abuse of the right of establishment.

Along the same line, the O.E.C.D. Model Treaty commentary on Article 29(9)(Example F) identifies factors that are considered legitimate for establishing a company in a specific jurisdiction. Included are the following:

- Skilled labor force
- Reliable legal system
- Business-friendly environment
- Political stability
- Membership of regional grouping
- Sophisticated banking industry.

Mere Presence of an Intermediate Holding is Not Decisive

In the *Eqiom* Case (C-6/16), the *Deister Juhler* Case(C-504/16), and the Danish Cases (C-116/16), the C.J.E.U. acknowledged that the mere interposition of a holding company cannot be the sole determining factor for identifying an abusive situation. Likewise, having a single owner or ultimate owner in the holding structure is not automatically an indication of abuse. The O.E.C.D. Model Treaty commentary on Article 29(9) is in line with this approach.

Multiple Investments

The fact that a holding company has multiple investments is an indication of non-abuse. This appears to be relevant for both the O.E.C.D. and the C.J.E.U. as implied in the *Deister Juhler* Case (C-504/16) and in the Danish Cases (C-116/16).

Beneficial Ownership

This concept is relevant for both the O.E.C.D. Model Treaty and the C.J.E.U. even though the outcome might be different.

Nationality or Residency of Ultimate Owner

Even though the C.J.E.U. appeared not to find the nationality/residence of a taxpayer relevant in the *Eqiom* Case (C-6/16) and the *Deister Juhler* Case (C-504/16), the opposite approach was taken in the Danish Cases (C-116/16). In the Danish Cases, the fact that the ultimate beneficial owner was based in a third country and would not benefit from the same favorable tax treatment had it received the income directly was indicative of abuse. By doing so, the C.J.E.U. aligned itself with the O.E.C.D. criteria.

Limited Economic Activity

The C.J.E.U. indicated multiple times that limited economic activity can be analyzed with other facts and circumstances as an indication of abuse. Companies that merely receive and pass on dividends are targeted by this approach. This is also the O.E.C.D.'s approach.

It should also be noted that, even though not yet formally adopted and subject to modifications, the A.T.A.D. 3/Unshell Directive brings additional substance elements to the analysis that imply abuse.

Differences in the O.E.C.D. and E.U. Approaches for Assessing Abusive Tax Structures

Despite their similarities, the O.E.C.D. approach with the P.P.T. and the E.U. approach with G.A.A.R. contain three main differences. As a result, the same set of facts and circumstances may be deemed abusive under one test, but not on the other.

Scope of Application

While the P.P.T. applies only in situations involving benefits derived from a D.T.T., the E.U. G.A.A.R. has a more comprehensive reach. The A.T.A.D., for example, applies to all taxpayers subject to corporate tax in one or more E.U. Member States, including entities with permanent establishments ("P.E'.s") in E.U. territories. In both instances, the P.P.T. and the G.A.A.R. have a subsidiary character, meaning that they apply even when a S.A.A.R. is applicable.

Abuse Threshold

On the one hand, the E.U. G.A.A.R., influenced by caselaw from the C.J.E.U., focuses on artificiality in arrangements, categorizing them as non-genuine and lacking valid commercial reasons reflecting economic reality. On the other hand, the O.E.C.D.'s P.P.T. employs a reasonableness test, evaluating the primary purpose of a transaction or structure and its relationship to core commercial activities.

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Burden of Proof

In the E.U., the responsibility of demonstrating abuse lies primarily with tax authorities, who must collect and present evidence to support their claims. In contrast, under the O.E.C.D.'s P.P.T., tax authorities bear the burden of proof regarding the element of intent while the taxpayer bears the burden of proof that the transaction is within the object and purpose of the particular benefit that is claimed under the applicable D.T.T.

"The legislation adopted by the B.V.I. and Cayman are similar in nature and require that an entity which carries on a relevant activity as defined below is required to satisfy the appropriate economic substance test in relation to the activity."

VIEW FROM THE B.V.I., CAYMAN, AND NEVIS

Background

This portion of the article focuses on economic substance legislation in the British Virgin Islands, the Cayman Islands, and Nevis.

The British Virgin Islands ("B.V.I."), Cayman Islands ("Cayman"), along with fellow U.K. Crown Dependencies and Overseas Territories, introduced Economic Substance Legislation in response to concerns of the E.U.'s Code of Conduct regarding favorable tax regimes. The targets of the Code of Conduct are those jurisdictions and tax regimes in non-E.U. Member States that generate profits without proper economic activity, resulting in potentially harmful economic consequences to Member States of the E.U. For this purpose, harmful economic consequences generally refer to lost tax revenue in the E.U. Member State with no offsetting tax imposed abroad or to hidden income of a tax resident in an E.U. Member State.

The legislation adopted by the B.V.I. and Cayman are similar in nature and require that an entity which carries on a relevant activity as defined below is required to satisfy the appropriate economic substance test ("E.S. Test") in relation to the activity.

Nevis is part of the Federation of St. Christopher ("St. Kitts") and Nevis (the "Federation"). While it is not a U.K. Crown Dependency or Overseas Territory. Nevis adopted a regulatory initiative requiring companies to file simplified tax returns with the local tax authority. The Nevis legislation draws no distinction between entities carrying relevant activities and those that do not.

Additionally, all three jurisdictions adopted legislation as part of their commitment to comply with the Base Erosion and Profit Shifting ("B.E.P.S.") initiative of the O.E.C.D., with a focus on B.E.P.S. Action 5 covering intellectual property regimes.

B.V.I. and Cayman

If a relevant entity In the B.V.I. and Cayman carries on at least one relevant activity, it must submit a return to the local authority. In the B.V.I., the local authority is the International Tax Authority and in Cayman it is the Department of International Tax Co-operation (each of which is the "T.I.A.").

Self-Certification

The return is submitted on an annual basis, providing certain prescribed information and demonstrating how the relevant entity has satisfied the E.S. Tests set out in the relevant legislation. The T.I.A. reviews the return and determines whether the relevant entity satisfies the E.S. Test.

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The process of determining whether a relevant entity is in scope for economic substance purposes is one of self-certification by its directors or controlling persons. However, the local authority has made it clear that each relevant entity will need to demonstrate the process leading to the self-certification. The material will be held in the entity's permanent files and will be made available to the T.I.A. upon request. Where a relevant entity conducts more than one relevant activity, the E.S. Test must be met in respect of each relevant activity.

Relevant Entities

In general, a relevant entity includes the following:

- A company that is incorporated in the B.V.I. or Cayman and an LLC formed in Cayman.
- A limited partnership registered in the B.V.I. or Cayman. For this purpose, a limited partnership formed in the B.V.I. includes a partnership without legal personality.
- A company incorporated outside of the B.V.I. or Cayman and registered as a foreign entity under the relevant local companies act.

Relevant entities do not include the following ("Excluded Entities"):

- Investment funds. However, if the investment fund conducts one or more separate and distinct activities that fall within the definition of a relevant activity under the local regime, it will be a relevant entity as to those activities. As a result, Directors and controlling persons must be mindful of the Economic Substance Act. Prudence dictates that a determination should be undertaken each year as to the scope of activities carried on by the investment fund other than investment business.
- An entity that is tax resident outside the B.V.I. or Cayman. While these entities are Excluded Entities, a return is required demonstrating tax residence abroad.
- Ordinary domestic companies resident in Cayman
- Trusts
- Not for profit associations

Relevant Activity

All B.V.I. or Cayman entities must submit a notice to the T.I.A. confirming whether a relevant activity has been conducted during the reporting period. Relevant activities include each of the following:

- Banking business
- Distribution and service center business
- Financing and leasing business (without consideration are excluded)
- Fund management business (B.V.I. Approved Manager exemption)

- Headquarters business
- Holding company business (pure equity holding entities have reducing economic substance return requirements)
- Insurance business
- Intellectual property business
- Shipping business

Requirements of the E.S. Test

A relevant entity conducting at least one relevant activity will satisfy the E.S. Test, if the relevant entity

- conducts core income generating activities ("CIGA") from within the B.V.I. or Cayman in relation to that relevant activity,
- is directed and managed appropriately from within the B.V.I. or Cayman, and
- having regard to the level of relevant income derived from the relevant activity carried out from within the B.V.I. or Cayman
  - has an adequate amount of operating expenditure incurred in the jurisdiction,
  - has an adequate physical presence, and
  - has an adequate number of full-time employees or other personnel with appropriate qualifications in the jurisdiction.

In applying the last bullet of the E.S. Test, the term "adequate" means as much or as good as necessary for the relevant requirement or purpose. The term "appropriate" means suitable or fitting for a particular purpose, person, or occasion.

Outsourcing

In both the B.V.I. and Cayman, a relevant entity can satisfy the E.S. Test in relation to a relevant activity by outsourcing relevant CIGA to another person in the B.V.I. or Cayman. Where that path is taken, the entity must monitor and control how the CIGA is carried on by the third party in the jurisdiction. If the CIGA is monitored and controlled by someone outside B.V.I. or Cayman, the E.S. Test will not be met.

While the relevant entity in the outsourcing arrangement files the tax return and self-certifies its compliance, the T.I.A. is in contact with the service provider who may need to verify information submitted to the T.I.A. by the relevant entity.

In no event may the outsourcing be employed to circumvent the E.S. Test.

Economic Substance Classification and Filing

For both jurisdictions, the Directors and controlling persons of the relevant entity are responsible for classifying and ensuring submission of the applicable Economic Substance return with the local authority.

Penalties

Financial penalties can be imposed in the B.V.I. or Cayman for non-compliance or failing to meet the E.S. Test. Penalties are also imposed for the failure to file the Economic Substance Return and for the failure to file the return on time. If the compliance failure is criminal in nature, Cayman law calls for fines and imprisonment.

Nevis

The Federation operates a worldwide system of corporate income tax. Companies that are tax resident in the Federation are taxable on a worldwide basis. Companies that are not Federation tax residents are taxed only on income that is sourced in the Federation. This approach to tax differs significantly from the approach that adopted by the B.V.I. or Cayman.

Tax Residence

The Federation is a commonwealth jurisdiction. Federation law does not define the term "resident." Consequently, the term resident is interpreted by reference to common law.

In broad terms, a company is deemed to be tax resident in the jurisdiction where management and control occur. Tax residence in the Federation is determined by the central management and control test, as established under common law.

Central management and control is not daily operational management. Normally, central management and control is considered to be located in the jurisdiction where the board of directors convene and make management decisions on behalf of the company. This general rule is supplemented by ensuring that the board of directors is capable of making business decisions. Consequently, board members must consist of individuals suitably qualified and capable of managing the affairs of the company. Key strategic decisions of the company (especially relating to its business should be made at meetings of the board of directors. These decisions relate to capital structure, business strategy, investments, and dividend policy. All these requirements should be documented in minutes of meetings of the board of directors.

"In broad terms, a company is deemed to be tax resident in the jurisdiction where management and control occur."

If a company's management and control are located outside the Federation and no income is generated within the Federation, it will not be considered a tax resident of the Federation. Thus, it is important for the board of directors to serve a real function in the governance of a Nevis company. The delegation of corporate secretarial type functions to third parties in the Federation will not result in the company having its central management and control in the Federation.

Business Enterprise

Where a company is tax resident is determined separately from where it has its legal seat. A company's incorporation in the Federation does not mean it will be tax resident there. It is also possible for a company to be incorporated outside the Federation and a tax resident in the Federation.

Where a company is not tax resident in the Federation, it will be taxable in the Federation if activities carried on in the Federation amount to a Business Enterprise. A resident/non-resident company must take a factual approach of its business

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operations to assess if it meets the definition of having a Business Enterprise, and thus taxable in the Federation on its income connected with operations carried out in the Federation. This must be done on a case-by-case basis.

Where a company has a Business Enterprise in the Federation, it would be liable for tax. Alternatively, where a company is not tax resident in the Federation and does not have a Business Enterprise in the Federation, it would fall outside the scope of tax and would not be taxable in the Federation.

The establishment of a financial account in the Federation should not give rise to the nonresident having a Business Enterprise in the Federation. Similarly, the delegation of corporate secretarial, shareholder nominee services, or other administrative functions to corporate service providers in the Federation should not lead to the creation of a Business Enterprise in the Federation.

Tax Returns

Taxable entities in the Federation must file the required tax return on an annual basis. The tax return is due not later than three and one-half months after the fiscal year-end of the entity.

The official filing date depends on the delivery method. If the tax return is hand delivered, the return will be date stamped by the Inland Revenue Department (the "I.R.D.") on the day it is received by the department and that date will be considered the filing date. If the tax return is mailed or delivered by some other delivery method, the postmarked date will be considered the date of filing. In the event that a tax return is filed late, penalties and interest will be applied.

Entities classified as nonresidents will be required to file a Simplified Tax Return annually with the I.R.D. This requirement to file the Simplified Tax Return for nonresident entities applies to all entities that are registered under the Nevis Business Corporations Ordinance and the Limited Liability Companies Ordinance. Directors of Nevis corporations and managers of L.L.C.'s are required to sign a declaration and provide the I.R.D. with information about tax residence, activities, and income of entities.

The Simplified Tax Return will need to be filed by the local registered agent of the entity. However, all required information must be provided by the directors or managers of the entity.

EFFECT OF RULING NO. 288/2023 – ITALIAN ANTI-HYBRID RULES ATTACK THE 2020 SWISS CORPORATE TAX REFORM

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Ruling No. 288/2023

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INTRODUCTION

Under the O.E.C.D./G-20 Base Erosion and Profit Shifting ("B.E.P.S.") initiative, hybrid mismatch arrangements have become a sensitive issue. This position culminated in the proposed anti-hybrid rules, *i.e.*, linking rules, to counter the double non-taxation resulting from double deductions or deductions without the inclusion of income by a counterparty.

Within the European Union ("E.U."), the Anti-Tax Avoidance Directive (E.U. Directive 2016/1164)[1] ("A.T.A.D. 1") introduced secondary legislation to ensure an effective and coordinated implementation of anti-avoidance tax measures. It establishes a minimum standard among Member States for countering tax practices that could affect the functioning of the internal market. An anti-hybrid rule is among the anti-tax avoidance measures contained in the A.T.A.D. 1. Among other things, it counters hybrid mismatches that arise in transactions touching corporate tax systems of two or more E.U. Member States.

Given the limited scope of A.T.A.D. 1, the Council decided that it was necessary to strengthen the level of protection against hybrid mismatches in the internal market. Consequently, the Council enacted Anti-Tax Avoidance Directive (E.U. Directive 2017/952)[2] ("A.T.A.D. 2"), which extends the scope of A.T.A.D. to third-country situations and counters new forms of asymmetric tax outcomes caused by permanent establishment ("P.E.") mismatches, imported mismatches, reverse hybrid mismatches, tax residence mismatches, and hybrid transfers.

THE ITALIAN ANTI-HYBRID RULES

Legislative Decree no. 142/2018[3] (the "Italian A.T.A.D. Decree") transposes A.T.A.D. 1 and A.T.A.D. 2 into the Italian tax system without significant deviation. It provides rules against the erosion of the tax base of E.U. Member States and the shifting of profits, including anti-hybrids rules.[4] The Italian anti-hybrid rules apply to fiscal years beginning on or after January 1, 2020, except for the provisions targeting the reverse hybrid mismatches, which will apply to fiscal years beginning on or after January 1, 2022.

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1 Council Directive (E.U.) 2016/1164 of July 12, 2016.

2 Council Directive (E.U.) 2017/952 of May 29, 2017.

3 Legislative Decree no. 142 of November 29, 2018.

4 Reference is made to Articles from 6 to 11 of the Italian ATAD Decree.

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Qualifying Taxpayers

The Italian anti-hybrid rules apply to all persons subject to Italian corporate income tax ("*Imposta sul reddito delle società – IRES*,"), generally imposed at the rate of 24%, including Italian P.E.'s of nonresident companies, partnerships treated as fiscally transparent under the Italian tax law, and individual entrepreneurs.

Scope

Mismatches involving taxpayers considered to be controlling or controlled enterprises located in different jurisdictions or arising in the context of a structured arrangement between two independent enterprises, wherever located, are covered by the Italian anti-hybrid rules. The notion of control[5] and structured arrangement[6] is in line with the definitions of under A.T.A.D. 1 and A.T.A.D. 2.

The Explanatory Note to the Italian A.T.A.D. Decree is aligned with point 28 of the Preamble to A.T.A.D. 2, and mirrors the explanations and examples included in the 2015[7] and 2017[8] O.E.C.D. B.E.P.S. Report on Action 2 – Hybrid Mismatch, which is a primary source of interpretation.

The purpose of the Italian anti-hybrid rules is to prevent double nontaxation by eliminating the tax advantages of mismatches and to put an end to (i) multiple deductions for a single expense, (ii) deductions in one country without corresponding taxation in another, and (iii) the generation of multiple foreign tax credits for the amount of a single foreign tax paid.

In particular, the Italian anti-hybrid rules target payments under a hybrid mismatch arrangement that give rise to one of the following three outcomes:

- **Deduction and non-inclusion mismatch ("D/N.I.").** This arises when a payment results in a deduction in one jurisdiction with no corresponding inclusion in the taxable base of the recipient located in the other jurisdiction. The D/N.I. must be derived from different tax treatment (irrespective of the legal label) in the two jurisdictions involved in an instrument, payment, entity, or branch.
- **Double deduction ("D/D").** This occurs when taxpayers are entitled to a deduction in two countries for the same payment.
- **Indirect D/N.I.** This relates to payments that are deductible by the payor under the rules of the its jurisdiction of residence but are not subject to tax in the jurisdiction of residence of the payee.

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[5] Reference is made to Council Directive (E.U.) 2016/1164 of July 12, 2016, Article paragraph 1, no. 4.

[6] Reference is made to Council Directive (E.U.) 2017/952 of May 29, 2017, Article 1, paragraph 1, no. 2, lett. c.

[7] O.E.C.D. (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2, OECD/G20 Base Erosion and Profit Shifting Project*, OECD Publishing.

[8] O.E.C.D. (2017), *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project*, OECD Publishing.

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Payments made under hybrid financial instruments and payments made by and to hybrid entities can give rise to D/N.I. Regarding D/N.I., the Italian anti-hybrid rules deny the deduction in the payer jurisdiction (the primary rule intervention). In the event the payer jurisdiction does not neutralize the mismatch, an additional defensive rule requires the payment to be included as ordinary income and taxed in the payee jurisdiction (the secondary rule intervention).

In line with point 11 of the Preamble to A.T.A.D. 1, the Explanatory Note to the Italian A.T.A.D. Decree clarifies that the Italian anti-hybrid rules are intended to address only cross-border mismatches and do not apply to mismatches arising between two taxpayers resident in Italy.

"In the event the payer jurisdiction does not neutralize the mismatch, an additional defensive rule requires the payment to be included as ordinary income and taxed in the payee jurisdiction. . ."

DEFINITION OF HYBRIDS AND MISMATCH ARRANGEMENTS

Hybrid mismatch arrangements may be divided into two broad categories, (i) hybrid instruments and (ii) hybrid entities.

Hybrid instruments may be further divided into hybrid transfers, in which persons in two or more jurisdictions claim ownership rights, and hybrid financial instruments, which are intended to allow the counterparties to take different positions as to the tax treatment of the same payment under an instrument.

In line with A.T.A.D. 2, the Italian A.T.A.D. Decree identifies different ways in which a D/N.I. (including an indirect D/N.I.) or a D/D mismatch can arise. They include the following:

- **Use of hybrid financial instruments.** A hybrid mismatch could arise where the D/N.I. is attributable to the differences in the tax treatment of the instrument or the payments made under the instrument. Examples include an instrument treated as a debt in the payer jurisdiction, but treated as equity subject to a participation exemption regime in the payee jurisdiction. Here, the payer will be entitled to a deduction for the interest payment, but the payee does not include the amounts received in taxable income.
- **Disregarded hybrid payments.** Here, a hybrid payment is deductible in the residence country of the payer, such as Italy, but is not recognized as a payment in the residence country of the payee, such as Switzerland.
- **Structures producing double deductions.** Here, a hybrid structure exists, allowing taxpayers in two countries, such as Italy and Switzerland, to claim a deduction for the same payment.
- **Reverse hybrid.** Here, there is a mismatch in identifying the taxpayer in a payment received by the entity, often a transparent partnership. In the country of residence of the entity (Italy), the payment is treated as income of its shareholder. At the same time, in the country of residence of the shareholder (Switzerland), the payment is treated as income of the entity.
- **Dual resident entities.** Here, an entity is treated as a tax resident in two different countries such as Italy and Switzerland, enabling it to obtain benefits of domestic laws or treaties of both countries.

- **Imported mismatches.** Here, a country (Italy) is denied a deduction for a payment to a resident of a second country where all of the following conditions are met:
    - The recipient is resident in a country (Switzerland) that does not have hybrid mismatch rules.
    - The payment does not itself give rise to a hybrid mismatch for the payor.
    - The taxable income of the recipient is reduced by a payment that gives rise to a hybrid mismatch or a payment made to a third person that claims the benefit of a hybrid mismatch.
- **Deemed branch payments.** Here, there is a notional payment by a taxpayer that is not calculated by reference to an actual expenditure recognized in its accounts.
- **Branch payee mismatches.** Here, (i) a taxpayer in a country (Italy), (ii) maintains a branch outside of that country (Switzerland), (iii) claims a deduction for a payment to the branch, and (iv) taxable income is not recognized by the branch.

Important Caveat

Since cross-border mismatches may also arise in other contexts (*e.g.*, the payment (i) is deductible, (ii) is characterized as interest, and (iii) is paid to a tax-exempt entity), the only types of mismatches targeted by the Italian anti-hybrid rules are those that rely on a hybrid element to produce such outcomes.

CIRCULAR LETTER NO. 2/2022 – GUIDELINES FURNISHED BY THE ITALIAN TAX AUTHORITIES

On January 26, 2022, the Italian tax authorities published Circular Letter no. 2/2022 furnishing general instructions on Italian anti-hybrid rules.[9] The most important clarifications address the following items:

Taxes Covered by the Italian Anti-Hybrid Rules

The Italian tax authorities clarified that the Italian A.T.A.D. Decree does not apply to regional tax ("*Imposta regionale sulle attività produttive – I.R.A.P.*"), generally imposed at the rate of 3.9%. Where an income tax treaty covers local taxes such as regional and municipal taxes, the Italian anti-hybrid rules only consider taxes applied at the national level.

Definition of Negative Item of Income

The Italian tax authorities clarified that this notion should be interpreted in a broad way including any item of cost correlated with a financial flow. Examples listed by the Italian tax authorities include service fees, rental fees, interest expense, and royalty payments. Interestingly, it does not include cost of goods sold.

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[9] The Italian tax authorities published tax ruling no. 833/2021 on December 17, 2021, providing a preliminary set of limited clarifications on the Italian A.T.A.D. Decree on a cross-border royalty payment's scheme.

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Special Tax Regimes

The Italian tax authorities affirmed that no hybrid mismatch or transaction can be challenged when the non-inclusion is caused by a tax status of financial instruments or by a tax exemption regime applicable to the beneficiary for other D/N.I. transactions or as a consequence of a special tax regime.

Nature of Anti-Hybrid Rules

The Italian tax authorities stated that the Italian anti-hybrid rules qualify as tax system rules and not as anti-avoidance rules. This means that if a hybrid mismatch and a tax evasion are challenged as a consequence of a tax audit, possible criminal violations may arise in addition to the tax consequences.

Although the Circular Letter was composed of 115 pages and various examples, the Italian tax authorities do not address all open points previously raised by stakeholders.

RULING NO. 288/2023 –UPDATED GUIDANCE ON THE ITALIAN A.T.A.D. DECREE

On April 7, 2023, the Italian tax authorities issued tax ruling no. 288/2023 (the "Ruling"), furnishing additional administrative interpretations of the Italian A.T.A.D. Decree. The facts in the Ruling involved a Swiss parent company belonging to a multinational group. The ultimate parent company of the group was a U.S. resident entity. The Italian member of the group was owned by a Swiss intermediary parent company. The Italian company acted as a limited risk distributor. It's purchases of inventory from the Swiss parent ultimately were taken into account in determining cost of goods sold ("C.O.G.S.").

Through the close of tax year 2019, the Swiss parent company computed taxable income in Switzerland under the Principal company regime. For Swiss federal tax purposes, that regime provided for the unilateral recognition in Switzerland of the existence of a deemed foreign P.E. and the attribution to the P.E. of part of the Swiss company's profits. In a nutshell, this specific regime allowed the Swiss company to reduce the base upon which taxable income was computed.

From January 1, 2020, the Principal company regime was abolished pursuant to the Swiss Corporate Tax Reform.[10] This led to a repatriation by the Swiss company of its deemed P.E. and a step-up in the adjusted cost basis of the foreign-originated goodwill acquired in the deemed repatriation. The stepped-up cost basis could be amortized over a ten-year period.[11] The amortization could be applied to offset gross profit on sales to internal or external customers or distributors.

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[10] Reference is made to Federal Act on Tax Reform and AHV Financing (May 19, 2019 – Effective date January 1, 2020), and to Swiss Federal Tax Administration, Circular Letter no. 8 (November 15, 2018 – Effective date January 1, 2020), "International tax allocation for principal companies."

[11] Reference is made to Article 61a, par. 1 and 2 of Swiss federal act on Federal Direct Tax of December 14, 1990, allowing taxpayers to declare for Swiss income tax purposes any hidden reserves (including any goodwill) existing at the "beginning of taxation" in Switzerland, without this giving rise to any tax liability.

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In response to a question raised by an Italian company, the Italian tax authorities ruled that the amortization of the notional goodwill value in Switzerland triggered the application of the Italian anti-hybrid rules for D/N.I.[12] The Italian tax authorities explained that the step-up in adjusted cost basis for the foreign-originated goodwill and the of related amortization deductions led to a hybrid mismatch that falls within the scope of the Italian A.T.A.D. Decree.[13] The foreign-originated goodwill represented a negative item of income that triggered a deduction without a corresponding attribution of income in the country (*i.e.*, Italy) where the P.E. was deemed to exist.

Based on the above, C.O.G.S. incurred by the Italian company could not be claimed as an offset to sales when computing gross income to the extent of the amortization deduction claimed by the Swiss company for the accounting period in issue.

Effect on Other Companies

The interpretation provided with the Ruling is not binding on the applicant or other taxpayers. However, the answer given by the Italian tax authorities in tax rulings is strictly followed as guidance and scrutiny practice by tax auditors.

COMMENTS ON THE RULING

The Ruling reflects a hidden assumption that the Swiss tax regime in force from 2020 is a mere extension of the Principal company regime in force through the end of 2019. The Swiss company was unilaterally allowed to step up an amount of notional goodwill and to amortize that amount over a 10-year period. Nothing was paid by the Swiss company to acquire the goodwill. It was simply a consequence of the termination of the Principal company regime. Viewed in that light, it was analogized to old wine in new bottles.

"Whether the belief of the Italian tax authorities is correct is an open question."

Whether the belief of the Italian tax authorities is correct is an open question. The new regime in Switzerland calls for full taxation of profits from sales to the Italian subsidiary. The allowance of amortization deductions is not a special tax regime. Indeed, the Swiss treatment is aligned with rules in force in most European countries.

The rationale of the Italian A.T.A.D. Decree is clear. The Italian A.T.A.D. Decree does not (and cannot) interfere with the tax policy of a government. If Switzerland wishes to foster the Swiss companies engaging in international trades, without exploiting legislative loopholes, it is free to do so.

The Italian tax authorities seem to overrule that approach in the Ruling.

FINAL QUESTIONS

Several questions remain open by the Ruling, and depending on the answer, over-reaching may have occurred.

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12 Reference is made to Article 8, par. 3 of the Italian A.T.A.D. Decree.

13 Reference is made to Article 6, par. 1, letter no. 5 of the Italian A.T.A.D. Decree.

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Is the distortion caused by a hybrid mismatch or by a mere introduction of new tax legislation in Switzerland?

In Circular Letter no. 2/2022, the Italian tax authorities clarified that no hybrid mismatch/transaction can be challenged whenever the non-inclusion is caused by (i) special tax status for a financial instrument, (ii) a tax exemption regime enjoyed by the taxpayer for other D/N.I. transactions, or (iii) as a consequence of a special tax regime. Here, the new legislation was enacted through a wide ranging Swiss tax reform. Should that be sufficient to lead to the conclusion that it is something different from a special tax regime?

Moreover, according to the principle of rule of law, the Italian A.T.A.D. Decree may only tackle mismatches deriving from the hybrid instruments and arrangements expressly listed in the Italian A.T.A.D. Decree.[14]

Which provision of Italian A.T.A.D. Decree expressly addresses the transaction in the Ruling?

The Ruling does not fall in any of the hybrid mismatches identified by the Italian A.T.A.D. Decree.

In the Ruling's fact pattern, no payment or cash flow associated caused the goodwill.[15] The Italian tax authorities in fact affirmed that the notional value was recognized by the Swiss company as a consequence of the termination of the Principal company regime. This means that there is no positive item of income correlated to the supposed negative item of income – the amortization deduction generated by the deemed repatriation of goodwill to Switzerland – and that the distortion is caused only by the enactment of new legislation in Switzerland.

Nonetheless, the Italian tax authorities took a highly formalistic approach in justifying its conclusion. It stated the following:

> [I]n other words, the goodwill amortization represents, from a substantial point of view, the method to recognize for tax purposes, even after the abolition of the Principal company regime, the 'internal dealing' between the Swiss parent company and the deemed permanent establishments. This mechanism will allow to transfer negative items of income otherwise not existent.

Where can we find an "internal dealing" if the structure is grounded on a Swiss domestic tax relief?

There is no internal dealing. The Italian tax authorities purport that the termination of the Principal company regime is a notional repatriation of the deemed permanent establishments, which should be a taxable event in Switzerland. However, the amortization deductions over the 10-year period eliminate tax.

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[14] Reference is made to Articles 8, 9, and 10 of the Italian A.T.A.D. Decree.

[15] The example of Circular Letter no. 2/2022 reported in the Ruling to support the Italian tax authorities' reconstruction of the events relates to a foreign company that purchases intangible assets to deduct the relevant annual amortization amounts. However, there is no purchase or payment in the facts involved in the Ruling.

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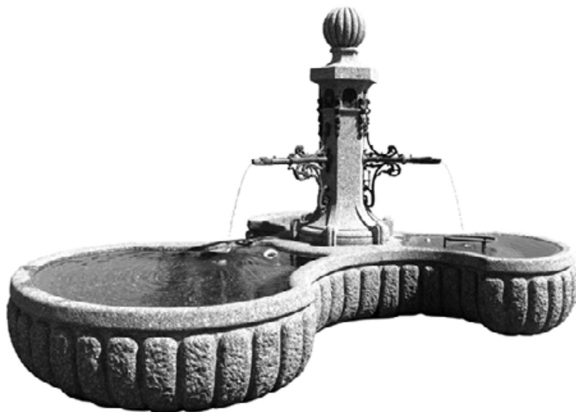
In other words, the goodwill's amortization for the Italian tax authorities represents internal dealing between the Swiss head office and the deemed permanent establishment that results in the creation of nontaxable income.

In our view, the conclusion of the story is best described as follows:

- The Italian tax authorities seem to be offended by the old Principal company regime.
- On this basis they claimed that the old regime pollutes the new regime (and its transitional measures) in force beginning fiscal year 2020.

This approach may appear appealing, but it is not convincing.

A more detailed analysis of the technical issues shows that the arguments developed by the Ruling seems to be weak and disputable in point of fact and in point of law. Rather than a replacement or continuation of the old regime, the new regime is a "totally" distinct regime.



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THE POUR-OVER CLAUSE IN A CROSS-BORDER CONTEXT

Author
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Alter Ego Trust
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Waslenchuk Estate

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INTRODUCTION

With all the career and job opportunities available, many Canadians and Americans choose to cross the border to pursue new goals. Providing trust and estate planning advice to Canadians living in the United States and Americans living in Canada is no longer a rare situation. Where an individual has spent part of his[1] life in one country and part in the other, his will and power of attorney may have been executed in one country but not amended following the arrival in the other country. In case of incapacity or death, this may cause serious headaches to family members. Even though *inter vivos* and testamentary trusts are used in both Canada and the United States, the estate planning strategies differ depending on the jurisdiction in which implemented. For example, U.S. revocable trusts, also called living trusts and grantor trusts, are frequently used in the United States. For assets transferred to the trust while the grantor is alive, the U.S. revocable trust avoids the probate process and acts as a will substitute. Those assets are transferred in accordance with the provisions of the trust, not the will.

A U.S. revocable trust may also be used to receive assets upon the grantor's death. One mechanism to achieve a transfer of assets from the grantor's estate to the revocable trust is the pour-over will that includes a pour-over clause. A pour-over will covers assets that were not transferred into the U.S. revocable trust while the grantor was alive. A pour-over clause is a provision directing that all or part of the grantor's estate be added to the corpus of an existing trust which is revocable and amendable. The validity of the pour-over clause is recognized in the United States. However, in Canada, courts have been hesitant to recognize the validity of a pour-over clause included in a Canadian will.

TYPES OF TRUSTS IN CANADA

For Canadian tax purposes, a testamentary trust is a trust that arose on and as a consequence of the death of an individual.[2] An "*inter vivos* trust" means a trust other than a testamentary trust. It is a trust set up during the settlor's lifetime or a testamentary trust that has lost its qualification as a testamentary trust. The person setting up an *inter vivos* trust is generally referred to as the "settlor" whereas the testator would be the person creating a testamentary trust.

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[1] In this text, the masculine includes the feminine and is used only to ease the reading.

[2] Subsection 108(1) of the *Income Tax Act*, R.S.C. 1985, c.1 (5th Supplement), as amended, hereinafter referred to as the "I.T.A."

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In Canada, *inter vivos* trusts are typically set up to hold private company shares to split income and capital gains among the beneficiaries and for asset protection.

As for testamentary trusts, a spousal testamentary trust may be recommended where the testator wishes to maintain some control over assets following the testator's death, while benefiting from the rollover that allows a transfer of assets at death on a tax-deferred basis.[3] Taxes are payable upon death of the surviving spouse,[4] and the remaining assets may be transferred outright to beneficiaries or to testamentary trusts.

Where assets are transferred to a testamentary trust that does not qualify as a spousal testamentary trust, the deceased individual is deemed to have disposed of his assets[5] immediately before death and income taxes are payable on the accrued gain.[6] Fifty percent of the gain is taxable.

Prior to 2016, the main difference between an *inter vivos* trust and a testamentary trust was that income earned by the testamentary trust was taxed at graduated rates, as is the case for individuals, while the income earned by an *inter vivos* trust was taxed at the highest marginal tax rate. Tax savings could be obtained by splitting income between the testamentary trust and the trust beneficiaries. For example, if the trust had two beneficiaries, it was possible to tax part of the trust income inside the trust at graduated rates, and to tax part of the trust income in the hands of the beneficiaries. Tax savings could be realized, especially where the beneficiaries had no other income. In addition, prior to 2016, the spousal testamentary trust was a popular tax strategy as income could be split between the trust and the spouse. Beginning in 2016, the spousal testamentary trust no longer provides tax benefits. For non-spousal testamentary trusts with several beneficiaries, tax savings can still be achieved by splitting income among the beneficiaries.

Therefore, prior to 2016, considering the tax savings that could be achieved with a testamentary trust, using an *inter vivos* trust to transfer assets at death was not a widespread strategy. But things changed in 2016, when the Canadian government decided to tax income from both *inter vivos* and testamentary trusts at the highest marginal tax rate.[7] The same applies at the provincial level. As such, a trust pays tax on its income at the highest marginal tax rate applicable in the province where the trust resides.

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[3] Subsection 70(6) I.T.A.

[4] Or if the trust sells assets.

[5] Some exceptions apply.

[6] Subsection 70(5) I.T.A.

[7] Subject to two exceptions, one being an estate that qualifies as a graduated rate estate or G.R.E. for the 36-month period following the death of the testator and the other being a qualified disability trust set up for an individual who may claim the Canadian disability tax credit. These trusts may benefit from the graduated tax rates (but for a maximum of 36 months for the G.R.E.).

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REVOCABLE TRUSTS IN CANADA

The Canadian Income Tax Act contains provisions allowing a taxpayer to set up an *alter ego* trust,[8] if aged 65 or over, or a self-benefit trust.[9] In both cases, assets can be transferred to the trust on a tax-deferred basis and the trust can generally be revoked during the settlor's lifetime. Taxes are payable when the trust sells assets and upon the settlor's death.

Whereas a self-benefit trust may not have contingent beneficiaries, an *alter ego* trust may. An individual aged 65 or over may transfer property to an *alter ego* trust on a rollover basis if the following conditions are met:[10]

- The trust was created after 1999.
- The trust and the individual are resident in Canada.
- The individual is entitled to receive all the trust income during his lifetime.
- No other person than the individual may, before his death, receive or otherwise obtain the use of any of the income or capital of the trust.

Even though only the settlor may receive or obtain the use of any of the income or capital of the trust during his lifetime, the trust may include contingent beneficiaries who may receive income and capital from the trust following the settlor's death. This strategy allows for assets to be transferred according to the provisions of the *inter vivos* trust, rather than under a will. For example, Mother could set up an *alter ego* trust to which she transfers her real estate and investment portfolio. This transfer will be made on a tax-deferred basis. The trust can provide that upon her death, her children will become beneficiaries of the trust. The assets within the trust are not subject to probate and the beneficiaries can access the assets without delay.

As such, the *alter ego* trust can be used in the estate planning context as a will substitute. However, as the trust document will not deal with all the steps required to liquidate the estate, and as some assets may be kept outside the trust, a simple will to govern the liquidation of the estate usually would be drafted.

When choosing which assets should be transferred to an *alter ego* trust, one must remember that pension plans such as Registered Retirement Savings Plans and Registered Retirement Income Funds, cannot be transferred to a trust without triggering tax. Property such as an investment portfolio, a principal residence, a cottage, rental property, shares of operating and holding companies, and cash can be transferred to the *alter ego* trust. The *alter ego* trust also serves as a tool for asset protection purposes.

The *alter ego* trust may be set up as an alternative to a power of attorney or enduring power of attorney (or protection mandate in the province of Quebec) for managing the assets of the settlor. This may be appropriate when the settlor has health problems that affect his mental capacity, such as Alzheimer's disease, or if there are doubts about the attorney's honesty and integrity. The settlor may be one of the

[8] A joint spousal or common-law partner trust may also be set up. In such a case, taxes are payable upon death of the surviving spouse. Subsection 248(1) I.T.A.

[9] Subsections 73(1), (1.01)(c)(ii), and (1.02)(ii) I.T.A.

[10] Subsections 73(1), (1.01)(c)(ii), and (1.02)(i), and 248(1) I.T.A.

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trustees and should he lose capacity, the trust will remain in place, with the remaining or replacement trustees.

Prior to 2016, using an *alter ego* trust for estate planning purposes could have triggered higher taxes. But since 2016, as explained above, income from both types of trusts is taxable at the highest marginal tax rate. As such, from a tax rate point of view, there is no difference between the two anymore.[11]

Considering the conditions that must be met for a trust to be an *alter ego* trust, a U.S. revocable trust would most likely not qualify as an *alter ego* trust.

Another point worth mentioning is that while a U.S. revocable trust is ignored for U.S. tax purposes, it is treated as a regular trust in Canada. This means that a transfer of assets to the U.S. revocable trust while the grantor/settlor is alive would trigger a deemed disposition for Canadian tax purposes and taxes would be payable on the accrued gains.[12]

THE POUR-OVER CLAUSE IN THE U.S.

A U.S. revocable trust (also called living trust or grantor trust) refers to a trust that is set up during the lifetime of the grantor, that can be amended and totally revoked while the grantor is alive.

The revocable trust is often used as an estate planning strategy. As mentioned above, assets can be transferred to the trust while the grantor is alive or upon the grantor's death. One advantage of the revocable trust is that it avoids the probate process upon the grantor's death on the assets that have been transferred to the trust while the grantor was alive. In case of incapacity or death, the trust may continue and is not automatically wound up. When used to transfer assets upon the grantor's death, a pour-over clause will often be used. As already mentioned, a pour-over clause is a provision directing that all or part of the grantor's estate be added to the corpus of an existing trust.

THE POUR-OVER CLAUSE IN CANADA

Situations where a pour-over clause may be used or considered in the Canadian context include the following:

- A U.S. citizen who set up a U.S. revocable trust while living in the United States moved to Canada on a permanent basis and wishes to transfer his Canadian assets to the U.S. revocable trust upon his death.

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[11] But before using the *alter ego* trust as a will substitute, the type of assets held by the taxpayer must be reviewed, as well as the possibility of transferring assets on a tax-deferred basis to a surviving spouse or spousal testamentary trust. As taxes will be payable upon the settlor's death, assets held inside the trust cannot be transferred to a spouse or to a spousal testamentary trust on a rollover basis.

[12] A U.S. revocable trust may raise tax issues for an individual who is a Canadian resident for tax purposes, such as double tax and a mismatch of foreign tax credits. These issues are however beyond the scope of this article.

- A Canadian parent with a child living in the United States is looking for a strategy to reduce the child's exposure to U.S. estate tax and is then considering adding a pour-over clause in his Canadian will. A properly drafted U.S. revocable trust would be set up while the Canadian parent is alive for the benefit of the U.S. child and his children. This trust would generally be set up with a nominal amount. Following the Canadian parent's death, the U.S. revocable trust would receive assets from the parent's estate to reduce the child's exposure to U.S. estate tax.

However, based on case law, is a pour-over clause a valid technique to transfer Canadian assets at death?

"Regarding the revocable trust, one interesting point is that in addition to being amendable and revocable, the trust included a provision allowing the trustees to change the beneficiaries."

WHAT DO THE COURTS IN CANADA THINK ABOUT THE POUR-OVER CLAUSE?

In British Columbia

Kellogg Estate

In *Kellogg Estate (Re)*,[13] the court was asked to decide whether a real estate property located in British Columbia known as the "Musgrave Farm" could be transferred to a U.S. revocable trust under a pour-over clause found in a will made while the testator was living in Washington.

Robert Payne Kellogg and his wife made their wills in the U.S. in 1994 and a U.S. revocable trust was created at the same time (the "KF Trust").

Robert Payne Kellogg passed away on April 15, 1999, when he was living in Washington.

Regarding the revocable trust, one interesting point is that in addition to being amendable and revocable, the trust included a provision allowing the trustees to change the beneficiaries. The trust was amended after the will was executed to remove one of the beneficiaries of the trust.

The following provisions were found in the deceased's Will:

> Residue of Estate
>
> [a] I give, devise and bequeath all the rest, residue and remainder of my property of every kind and description (including lapsed legacies and devises), wherever situated and whether acquired before or after the execution of this Will, to the Trustee under that certain Trust executed by me, which is known as [the KF Trust]. * * *
>
> [b] If for any reason the said Trust shall not be in existence at the time of my death, or if for any reason a court of competent jurisdiction shall declare the foregoing testamentary disposition to the Trustee under said Trust as it exists at the time of my death to be invalid, then I give all of my estate including the residue and remainder thereof to that person who would have been the Trustee under

[13] 2013 BCSC 2292, 2015 BCCA 203.

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said Trust, as Trustee, and to their substitutes and successors under the Trust, as such trust is described hereinabove.

Justice Gray held that to recognize the validity of the pour-over clause would allow Robert Payne Kellogg to change his will without having to comply with the requirements of the *Wills Act* of British Columbia.[14] For the court, a gift cannot "pour over" on terms which did not exist at the time the will was executed. Consequently, a pour-over clause to a revocable, amendable, *inter vivos* trust is invalid. The fact that the trust could be amended in the future and that it was amended was determinative.

After concluding that the pour-over clause was invalid and mentioning that there is a strong presumption against intestacy, Justice Gray reviewed the provision of the will mentioned above under [b] called the Incorporation by Reference Clause applicable should the pour-over clause be declared invalid. After analyzing the requirements for incorporating a document in a will, Justice Gray indicated that the Incorporation by Reference Clause incorporates the terms of the KF Trust indenture, which governed the trustee on the date that Robert Payne Kellogg executed the will. Justice Gray came to the conclusion that the Musgrave Farm is to be held on a testamentary trust which is on the same terms as the KF Trust, without amendment, and with the result that the initial beneficiaries have an equal share in the Musgrave Farm. The beneficiary that was removed by the trustees was then added back.

Quinn Estate

The validity of a pour-over clause was also reviewed by the court in *Quinn Estate*.[15]

Pat Quinn, a former well-known head coach and general manager in the National Hockey League was a Canadian and American citizen. His wife, Sandra, had a green card and was a Canadian citizen. While living in the U.S., Pat Quinn set up a U.S. revocable trust for his wife and himself. The trust was settled on March 4, 1996. The trust deed provided that Pat Quinn and his spouse could withdraw property from the trust as well as amend it.

On April 1, 1996, Pat Quinn executed a will in respect of his Canadian assets. The Canadian will was prepared by his U.S. attorney and was executed in British Columbia. All the requirements for proper execution of a will were met.

In March 1997, Pat Quinn made some changes to the revocable trust so that it would qualify as a qualified domestic trust ("Q.D.O.T.").

Under the revocable trust, Pat and Sandra Quinn were the first beneficiaries. Upon death of the surviving spouse, assets held in Canada were to pour over in the U.S. revocable trust for the benefit of Pat Quinn's adult daughters Valerie and Kathleen. At the time of his death, on November 23, 2014, Pat Quinn was living in British Columbia.

Sandra Quinn, in her capacity as executor of the Canadian will of Pat Quinn, was seeking the court's determination as to whether a pour-over clause was invalid.

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[14] Which was repealed by the Wills, Estates and Succession Act ("*WESA*"), SBC 2009, c. 13, s. 193, effective March 31, 2014.

[15] 2018 BCSC 365, 2019 BCCA 91.

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Under British Columbia law, to be valid, a will must meet all of the following requirements:

- It must be in writing.
- It must be signed at its end by the will-maker, or the signature at the end must be acknowledged by the will-maker as his or hers, in the presence of two or more witnesses present at the same time.
- It must be signed by two or more of the witnesses in the presence of the will-maker.

Although Pat Quinn's Canadian lawyer advised him, upon his return to Canada, to wind up the revocable trust and revise his estate plan, Pat Quinn unfortunately passed away before he could make the required changes.

In finding the pour-over clause to be invalid, the court stated:

> [49] The Legislature's purpose in requiring particular formalities for the proper execution of a will is to ensure certainty as to the deceased's final wishes and to avoid controversy (and possible litigation). The possible use of a revocable, amendable, *inter vivos* trust as the recipient of a testamentary gift, bequest or devise creates that uncertainty the Legislature sought to avoid. Put bluntly, a person could one day execute his or her will, fully observing the execution strictures of s. 37(1) of WESA, leaving the residue of his or her estate to a revocable, amendable, *inter vivos* trust, which he or she could then revoke or amend the following day without regard to any execution strictures.
>
> [50] Having two witnesses present at the time of a will-maker's execution of his or her will or codicil serves to protect against fraud or undue influence, or the perception of such, thereby helping to ensure certainty of the will-maker's final wishes. A well-founded perception that there is the protection against fraud or undue influence often serves to maintain, give, or secure family harmony, especially as the will-maker approaches his or her later part of life.

The court saw two problems with the revocable trust. The first problem was that since the trust was amendable and revocable and had in fact been amended after the execution of Pat Quinn's will, this amounted to an amendment not made in compliance with the formalities of the British Columbia's Wills, Estates and Succession Act.

The second problem is that since the trust can be amended, it cannot be known with certainty how the property will devolve upon Pat Quinn's death since the transfer of the property is governed by terms not found in the will itself.

Pat Quinn's daughter, Valerie, tried to convince the court to uphold the validity of the pour-over clause that transferred the Canadian assets to the U.S. revocable trust. Her lawyer urged the court to distinguish this situation from *Kellogg Estate* where the amendment involved a change in beneficiaries as opposed to a change of an administrative nature.

Unfortunately, the court concluded that the clause was invalid, and that the residue of the property should be vested according to the rules of intestacy.

The court of appeal for British Columbia refused to apply the doctrine of Incorporation by Reference to validate the pour-over clause because as of the date of Pat Quinn's will, the trust, being amendable and revocable, was not a presently existing document and a testator cannot, by his will, create for himself a power to dispose of his property by an instrument not duly executed as a will or codicil under British Columbia law.

Waslenchuk Estate

In *Waslenchuk Estate*,[16] the court applied the same reasoning as in *Quinn Estate*. In *Waslenchuk*, the testatrix set up a revocable trust and had her will prepared in November 2013 while she was living in Connecticut. Her will and the revocable and amendable *inter vivos* trust were executed in accordance with the formal requirements in force in that jurisdiction. Mrs. Walenchuk was looking for a vehicle to manage her assets in case of incapacity, provide for the ultimate distribution of her assets upon her death, and minimize the impact of probate.

However, she came back to British Columbia, where she was domiciled at the time of her death in 2016. Under her will, the residue of her estate was to be distributed to the revocable trust. The Supreme Court of British Columbia held that even though the revocable trust was never amended following the signing of the will, the pour-over clause was invalid.

The court referred to section 101 of the British Columbia Wills, Estates and Succession Act that indicates that regardless of where a will is made, the administration of an estate of a deceased person who was ordinarily resident or domiciled in British Columbia at the date of the person's death is governed by the statute:

> [54] A testamentary document such as a will is meant to reflect the testator's fixed and final intentions for the disposition of his or her estate upon death. A testator may change those intentions by revoking a will and executing a new one or by executing a codicil to the existing will, so long as the requirements in *WESA* are complied with.

In Nova Scotia

MacCallum Estate

There is one case decided by the Supreme Court of Nova Scotia, *MacCallum Estate*,[17] that approached the issue of the validity of a pour-over clause differently. It focused on whether there had in fact been an amendment or revocation of the trust after the will was executed.

Royal Trust Corporation of Canada ("Royal Trust") was the executor of the last will and testament of Helen F. MacCallum, and the trustee of the Helen MacCallum Alter Ego Trust. She passed away in 2020. The Royal Trust applied to the court for an interpretation of the legal effect of the will, specifically clause 3(d) that states:

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[16] 2020 BCSC 1929.

[17] 2022 NSSC 34.

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> *Rest of my Estate*. Pay or transfer the rest of my estate to Royal Trust, as trustee of the Helen MacCallum Alter Ego Trust (the "Trust"), to be added to the capital of the Trust and administered and distributed in accordance with the terms of the Trust. The receipt of the trustee of the Trust shall be a sufficient discharge and release to all concerned without any need to inquire into or investigate the terms of the Trust. If the Trust does not exist at my death, distribute the rest of my estate on the same trusts, terms and conditions as the Trust as it existed as of the date of this will.
>
> Although I wish to note it here for the benefit of my trustees, I expressly do not incorporate the trust Helen MacCallum Alter Ego Trust establishing the Trust into my will be reference and it does not form part of my will. I want it to remain a private document.

The Supreme Court of Nova Scotia upheld the pour-over clause in *MacCallum*. Because (i) the trust was created before the signing of the will, (ii) it was funded, and (iii) its terms had not been changed since the signing of the will, the considerations raised in *Kellogg* and *Quinn Estate* were not applicable. For the court, recognizing the validity of the will is supported by the public presumption against intestacy and is in keeping with the clear intentions of the testatrix. The court added that the requirements provided under the Wills Act to make sure a will is valid were enacted to protect the testator against fraud and undue influence and to make sure the testator has testamentary capacity. But it remains important to respect the testator's wishes and where there is a will, there is a presumption that the transfer of assets upon death should not be made under the rules of intestacy.

"The Royal Trust was then authorized as executor of the will to pay and transfer the residue of the estate to the alter ego trust."

The Royal Trust was then authorized as executor of the will to pay and transfer the residue of the estate to the *alter ego* trust.

In Ontario

Vilenski v. Weinrib-Wolfman

However, this is not the end of the story as the *Vilenski v. Weinrib-Wolfman*[18] court case, rendered in Ontario after *MacCallum Estate*, applied the findings in *Kellogg* and *Quinn*. The pour-over provision found in a will made in 2017 that indicated that the residue of the estate had to be paid to an *alter ego* trust that was set up before the signing of the will was declared invalid even though there were no changes to the trust after the making of the 2017 will. The trust was set up in March 2016. For the court, the mere possibility that the trust be modified is an issue. The formalities required for a will to be valid are not respected.

Tal Vilenski who was the estate trustee of the estate of Lynda Weinrib and trustee of the Lynda Weinrib Alter Ego Trust was questioning the validity of the pour-over clause in Lynda Weinrib's will, considering that there was no decided case that he could find in Ontario that deals directly with the validity of a pour-over clause.

The pour-over clause in Lynda Weinrib's will reads as follows:

> 4. (d) Residue My Estate trustee shall pay or transfer the residue of my estate to the trustees of The Lynda Weinrib Alter Ego Trust (the

[18] 2022 ONSC 2116.

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> said trust having been established by me immediately prior to the signing of this my Will) who are holding such office at the time of my death or, if there is no person holding the said office at the time of my death, the trustees who are first appointed to such office after my death.

The fact that the adult children beneficiaries under the will were prepared to consent to a declaration that the pour-over clause was valid did not change anything.

The court compared the reasoning and approach taken by the courts in British Columbia and Nova Scotia and adopted the reasoning in the *Quinn Estate* case and determined that the pour-over clause in the 2017 will was not valid.

In Quebec

With respect to the province of Quebec, the courts have not been asked to consider the validity of a pour-over clause.

However, as is the case in other Canadian provinces, the formalities governing the various kinds of wills must be observed, on pain of nullity. In the province of Quebec, three forms of wills are recognized: the notarial will, the holograph will, and the will made in the presence of witnesses. However, if a will made in one form does not meet the requirements of that form of will, it is valid as a will made in another form if it meets the requirements for validity of the other form. As such, pending a court decision on this matter, upon death, it might be prudent to transfer assets to a testamentary trust as opposed to a revocable *inter vivos* trust.

CONCLUSION

In Canada, each province has specific legislation applicable to wills and estates and strict requirements must be met for a will to be valid.

Where the strict formality requirements for testamentary documents are not followed, assets are transferred on intestacy.

Given the state of the case law in Canada, if a pour-over clause is to be included in a will, estate planning practitioners should consider creating the trust directly in the Canadian will as opposed to having a separate document. The idea is to mirror the provisions of the revocable trust in the will.

Should a separate document be more appropriate, considering the facts and circumstances, another option may be to set up an irrevocable trust, instead of a revocable trust.

To be even more cautious, adding “backup” language in the will to avoid intestacy should be considered.

In any event, it will be interesting to see if courts from other provinces will follow *Quinn Estate* or will rather agree with the findings in *MacCallum Estate*.

There is no doubt that the combined expertise of Canadian and U.S. estate planning experts can be of great value when dealing with cross-border tax and legal issues and may prevent unpleasant surprises for individuals with ties to both Canada and the United States.

CHANGES ANNOUNCED TO DUTCH ENTITY CLASSIFICATION RULES AND TAX REGIMES FOR FUNDS

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Tags
A.T.A.D.
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F.B.I.
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Open C.V.
V.B.I.

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INTRODUCTION

In the Netherlands, traditionally the third Tuesday in September, which is known as Princes' Day, marks the opening of the new parliamentary year. At this occasion, the budget for the next year is also presented to parliament, including a "Tax Plan" (*Belastingplan*) containing fiscal measures.

The 2024 Tax Plan was presented on September 19, 2023, by the sitting Dutch government, which is merely a caretaker cabinet, which remains in office until a new coalition has been formed after the November general elections. Nonetheless, the Tax Plan comprises a number of legislative proposals that, if adopted by parliament, will have a significant impact on businesses and financial institutions, particularly in relation to Dutch investment institutions. The general consensus is that the legislative process should continue, since most of the proposals were subject to public consultation previously and some are long overdue.

The latter applies particularly to the measures concerning fundamental changes to Dutch entity classification rules, notably those applicable to a Dutch limited partnership (*commanditaire vennootschap* commonly referred to as a "C.V.") or a foreign partnership, as well as a Dutch fund for joint account (*fonds voor gemene rekening* or "F.G.R.").

Since existing Dutch entity classification rules substantially deviate from those applied in most other jurisdictions, the rationale for introducing entirely new rules is to reduce the number of hybrid mismatches. Following the implementation of the second iteration of the E.U. Anti-Tax Avoidance Directive ("A.T.A.D'.), such mismatches typically cause undesirable complexity. Therefore, the Dutch tax authorities are now prepared to abandon the entity classification rules that traditionally applied in the Netherlands.

Initially, the intention was to change Dutch entity classification rules that were in effect from January 1, 2022, which coincides with the implementation of A.T.A.D.2. However, due to severe criticism received from market parties during the public consultation at the time, the process was delayed. Most of the criticism came from Dutch financial institutions, claiming they would be adversely impacted by the originally proposed changes to the classification rules for a Dutch F.G.R. Although this is reflected in the current proposed legislation, these rules are removed from the new rules for classifying a Dutch C.V., and laid down in a separate legislative proposal.

The 2024 Tax Plan includes a proposal to amend the two specific Dutch tax regimes for funds, *i.e.*, the criteria to qualify as an exempt investment institution (*vrijgestelde beleggingsinstelling*) or a fiscal investment institution (*fiscale beleggingsinstelling*). In order to allow taxpayers sufficient time to adapt their structures accordingly, it is

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proposed that all of these measures will enter into force as of January 1, 2025.

In this article, the main contours of the above legislative proposals and their implications for investment in or via the Netherlands are discussed.

PARTNERSHIPS

General Partnership

In the Netherlands a general partnership is fiscally transparent by default. Obviously such classification is not affected by the 2024 Tax Plan. However, at present, an exception to this rule still applies to a Dutch partnership with a capital divided into shares (*personenvennootschap waarvan het kapitaal geheel of gedeeltelijk in aandelen is verdeeld*). While that type of partnership currently is treated as opaque for Dutch tax purposes, under the new rules it will also become fiscally transparent.

C.V.

In comparison to a general partnership, a limited partnership such as a Dutch C.V. has two different types of partners: a general partner with unlimited liability and one or more limited partners, each having liability capped at the amount of capital contributed. Due to the combination of limited liability and legal flexibility, the legal form of a limited partnership is often used for structuring investment funds, particularly real estate ventures and private equity funds.

However, the existing Dutch entity classification rules are rather complex for a C.V., since a Dutch limited partnership or a comparable foreign limited partnership may either qualify as opaque – meaning it is subject to Dutch corporate income tax for its own account – or fiscally transparent. The former is known as an open C.V./L.P., while the latter is commonly referred to as a closed C.V./L.P.

Under current law, fiscal transparency based on closed C.V. status requires a limited partnership to meet certain stringent restrictions regarding the admission of new partners, as well as the transfer of a limited partnership interest. In a nutshell, both require the written prior approval of all partners. Although this principle stems from the notion that forming a partnership has a personal character, that approach has become rather obsolete, particularly within the context of an investment fund. Moreover, applying these restrictions is generally perceived to have an adverse commercial effect.

For this reason, as well as to align Dutch entity classification rules with common international standards, the proposed new entity classification rules completely abandon the criterion of consent, which represents a significant shift in the Dutch fiscal framework. Instead, the proposed new rules entail that, going forward, all Dutch and foreign limited partnerships will be treated as fiscally transparent, *i.e.*, regardless of any further criteria and without exception.

Foreign Entity Without a Dutch Equivalent

In addition to partnerships, certain entities exist under foreign law in a legal form which does not have an equivalent under Dutch law. Where such entity is a non-resident taxpayer, it is proposed that going forward the Netherlands will simply follow the fiscal classification in the relevant foreign jurisdiction. This rule would apply in

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case such foreign entity must recognize taxable income in the Netherlands (*e.g.*, from real estate or a permanent establishment), holds an interest in a Dutch entity, or vice versa.

By contrast, where such noncomparable foreign entity is considered to be a tax resident in the Netherlands, it will be treated as a taxable entity in the Netherlands, and thus opaque for Dutch tax purposes, regardless of its fiscal qualification in the jurisdiction under which laws it exists.

Transitional Law

Since all limited partnerships will be treated as fiscally transparent going forward, the phenomenon of the taxable open C.V. will cease to exist once the new rules enter into force. As a result, an open limited partnership will be deemed to transfer its assets and liabilities in return for fair market value consideration immediately prior to that moment, which may lead to recognition of unrealized taxable profits such as goodwill and hidden reserves. Concomitantly, the limited partners in an open C.V. will be deemed to acquire their *pro rata* share in the partnership's assets and liabilities, meaning they will be entitled to a corresponding step-up in base.

To mitigate the effects of gain recognition without the receipt of cash consideration, transitional legislation has been proposed. Although the wording of such legislation might suggest that its scope is restricted to an open C.V. and its participants, the explanatory notes seem to indicate that it extends to any foreign limited partnership that is subject to tax in the Netherlands under current law.

"Since all limited partnerships will be treated as fiscally transparent going forward, the phenomenon of the taxable open C.V. will cease to exist once the new rules enter into force."

In any case, the relevant transitional law stipulates that, provided certain conditions are met, a limited partner may contribute its limited partnership interest into another Dutch taxable entity in a tax neutral way, *i.e.*, through a share-for-share merger. Should the assets of the partnership comprise real estate situated in the Netherlands, an exemption from real estate transfer tax may apply in such case.

In addition, the proposed transitional legislation facilitates rollover relief for latent capital gains on interests held in a limited partnership, which might otherwise need to be recognized at the moment the new rules enter into force.

As a last resort, corporate taxpayers may request payment deferral over a period of up to ten years in relation to any Dutch tax due as a result of the disappearance of the open C.V.

FUND FOR JOINT ACCOUNT

Unlike a C.V., which has its specific legal basis in the Dutch Civil Code, the legal form of an F.G.R. is purely a contractual arrangement. As such, in the Netherlands an F.G.R. is commonly used for collective investment. Although in principle an F.G.R. may be used for a wide range of asset classes, including private equity and real estate, in practice it is mostly used for structuring hedge funds and collective investments in transferable securities.

As is the case for a C.V. or comparable foreign limited partnership, the entity classification rules that currently apply in the Netherlands to a Dutch F.G.R. or a comparable mutual fund established under foreign law are quite complex. They may be classified either as opaque, and for that reason, subject to Dutch corporate income

tax or fiscally transparent. Similar to a C.V., the former is known as an open F.G.R. and the latter is commonly referred to as a closed F.G.R.

Under current law, in order to create fiscal transparency, participations in the F.G.R. may not be considered as freely tradable. That result is commonly achieved in one of two ways. The first is to apply the same restrictions to a transfer of participations in the F.G.R. that apply in case of a closed C.V. Consequently, this implies that a transfer of participations in a closed F.G.R requires written prior approval from all other participants. The second is to provide restrictions in the constituent documents that participations can be transferred only to the F.G.R,. itself. This is commonly known as the redemption model. Any other form of transfer is null and void. Either way, the participations in the fund are not considered to be freely tradable.

Going forward, the requirement of consent will no longer play a role in determining whether an F.G.R. or a comparable fund under foreign law should be treated as a partnership. By contrast, restricting free transferability of participations through mandatory use of the redemption model will largely survive the changes to Dutch entity classification rules.

Under the 2024 Tax Plan, any F.G.R. that is not regulated by definition qualifies as a closed F.G.R. Only a U.C.I.T.S. (*instelling voor collectieve belegging in effecten*) or other investment institution (*beleggingsinstelling*) as defined in the Financial Supervision Act (*Wet op het financieel toezicht*) may qualify as an open F.G.R. This implies that going forward, family funds and other relatively small ventures will be treated as fiscally transparent, unless they change the structure to fall within the definition of a U.C.I.T.S. or other investment institution and thus to accept regulation.

Typically, regulated funds are eligible for the two special Dutch tax regimes for investment institutions, meaning that fiscal transparency may not be desired in all cases. However, during the public consultation it became clear that many regulated investment institutions in the Netherlands still prefer fiscal transparency over application of either of the two special regimes. For this reason, following the consultation an exception was added to the Tax Plan, which essentially means that the redemption model remains in existence. On that basis, as before, a regulated F.G.R. can still qualify as fiscally transparent by virtue of the fact that its participations are not considered freely tradable.

Transitional Law

Since any F.G.R. that is not regulated will be treated as fiscally transparent under the new rules, an existing open F.G.R. which is not in scope of the Financial Supervision Act will cease to be a taxable entity once these rules enter into force. Consequently, an open F.G.R. will be deemed to transfer its assets in return for fair market value consideration immediately prior to becoming fiscally transparent, thereby triggering recognition of all unrealized capital gains for Dutch tax purposes. At the same time, participants in an open F.G.R. will be deemed to acquire their *pro rata* shares in the fund's assets at fair market value, meaning that in principle they will be entitled to a corresponding step-up in basis.

To mitigate the effects of the above, transitional legislation is proposed for an open F.G.R. First, to the extent the investors in the F.G.R. are subject to Dutch corporate income tax, an election for rollover relief can be made, meaning that such investors continue the fiscal book value of their *pro rata* share in the fund's assets. In that

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case, the investors forego a step-up in basis and the F.G.R. does not recognize any unrealized capital gains.

Another possibility is to defer payment of the corporate income tax due on capital gains recognized upon the deemed asset transfer. Gain would be recognized over 10 years.

Finally, the transitional law offers a participant the possibility to contribute its participation into another Dutch taxable entity in a tax neutral way by participating in a share-for-share merger, provided certain conditions are met. Should the fund's assets comprise real estate situated in the Netherlands, an exemption from real estate transfer tax may apply, as well.

EXEMPT INVESTMENT INSTITUTION ("V.B.I.") REGIME

As discussed above, under the proposed new entity classification rules, a regulated F.G.R., other than one that applies the redemption model to achieve fiscal transparency, qualifies as an open F.G.R., which implies that it is subject to Dutch corporate income tax. However, this does not necessarily imply that the F.G.R. actually pays tax in the Netherlands, since it may well be eligible for one of the two special Dutch tax regimes for investment institutions.

One of these regimes is the exempt investment institution regime (*vrijgestelde beleggingsinstelling*, commonly referred to as a "V.B.I. regime"). In a nutshell, the V.B.I. regime entails that the investment institution is exempt from Dutch corporate income tax and not obliged to withhold Dutch dividend tax on its profit distributions. To qualify for the V.B.I. regime, the investment institution must meet several criteria, notably that it invests only in financial instruments as defined in the Financial Supervision Act and within that context applies a policy of diversification in assets as a means of risk spreading.

The V.B.I. regime aims to facilitate collective investment in financial instruments by retail and institutional investors in the Netherlands. In line with this purpose, only a public limited liability company (N.V.) or an open F.G.R. can avail itself of the V.B.I. regime. Nonetheless, the V.B.I. regime is frequently used by nonregulated entities.

The proposed new entity classification rules already prevent such unintended use in the case of an F.G.R. in that, if not regulated, an F.G.R. is fiscally transparent by default, and hence not eligible for the V.B.I. regime. However, without further measures, an N.V. could still benefit from the V.B.I. regime, despite being unregulated. Therefore, it is proposed that the V.B.I. regime will be amended in such a way that, going forward, it will only be available to U.C.I.T.S. and investment institutions as defined in the Financial Supervision Act, meaning that unregulated structures will be entirely excluded.

DUTCH FISCAL INVESTMENT INSTITUTION REGIME

In addition to the V.B.I. regime, a public limited liability company in the form of a Dutch N.V. or an open F.G.R. may also seek to apply the other special Dutch tax

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regime for investment institutions, known as the fiscal investment institution (*fiscale beleggingsinstelling* or "F.B.I." In principle, the F.B.I. regime may also be applied by a private limited liability company such as a Dutch B.V.

As with the V.B.I. regime, the *raison d'être* of the F.B.I. regime is to facilitate collective investment in such a way that the tax burden does not exceed the level that would exist for an individual investment. In a nutshell, the F.B.I. regime entails that the relevant investment institution is subject to Dutch corporate income tax at a 0% statutory rate, which technically is not an exemption, although the tax results are economically the same. However, the F.B.I. regime does entail an obligation to withhold Dutch dividend tax at the statutory rate of 15% on annual profit distributions. Other criteria include detailed anti-concentration provisions, as well as a restriction on the use of leverage.

In comparison to the V.B.I. regime, application of the F.B.I. regime is not restricted to financial instruments as defined in the Financial Supervision Act or any other specific asset category. Instead, a qualifying investment can be any asset that is held as a passive portfolio investment. Consequently, the F.B.I. regime currently is often used for investments in real estate. This will change on a go-forward basis. The 2024 Tax Plan introduces a new restriction, pursuant to which the F.B.I. regime no longer applies to direct investments in real estate situated in the Netherlands. This is already the case for the V.B.I. regime, for which real estate does not qualify as a financial instrument.

Those investment institutions that currently invest in Dutch real estate may benefit from proposed transitional measures, including exemptions from Dutch real estate transfer tax that would be due upon a restructuring.

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SINGAPORE: TAX ON DISPOSAL OF FOREIGN ASSETS

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Tags
Capital Gains
C.O.C.G. Guidance
P.E.H.E.
Section 10L
Section 10(25)
Singapore

INTRODUCTION

On June 6, 2023, the Singapore Ministry of Finance ("M.O.F.") released for public consultation 33 proposed legislative amendments to the Income Tax Act 1947 ("S.I.T.A.").

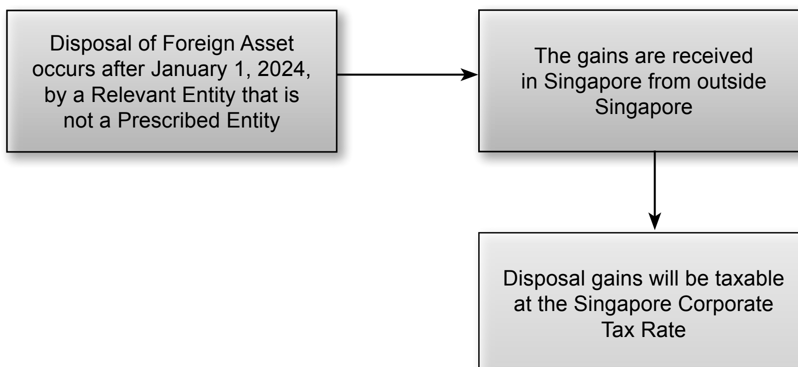
Under the Proposed Section 10L, the proceeds of gains arising from the sale or disposal of a Foreign Asset received in Singapore from outside of Singapore by a Relevant Entity will be treated as income chargeable to tax under Section 10(1)(g) of the S.I.T.A. In addition, the Inland Revenue Authority of Singapore ("I.R.A.S.") will have the power to adjust the disposal gains where the consideration is not at market value. The change in law will be effective from January 1, 2024. It will override anything to the contrary in the S.I.T.A. except for certain Prescribed Entities.

On September 8, 2023, the M.O.F. issued feedback to comments it received in regard to Section 10L. This article explains the context of Section 10L and the I.R.A.S. feedback to comments received.

PURPOSE OF SECTION 10L

Section 10L was introduced to align the treatment of disposal gains from the sale of foreign assets to the E.U. Code of Conduct Group Guidance ("C.O.C.G. Guidance"). In December 2022, updated Guidance on Foreign-Sourced Income Exemption Regimes ((F.S.I.E. Regimes") was introduced to explicitly require capital gains, as a general class of income covered by an F.S.I.E. Regime, to be subject to an economic substance requirement.

OPERATION OF SECTION 10L



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SCOPE OF SECTION 10L

The scope of Section 10L is wide. It overrides all other provisions in the S.I.T.A. that would provide a contrary result, such as treating gains as not taxable or exempt under the S.I.T.A. Hence, the provisions of Section 10L would override Section 13W, which exempts gains or profits from the disposal of ordinary shares under certain constraints.

DEFINITION OF A RELEVANT ENTITY

A Relevant Entity is any entity having financial results that are included in a set of consolidated financial statements prepared by the parent entity of the group, provided that at least one member of the group has a place of business outside Singapore. The term Entity is defined as any legal person, including a limited liability partnership. It does not include an individual, a general partnership, a limited partnership, or a trust.

Based on the above, individually owned businesses, individuals, and foreign businesses that are not operating in or from Singapore are not subject to Section 10L.

DEFINITION OF A PRESCRIBED ENTITY

Section 10L only applies to Relevant Entities that are not specifically excluded. Entities that are specifically excluded are known as Prescribed Entities, and include

- financial institutions defined in the Financial Services and Markets Act 2022;
- entities generating income that is exempt from tax or is taxed at a concessionary rate under the specified provisions of the law related to specific substantive business activities in Singapore. An example is an entity that qualifies for benefits under the global trader program. Examples of entities that will continue to be Relevant Entities are Singapore funds and family offices that benefit from incentives; and
- Excluded Entities, as defined below.

DEFINITION OF AN EXCLUDED ENTITY

An Excluded Entity is a Prescribed Entity that does not qualify as an Entity described in the first two bullets in the preceding paragraph, but meets certain economic substance requirements in Singapore.

Depending on whether the "Excluded Entity" is a Pure Equity-Holding Entity ("P.E.H.E.") or an entity that is not a ("Non-P.E.H.E."), prescribed economic substance requirements will need to be met.

P.E.H.E.

This is an entity whose main function is to hold shares or equity interests and derives only (i) dividends, (ii) disposal gains, and (ii) incidental income. The entity will need to comply with various obligations imposed under Singapore law and have its

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operations managed and performed in Singapore by employees or other persons that operate through local outsourcing arrangements.

Non-P.E.H.E.

This is an entity that is not a PEHE. The entity will need to have its operations managed and performed in Singapore and have reasonable economic substance in Singapore in terms of employees or other persons who perform services in Singapore under local outsourcing arrangements.

Reasonable economic substance will be determined based on the following factors:

- The number of employees or magnitude of outsourcing arrangements
- The experience and qualifications of the employees or individuals involved in the outsourcing arrangement
- The amount of business expenditure incurred inside and outside of Singapore relative to the entity's income
- Whether key business decisions are made by persons in Singapore

In the M.O.F. feedback, the M.O.F. agreed that a Non-P.E.H.E. need not carry on a trade, business, or profession in Singapore. The requirement will be removed in the final wording of Section 10L.

Economic Substance

During the consultation period, comments were received asking the M.O.F. to legislatively prescribe bright-line tests that would establish whether economic substance requirements have been met. Minimum thresholds would be an example of the requests received. The purpose of this would be to reduce uncertainty for taxpayers in determining if disposal gains are subject to tax.

The M.O.F. did not accept this request, commenting that it would not be practical to prescribe minimum thresholds in legislation because business models and scale of operations vary even within the same sector. However, the I.R.A.S. stated it would provide further guidance through an e-Tax Guide, including examples for certain sectors.

The I.R.A.S. will require Entities to maintain all records reasonably required to ascertain (i) the circumstances in which disposal gains would be considered to have been received in Singapore, (ii) the computation of the taxable gains, and (iii) the relevant economic substance requirements have been met.

It is not clear yet whether the I.R.A.S. will implement an advanced ruling process for Entities regarding sufficient substance. In comparison, Hong Kong an implemented an advanced ruling system to provide certainty to taxpayers.

THE DEFINITION OF A FOREIGN ASSET

The I.R.A.S. will use certain determining factors to assess where an asset is situated. Section 10L describes the appropriate factor for most types of assets:

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- For shares, it is where the disposed entity is incorporated.
- For immovable property, it is where the property is located.
- For a ship or aircraft, it is where the owner is resident.
- For intangible movable property, it is where the ownership rights would be primarily enforceable.
- For secured or unsecured debt, it is where the creditor is resident.
- For tangible movable property not covered elsewhere, it is where the property is located.

GAINS RECEIVED IN SINGAPORE

Section 10L applies only in cases where the proceeds of gains arising from the sale of assets located outside Singapore are received in Singapore. The statute defines transactions where the consideration or proceeds of gain are received in Singapore:

- Any amount of the consideration or proceeds is remitted to, transmitted to, or physically brought into Singapore.
- Any amount of the consideration or proceeds is applied towards the satisfaction of any debt incurred in respect of a trade or business carried on in Singapore.
- Any amount of the consideration or proceeds is applied to the purchase of movable property that is brought into Singapore.

"Section 10L applies only in cases where the proceeds of gains arising from the sale of assets located outside Singapore are received in Singapore."

The above definition is almost identical to the wording under Section 10(25) of the S.I.T.A.:

> To avoid doubt, it is declared that the amounts described in the following paragraphs are income received in Singapore from outside Singapore whether or not the source from which the income is derived has ceased:
>
> a) any amount from any income derived from outside Singapore which is remitted to, transmitted or brought into, Singapore;
>
> b) any amount from any income derived from outside Singapore which is applied in or towards satisfaction of any debt incurred in respect of a trade or business carried on in Singapore; and
>
> c) any amount from any income derived from outside Singapore which is applied to purchase any movable property which is brought into Singapore.

It is widely expected that the principles of existing I.R.A.S. guidance under Section 10 (25) will apply to Section 10L. Here are several examples.

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Re-investment of Proceeds Outside of Singapore

With respect to Section 10(25), the I.R.A.S. has clarified that proceeds of foreign source income reinvested overseas without repatriation to Singapore should not be considered to have been received in Singapore as a result of reinvestment overseas. Taxation continues to be deferred.

Payment of Overseas Dividend

Similarly, with respect to Section 10(25), the I.R.A.S. has clarified that foreign source income should not be considered to be received in Singapore under Section 10(25) where such income is utilized to pay a single tier, tax exempt dividend directly into a shareholder's offshore bank account and does not involve a physical remittance, transmission, or bringing of funds into Singapore.

Satisfaction of Trade Debts

It is unclear whether the use of foreign income to satisfy debts incurred by a Relevant Entity that is an investment holding company not conducting a trade, business, or operation and not having economic substance in Singapore would be considered as having been received or deemed received under Section 10(25)(b), in light of the Section 10L provisions which emphasize economic substance. Section 10(25)(b) may not provide guidance as the I.R.A.S. position in the context of Section 10(25) is that a passive investment holding company is not considered to be carrying on a trade or business in Singapore.

TAXATION OF DISPOSAL GAINS UNDER SECTION 10L

Given the above provisions, gains arising from the sale of foreign assets that fall within the scope of Section 10L, but are not considered to be received in Singapore, are not subject to tax in Singapore until received or deemed received in Singapore. At that time, the Entity will be taxable on the disposal proceeds, reduced by any expenditure incurred to acquire, protect, preserve, create, or improve the foreign asset or to sell or dispose of the foreign asset.

To the extent that the sales price is determined to be less than the open-market price, the I.R.A.S. is able to adjust the sales price to the open market price.

The M.O.F. feedback also confirmed that it will allow foreign source disposal losses to be set off against foreign source disposal gains that are subject to tax. The set-off will be restricted to foreign source disposal losses that would have otherwise been brought to tax if they were gains. In addition, unutilized foreign source disposal losses may be carried forward indefinitely for setoff against foreign sourced disposal gains in future years.

HONG KONG

Effective January 1, 2023, Hong Kong implemented similar rules to tax foreign-sourced income ("F.S.I.E."), such as dividends, interest, royalties, and capital gains. As a result of the C.O.C.G. Guidance, Hong Kong will make some adjustments to its F.S.I.E. Regime, effective January 1, 2024.

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CONCLUSION

The Proposed Section 10L will impose tax on gains derived from the disposal of foreign assets by non-Prescribed Entities that are considered Relevant Entities where the disposal proceeds are received in Singapore. Multinational groups that use Singapore as a holding jurisdiction for regional assets should revisit their holding structures to ensure that the Singapore Entities have adequate economic substance in Singapore. Without such substance, gains realized from the disposal of assets located outside Singapore tax in Singapore could be taxed in Singapore beginning January 1, 2024, if the resulting proceeds that are received in Singapore.

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BRITISH VIRGIN ISLANDS ECONOMIC SUBSTANCE REQUIREMENTS

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Tags
B.E.P.S.
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INTRODUCTION

Every B.V.I. company and limited partnership has some obligations in respect of the economic substance regime and must take the following steps:

- It must have adequate systems and controls to ensure compliance with this regime.
- During each compliance period, it must determine whether it carries on or receives gross income from any of the nine relevant activities. If so, it must determine whether it qualifies for exemption due to its tax status.
- It must file an economic substance at required intervals, generally on an annual basis, even if the entity is not subject to any economic substance requirements.

This article summarizes the B.V.I. economic substance regime and provides practical guidance for compliance and reporting.

BACKGROUND

The 15-point Base Erosion and Profit Shifting ("B.E.P.S.") Action Plan of 2015 developed by the Organization for Economic Cooperation and Development (the "O.E.C.D.")' marked a watershed moment for international tax advisers.

B.E.P.S. Action 5 requires that no or only nominal tax jurisdictions ("N.T.J.'s")) adopt substantial activities requirements proposed by the O.E.C.D.'s Forum on Harmful Tax Practices ("F.H.T.P."). In addition, the European Union ("E.U.") Code of Conduct Group ("C.O.C.G.") evaluates whether countries require economic substance as a precondition for the allowance of tax advantages linked to certain geographically mobile activities. On June 22, 2018, the C.O.C.G. published a scoping paper identifying nine relevant activities and economic substance criteria, which it expected N.T.J.'s to adopt by 2019. Failure to comply with E.U. requirements carries the threat of being placed on Annex I of the E.U.'s list of noncooperative jurisdictions for tax purposes (the "E.U. Blacklist").

Twelve N.T.J.'s were identified – Anguilla, Bahamas, Bahrain, Barbados, Bermuda, the B.V.I., the Cayman Islands, Guernsey, Isle of Man, Jersey, the Turks and Caicos Islands and the United Arab Emirates.[1]

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[1] The United Arab Emirates has subsequently adopted a corporate income tax system effective from June 1, 2023.

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The B.V.I.'s economic substance requirements were implemented via the Economic Substance (Companies and Limited Partnerships) Act 2018 (the "Economic Substance Act"), which came into force on January 1, 2019, with a six-month transitional period for companies and limited partnerships with separate legal personality and that were registered in the B.V.I. before that date. Of such entities, the vast majority were companies incorporated under the B.V.I. Business Companies Act (the "B.C. Act"). As a result, by default, the key commencement date was June 30, 2019, for most B.V.I. companies registered prior to 2019.

In October 2019, the O.E.C.D. released guidance on its framework for the spontaneous exchange of economic substance information by N.T.J.'s. As a result, economic substance reporting requirements were introduced via various amendments to the Beneficial Ownership Secure Search System Act 2017 (the "B.O.S.S. Act") between 2019 and 2021. N.T.J.'s exchange certain information under the O.E.C.D. standard, thereby enabling recipient tax administrations to conduct risk assessments and apply anti-B.E.P.S. provisions under their domestic laws.

Limited partnerships without separate legal personality ("Relevant Partnerships") were added to the regime effective July 1, 2021, with a six-month transitional period for those formed prior to such date.[2]

Owing to the tight timeframes for implementation and the high-level nature of the C.O.C.G.'s scoping paper, many key concepts and requirements are not defined in detail in the Economic Substance Act, itself. The scoping paper uses many defined terms and concepts that are not in common use in the B.V.I. or common law and which are untested before a B.V.I. court. Further guidance appeared in economic substance rules and explanatory notes (the "Economic Substance Rules") published by the B.V.I. International Tax Authority ("I.T.A."), which is the regulator for the regime. The Economic Substance Rules were most recently updated as version 3 on 24 February 2023.[3]

The I.T.A. is now investigating and taking enforcement action where appropriate against certain entities in respect of the first compliance periods that commenced in 2019. The I.T.A. has broad powers under the Economic Substance Act and, in June 2022, its powers were increased via amendments to the International Tax Authority Act (the "I.T.A. Act") and related regulations. Under that Act, all companies and limited partnerships registered in the B.V.I. are required to have adequate systems and controls in place to ensure compliance with the Economic Substance Regime.

As part of their monitoring of compliance and enforcement by the N.T.J.'s, the C.O.C.G. and F.H.T.P. regularly review the I.T.A. and the I.T.A. generally has up to six years from the end of the relevant period to determine noncompliance. Directors or general partners of relevant B.V.I. entities and their advisors should therefore continue to monitor B.V.I. entities to ensure compliance.

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[2] As most Entities are companies incorporated under the BC Act, we focus on companies in this article. Limited partnerships should consider the specific guidance in Part 16 of the Rules.

[3] At the time of writing, version 3 of the Rules is available here. Subsequent references to a "Rule" or "Explanatory Note" are to the corresponding Rule or Explanatory Note in that version.

HOW IS THIS RELEVANT TO EACH B.V.I. ENTITY?

Whether domestic or foreign, every company and limited partnership registered in the B.V.I. (an "Entity") has some obligations under the regime – even if merely to file nil returns via its registered agent.

Economic Substance Act Requirements

The key obligation under the Economic Substance Act is for an Entity that carries on any relevant activity during any financial period to comply with economic substance requirements in relation to each such activity.

Under Rule 1, an Entity will be deemed to carry on relevant activity during any financial period in which it receives gross income from that activity. Our interpretation of Explanatory Notes 2.2 and 6.4 is that an activity must generate gross income, or be expected to generate gross income at some point to be a relevant activity of the Entity. Subject to Rule 1, the absence of any gross income during any specific financial period generally is not determinative.[4]

Relevant Activities and Investment Funds Exemption

The Economic Substance Act defines nine relevant activities, and detailed guidance on each definition appears in Part 5 of the Rules. The relevant activities are the following:

- Banking business
- Insurance business
- Fund management business
- Finance and leasing business
- Headquarters business
- Distribution and service center business
- Shipping business
- Holding business
- Intellectual property ("I.P.") business

Investment fund business (as defined) is expressly excluded from being a relevant activity.[5] However, as mentioned above, fund management business is included.[6]

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[4] Gross income is defined by Rule 20 and purposively we do not think 'income' has its narrow accounting sense (*i.e.*, it should include capital gains or other gains on sale).

[5] This means the business of operating an investment fund, which means an entity whose principal business is the issuance of investment interests to raise funds or pool investor funds with the aim of enabling a holder of such an investment interest to benefit from the profits or gains from the entity's acquisition, holding, management, or disposal of investments and which includes any entity through which an investment fund directly or indirectly invests or operates (but not an entity that is itself the ultimate investment held. It does not include a person licensed under the Banks and Trust Companies Act, 1990 or the Insurance Act, 2008, or a person registered under the Cooperatives Societies Act 1979 or the Friendly Societies Act 1928.

[6] Fund management business is activity requiring a license under category 3 of Schedule 3 of the Securities and Investment Business Act 2010.

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In practice, we are finding that persons not familiar with the Economic Substance Regime are most frequently caught out by the breadth of the finance and leasing business definition. There are no carveouts for intragroup debt.

The definitions of (i) the distribution and service center business and (ii) the headquarters business are specifically aimed at intragroup sales of goods and provision of services.

The intellectual property business regime is particularly fearsome so any Entity holding any form of intellectual property rights should ensure it has considered this topic.

The concept of relevant activity is also misleading in that the passive receipt of income may be sufficient to bring an Entity into scope by virtue of Rule 1.

Financial Periods

Compliance with the economic substance and related reporting requirements is assessed for each financial period. A financial period cannot cover more than 12 months.

Part 10 of the Rules prescribes default financial periods determined by the Entity's date of registration in the B.V.I. In broad terms, the default financial periods are as follows:

Registration Date	Start of First Financial Period	End of First Financial Period
Company / limited partnership with separate legal personality registered **before** January 1, 2019	June 30, 2019 by default	June 29, 2020
Company / limited partnership with separate legal personality registered **from** January 1, 2019 onwards	Date of incorporation	12 months from date of incorporation
Relevant Partnership that is registered **before** July 1, 2021	January 1, 2022 by default	December 31, 2022
Relevant Partnership that is registered **on or after** July 1, 2021	Date of formation	12 months **from** date of formation

There are various mechanisms to alter these default financial periods, by filing an election or application with the I.T.A. The financial period need not coincide with the Entity's financial year for accounting or tax purposes. Of crucial importance is the need to refer to individual, non-consolidated company financial statements because intra-group balances can influence the Entity's classification and reporting information.

In many cases, it will be simplest to align the financial period with the Entity's financial year – particularly in view of the new annual return requirement applicable to companies under the B.C. Act from 2024 onwards.

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Nonresident Entities for Tax Purposes

Broadly speaking, a legal entity that is nonresident for tax purposes in the B.V.I. is not treated as an Entity. To be considered a nonresident, the entity must be resident for tax purposes in a jurisdiction that is not on the E.U. Blacklist. Part 4 of the Rules expands the traditional concept of residence to include certain transparent Entities and Entities all of whose income from relevant activities is subject to tax, other than withholding tax.

Special provisions dealing with entities claiming residence in another N.T.J. are provided under Rules 5 and 5A.

"In practice, the nonresident tests can be complex to apply."

An Entity must claim nonresident status in its report for the financial period and either (i) provide evidence complying with Rule 3 (or 5A, if applicable) or (ii) submit a provisional nonresidence application under Rules 6-10, and if its application is accepted, provide evidence of residence in a country that is not on the E.U. Blacklist within the timeframe allowed by the I.T.A.

In practice, the nonresident tests can be complex to apply. The determination depends in large part on questions of law in other jurisdictions and whether the other jurisdiction is on the E.U. Blacklist. Entities may need to seek advice from their B.V.I. and tax advisors to help when preparing reports and supporting evidence.

Broadly, a nonresident claim will result in spontaneous exchanges of all information regarding the Entity on the B.O.S.S. registered agent database with the overseas competent authority in each relevant overseas jurisdiction as described in Part 14 of the Rules. If a beneficial owner or legal owner as defined for purposes of the B.O.S.S. Act of the Entity is resident in an E.U. Member State, information will also be exchanged spontaneously with the competent authority in the Member State in which the beneficial owner or legal owner resides.

Reporting Obligations

Broadly, every Entity must identify if it carries on any of nine relevant activities during the financial period, and if so, the specific relevant activities carried on. Unless it is an "exempt person" for the purposes of the B.O.S.S. Act that does not carry on any relevant activity, the Entity must ascertain and report certain prescribed economic substance information to the I.T.A. via its registered agent. The precise information depends on the activities and ownership of the Entity and whether it claims to be nonresident.[7]

The reporting deadline is six months following the end of the relevant financial period. The I.T.A. has the power to impose penalties for late filing.

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[7] From October 1, 2019, exempt persons that were previously exempt from beneficial ownership reporting obligations under the B.O.S.S. Act are no longer exempt if they carry on any relevant activity. Broadly, the exempt person definition includes (i) certain licensees and regulated persons under B.V.I. financial services legislation, (ii) entities whose securities are listed on a recognized exchange, and (iii) subsidiaries of entities within (i) or (ii).

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WHAT ARE THE ECONOMIC SUBSTANCE REQUIREMENTS FOR EACH RELEVANT ACTIVITY?

The Pure Equity Holding Entity Definition

Holding business is defined as the business of being a pure equity holding entity (a "P.E.H.E.") that only holds equity participations in other entities and only earns dividends and capital gains. This is a narrowly defined term of art and should not automatically be equated with being a holding company in the commercial sense.

Except as provided below, if an Entity has non-equity assets or sources of gross income other than dividends or gains on equity assets, it will generally not be a P.E.H.E. Consequently, it will need to consider whether it carries on any of the other eight relevant activities.

Viewed purposively, we do not think that having a bank account to receive dividends and pay expenses or physical premises used in the holding business should take an Entity outside the narrow P.E.H.E. definition.

Economic Substance Requirements for a Holding Business

An Entity meets the economic substance requirements for holding business if two conditions are met. First, it must comply with its statutory obligations under the B.C. Act or the Limited Partnership Act, as applicable. Second, it must have adequate employees and premises in the B.V.I. for holding or managing its equity participations. The Economic Substance Rules acknowledge that holding of equity participations may be entirely passive in nature. In reality, no employees or premises may be required during a financial period. In such cases, the industry expectation is that having a B.V.I. registered office may be adequate.

I.P. Business

Broadly, an Entity will be considered to carry on I.P. business if it holds I.P. rights in intangible assets from which identifiable income or gains accrue (that are separately identifiable from any income generated from any tangible asset in which the right subsists).

In addition to the general economic substance requirements outlined below, Entities involved in I.P. businesses are subject to particularly burdensome economic substance requirements as I.P. was identified by the C.O.C.G. and F.H.T.P. as giving rise to increased B.E.P.S. risks. To illustrate, a requirement exists for any specialist equipment used in the I.P. business to be located in the B.V.I.

Certain presumptions of noncompliance with economic substance requirements may also apply as set out in Part 9 of the Rules. In practice, compliance for most I.P. businesses is extremely difficult and any Entity holding I.P. rights should ensure it has considered economic substance requirements carefully.

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Other Relevant Activities

Entities carrying on any of the other seven relevant activities comply where all of the following requirements are met:

- The relevant activity is directed and managed in the B.V.I.
- Having regard to the nature and scale of the relevant activity:
  - An adequate number of suitably qualified employees are physically present in the B.V.I., even if employed by another entity.
  - Adequate expenditures for the relevant activity are incurred in the B.V.I.
  - The Entity has physical offices or premises in the B.V.I. as appropriate for its core-income generating activities ("C.I.G.A.").
- The entity conducts C.I.G.A. in the B.V.I.
- In the case of income-generating activity carried out for the Entity by another entity, no C.I.G.A. is carried on outside the B.V.I. and the arrangements comply with certain other anti-avoidance provisions relevant to outsourcing.

The holding business regime is quite straightforward and the most common relevant activity encountered in practice. For Entities carrying on any of the other relevant activities, there is no one-size-fits-all solution. Professional advice is usually required to review the structure carefully and make necessary changes as the potential consequences of non-compliance are significant.

PATH FORWARD

Every Entity is required by law to ensure that it has adequate systems and controls in place to meet its obligations under the Economic Substance Regime.

In particular, every director or general partner of a B.V.I. Entity may find it prudent to ensure the following:

- He or she knows the Entity's financial period and has considered if the financial period should be altered to match the financial or fiscal year.
- On a continuing basis, he or she identifies whether the Entity may be carrying on or receiving gross income from a relevant activity.
- If the Entity carries on a relevant activity or receives gross income from any relevant activity, he or she determines the following:
  - Whether the Entity qualifies for exemption from the economic substance requirements because it is a tax nonresident.
  - If the Entity qualifies in principle as a tax nonresident, the steps and deadlines for filing a provisional claim and then marshaling evidence in support of that claim, including sufficient evidence of residence in a jurisdiction that is not on the E.U. Blacklist.

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- A fallback plan exists to allow in compliance with the economic substance requirements applicable to the Entity's relevant business. As discussed above, those requirements range from a simplified regime for holding businesses to very onerous requirements for I.P. businesses.

- He or she fully understands the reporting requirements that apply to the Entity, which depend on the foregoing points.

Part 12 of the Economic Substance Rules sets out the prescribed economic substance information which every Entity needs to consider.[8] The required information for financial periods commencing on or after January 1, 2022, has increased significantly, particularly for Entities carrying on relevant activity and not claiming to be nonresident. Entities affected by these changes will be well advised to allow longer than usual to prepare reports on a timely basis, leaving enough time for a thorough review by local counsel.

In view of the I.T.A. Act requirements, it may be prudent to record that the directors or general partners have considered these points in minutes or resolutions and, if the Entity carries on relevant activity, to document the steps taken to ensure compliance.

[8] Entities considering the reporting requirements for financial periods commencing prior to January 1, 2022 should refer to version 2 of the Rules.

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REGULATING THE ISSUANCE OF A.P.A.'S IN GREECE

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Pre-submission Conference
Key Assumptions
Rollback

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INTRODUCTION

Advance Pricing Agreements ("A.P.A.'s") regarding intercompany transfer pricing have been issued in Greece for several years.[1] The procedure for obtaining an A.P.A. was set forth in Circular POL.1284/2013. In late July, Decision A.1107/2023 of the Independent Authority for Public Revenue ("A.A.D.E.") introduced new procedural and timeline-related modifications.[2] The Decision is effective July 28, 2023.

Thies article provides a comprehensive outline of the updated process for the issuance of A.P.A.'s in Greece.

OBJECT OF THE A.P.A.

The object of the A.P.A. is to establish intercompany transfer prices that will be accepted by Greek tax authorities over a fixed time period. The A.P.A addresses acceptable methodology, comparative data, relevant adjustments, key assumptions about future conditions, and other special matters that relate to intercompany transfer pricing. An A.P.A. application may be submitted by a Greek parent of a multinational group, a Greek company maintaining permanent establishments abroad, a Greek subsidiary of a foreign parent company, or a permanent establishment maintained in Greece by a foreign corporation.

COMPETENT AUTHORITY

The competent authority for issuing an A.P.A. is the Directorate of Operational Planning of Audits of the General Directorate of Tax Operations of the A.A.D.E.

PRELIMINARY CONSULTATION

Pre-submission consultation is available so that prospective applicants may assess the likelihood of obtaining a successful result. At the pre-submission conference, a taxpayer may submit documentation that may help the competent authority in reaching an informed assessment that is acceptable to the applicant. At a minimum, it must include descriptions of business risks and functions of group members, the intercompany transactions involved, the proposed methodology, the time period covered by the A.P.A., and the countries in which counterparties are resident for tax purposes.

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1 Article 22 of the Greek Code of Tax Procedures (L. 4987/2022).

2 Government Gazette B' 4806/28.07.2023.

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During this stage, the taxpayer and the competent authority discuss the documentation to be included in the A.P.A. application and the competent authority may highlight any points of concern and make proposals regarding the content of the application.

Upon completion of the preliminary consultation stage, the competent authority issues a formal letter in which its preliminary views regarding the outcome of the assessment and the chance of success of the A.P.A. application. This is a modification compared to the previous regime, where any such notification by the competent authority to the taxpayer was verbal and informal.

It is noted that the discussions held during this stage and the written notification of the competent authority do not have a binding effect for any of the parties involved or any impact on the process following the filing of the official A.P.A. application. Moreover, all information and data provided are covered by the tax secrecy provisions. Nonetheless, the written notice ensures that examiners have a roadmap to follow based on information gathered in the pre-submission consultation.

FILING OF THE A.P.A. APPLICATION

The A.P.A. application is submitted to the competent authority. In case of bilateral or multilateral A.P.A.'s involving States with which Greece has concluded income tax treaties, the A.P.A. application and any accompanying or subsequent documentation must be submitted to the competent tax authority of the treaty partner jurisdiction on a simultaneous basis.

The application and relevant documentation may be submitted in English or any other accepted language, except for any documentation that the competent authority deems necessary to be submitted in the Greek language and specifically requests so.

The 30-day deadline for filing the A.P.A. application following the preliminary consultation stage no longer applies.

CONTENT OF THE A.P.A. APPLICATION

The A.P.A. application should include all information necessary for the competent authority to assess the application and form an opinion on the methodology to be used for the determination of the intercompany transfer prices based on the arm's length principle.

The A.P.A. application must contain at least the following items:

- The data of the applicant
- The data of all the involved related parties and permanent establishments
- The group structure
- The description of the intercompany transactions for which the A.P.A. is requested, and where applicable, an additional short justification for not including all intercompany transactions in the requested A.P.A.
- The proposed methodology for the intercompany transfer prices
- The key assumptions on which the A.P.A. is based

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- The time period covered by the A.P.A.
- Where applicable, a justification for requesting a unilateral A.P.A.

The A.P.A. application no longer is required to justify why the applicant deems the proposed transfer pricing methodology to be arm's length beyond the economic analysis.

"The A.P.A. application must state the assumptions on which the proposed methodology is based."

In addition, the taxpayer may file supplementary information, that address the following items:

- An analysis of industry and market trends that are expected to affect the business activities, commercial exploitation studies, or economic studies of the business activities
- A brief description of the current and business strategy and potential changes to that strategy
- An analysis of functions performed and risks taken on by all entities involved in the A.P.A. application
- Detailed information on the proposed methodology and its compliance with the arm's length principle
- A list of all A.P.A.'s that have been concluded by related persons involved in the A.P.A. application that concern the same or similar transactions, either in Greece or abroad
- Detailed financial data of the last three years for all group members involved in the A.P.A. application
- A list of relevant contracts
- Any other information deemed appropriate by the taxpayer in support of the correctness of the transfer pricing

KEY ASSUMPTIONS

The A.P.A. application must state the assumptions on which the proposed methodology is based. Key assumptions consist of (a) the functional, legal, and economic features of the taxpayer, or a specific industry or business activity and (b) the anticipated general economic conditions that are a prerequisite for the implementation of the A.P.A.

In addition, key assumptions must be based on verifiable, reliable, and independent data, to the extent possible. In addition, they must be determined according to the particular circumstances of the taxpayer, the commercial environment, and the transfer pricing methodology of the intercompany transactions. Finally, key assumptions should not be too narrowly defined. Rather, they should be based on a sufficient range of data so as to avoid making it difficult for the taxpayer to comply with the A.P.A..

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ASSESSMENT OF THE A.P.A. APPLICATION

The competent authority examines the provided information and assesses the A.P.A. application with the assistance of the Directorate of Direct Taxation, where applicable. If an applicant is requested to provide additional information or clarifications, a response must be submitted within two months from the date of the request. Previously, information simply needed to be provided within a reasonable period of time.

The competent authority is not limited in seeking information from the taxpayer, only. It may request information from foreign tax authorities using the information exchange procedure provided for by international conventions. In bilateral or multilateral A.P.A.'s, the competent authorities may conduct consultations with each other pursuant to the exchange of information provisions of the applicable income tax treaty. Exchanges of views or information can be effected through formal position papers, video conferences, and physical meetings.

The competent authority may carry out on-site inspections of the taxpayer's premises and interviews with the employees of an applicant.

FORMAL POSITION PAPER

Upon completion of the assessment stage, the competent authority issues a Formal Position Paper stating its conclusion and proposals, which is communicated to the taxpayer. In case of a bilateral or multilateral A.P.A., the taxpayer is notified of the final Formal Position Paper which is agreed following the completion of the consultations with the foreign tax authorities.

The Formal Position Paper must address the following:

- The conclusion of the competent authority or authorities, accompanied by a brief justification for the proposed methodology and the reason for its selection
- The reasons for any rejection or modification of the initially proposed methodology
- The actual facts on which the conclusion of the competent authority is based
- Details of the key assumptions on which the A.P.A. will be based
- A plan for monitoring the implementation of the A.P.A. and reasons for its revision, revoking, or cancellation
- The time period covered by the A.P.A.

It is expected that the position paper will address the above in cursory fashion.

FINAL MEETING

The Formal Position Paper, together with a written invitation for a final meeting, is communicated to the taxpayer at least twenty days in advance. The applicant is entitled to a copy of the minutes of the A.P.A. approval or rejection.

ISSUANCE OF THE A.P.A.

The A.P.A. is issued within 30 days from the date of the final meeting. Previously, the A.P.A. was issued with a 20-day timeframe.

In case of a unilateral A.P.A., a decision generally must be reached with 18 months from the date on which the application was filed. However, the competent authority may be given an extension by the Governor of the A.A.D.E. The extension may not exceed 36 months.

The A.P.A. includes the following:

- The details of the taxpayer
- The details of the related counterparties
- A description of the intercompany transactions that are covered
- The duration and date of commencement of the A.P.A.'s validity
- Detailed information regarding the agreed transfer pricing methodology for the concerned intercompany transactions
- The key assumptions for the implementation, and if deemed necessary, an acceptable margin of deviation
- Possible events or circumstances that will necessitate revision or early termination.

The A.P.A. is valid for a maximum of four years.

- ROLLBACK CLAUSE IN BILATERAL/MULTILATERAL A.P.A.'S

In case of a bilateral or multilateral A.P.A., the taxpayer may request the inclusion of a rollback clause, namely a request for the A.P.A. to have a retroactive effect for previous tax years, provided that the facts of the A.P.A. and the facts of the rollback years are substantially comparable. In order for a rollback to be granted, the tax administration must have the right to carry out an examination for the tax years in the rollback period. This means the rollback year must not be time-barred under a statute of limitations. In addition, a rollback year must not be under examination by the tax authorities.

If a rollback is requested, an applicant must submit all the necessary information that will enable the competent authority to validate the similarity of facts in the rollback period. Once factual similarity is validated, the rollback clause is included in the A.P.A. for the years that are not barred for reasons addressed above.

OBLIGATIONS OF THE TAXPAYER FOLLOWING THE ISSUANCE OF THE A.P.A.

Once an A.P.A. is issued, a taxpayer must submit an Annual Report of Compliance with the terms and conditions of the A.P.A. The report must be filed not later than 90 days from the deadline for filing tax returns for the tax year. Failure to timely filing the report results in the termination of the A.P.A. beginning with the year of

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non-compliance. If the A.P.A. has rollback effect, the taxpayer must submit the relevant Annual Compliance Report for each previous tax year covered by the A.P.A. within 90 days from the issuance of the A.P.A. Failure to timely filing the report results in the termination of the A.P.A. for the rollback period.

Any amended tax returns that are required to be filed for previous tax years are considered as timely if filed within 30 days from the issuance of the A.P.A..

REVISION, REVOCATION, OR CANCELLATION OF THE A.P.A.

The A.P.A. may be revised upon the request by the taxpayer or by the Governor of A.A.D.E. under the same process that applied to its issuance.

Under specific circumstances, the A.P.A. may be revoked or cancelled. In such case, a Special Position Paper is issued by the competent authority, notifying the taxpayer of the proposed cancellation or revocation. The taxpayer may protest such action in a written submission. The submission is followed by an opportunity to meet not earlier than ten days following the written protest. A final decision must be issued within 30 days from meeting.

In case of a revocation, the A.P.A. is considered as having never been issued, whereas in case of a cancellation the A.P.A. ceases to apply as of a specified time onwards.

ADMINISTRATIVE FEES

The following administrative fees are imposed:

- €1,000 upon filing of a Preliminary Consultation request
- €5,000 upon filing of an A.P.A. request or an A.P.A. revision request
- €10,000 for each involved State upon filing of a bilateral or multilateral A.P.A. request

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INVOKING M.F.N. CLAUSE UNDER INDIAN TAX TREATIES REQUIRES NOTIFICATION

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BACKGROUND

Foreign investment in Indian businesses increased significantly since the liberalization measures adopted by the Indian government in the early 1990s. Taxation played an essential role in attracting foreign investment during this period. One change made effective from April 1, 2020, was the elimination of the dividend distribution tax (the "D.D.T."). Prior to this date, dividends distributed by an Indian company were exempt from tax in India in the hands of shareholders. However, the Indian company making a distribution paid D.D.T. on the amount distributed. Effective from April 1, 2020, the concept of D.D.T. was abolished, and dividend income became taxable in the hands of shareholders.

T.D.S.

Indian companies are now required to withhold tax at source ("T.D.S.") when distributing dividends to shareholders. For dividends paid to non-resident shareholders, the rate of T.D.S. imposed under the Income-tax Act 1961 ("Act") is 20%, plus applicable surcharge and cess. A non-resident shareholder can benefit from a lower tax rate under an applicable income tax treaty. For a non-resident shareholder to claim income tax treaty benefits in India, it must furnish a tax residency certificate from its country of tax residence, along with other prescribed documentation. In addition, a non-resident shareholder must demonstrate commercial substance in its country of tax residence. In addition, it must demonstrate that the principal purpose of claiming the income tax treaty benefit is not tax evasion or tax avoidance.

Withholding Tax and M.F.N.

India's tax treaties with various countries mitigate double taxation and also reduce the scope of taxable income or lower the rate of tax in certain cases. The protocols of some of India's tax treaties include a clause known popularly as a most favoured nation ("M.F.N.") clause.

In principle, an M.F.N. clause allows the treaty partner country to import benefits from a subsequently signed Indian income tax treaty when certain conditions are met. To illustrate, India's tax treaties with the Netherlands, France, Switzerland, Spain, and several other countries allow for the application of a lower withholding tax rate in India where an income tax treaty signed by India enters into force at a later date and provides for a lower rate of Indian withholding tax or a reduced scope of taxable income, provided the treaty partner country is a member of the Organization for Economic Cooperation and Development ("O.E.C.D."). The wording of an M.F.N. clause may differ from treaty to treaty. However, a plain reading of a typical M.F.N. clause would suggest that once an income tax treaty comes into effect at a later date with another O.E.C.D. member country providing for a lower rate of withholding tax

on an item of income or a reduced scope of taxable income, the M.F.N. provisions in earlier treaties will apply without further action, unless negotiation is specifically called for in a particular treaty. An example is the India-Switzerland Income Tax Treaty.

However, the invocation of an M.F.N. clause without further negotiation as to the reduction of withholding tax has not been straightforward in India. Rather, it has been debated over the years across various regions and forums in India. Depending on the relevant facts, authorities have taken divergent views on whether a protocol containing the M.F.N. clause forms part of the income tax treaty itself or applies automatically without any specific notification by the tax authorities. Also debated is whether an income tax treaty negotiated with a country that is not a member of the O.E.C.D. ("non-member country") automatically becomes an income tax treaty that can trigger the application of the M.F.N. clause in another treaty when the non-member country with the lower withholding tax rate becomes a member of the O.E.C.D.

DEFINITIVE SUPREME COURT DECISION

The issue was settled recently by the Supreme Court of India in its much awaited judgment in the matter of *Assessing Officer Circle (International Taxation) 2(2)(2) New Delhi v. M/s Nestle SA*.[1] The judgment of the Supreme Court is binding across India and is the law of the land.

In the case, the Supreme Court was asked to clarify the following two issues:

- Does the M.F.N. clause apply automatically, or does it come into effect only after notice by the Indian authorities?
- Does the M.F.N. clause in income tax treaties with countries such as the Netherlands, France, Switzerland, and Spain apply automatically when India's treaty partner is a non-member country that becomes an O.E.C.D. member at a subsequent point in time?

In this case, the M.F.N. clause applied in India's income tax treaties with the Netherlands, France, and Switzerland.

CASES AND ISSUES BEFORE THE SUPREME COURT

The balance of the article includes the following:

- A brief summary of the background of the cases
- The issues presented to the Supreme Court of India
- The legal arguments of the taxpayers and the tax authorities
- The judgment of the Supreme Court
- The likely effect on other taxpayers if the case is not reconsidered

[1] TS-616-SC-2023.

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> ***"In essence, it held that the point in time when the status of a treaty partner country as an O.E.C.D. member is not the time of signing the income tax treaty, but rather is the time of the distribution."***

Concentrix Services Netherlands BV

The taxpayer was a tax resident of the Netherlands and a shareholder of several Indian companies that distributed dividends in years after the abolishment of the D.D.T. The tax rate on dividend income under the India-Netherlands Income Tax Treaty was 10%. However, the taxpayer made an application to the Indian tax authorities seeking to invoke the M.F.N. clause under the India-Netherlands Income Tax Treaty, which was signed in 1989. The taxpayer contended that the lower tax rate of 5% for dividend income provided in India's income tax treaties with Slovenia (signed in 2003), Lithuania (signed in 2011), and Columbia (signed in 2011) was imported into the India-Netherlands Income Tax Treaty under the M.F.N. clause. Slovenia, Lithuania, and Colombia were not O.E.C.D. members when their income tax treaties with India were negotiated, but each was an O.E.C.D. member on the date the application for a 5% withholding was submitted to the Indian tax authorities.

The tax authorities denied the application of the 5% tax rate on the ground that Slovenia, Lithuania, and Colombia were not O.E.C.D. members when their income tax treaties with India were signed. Slovenia became an O.E.C.D. member in August 2010, Lithuania became an O.E.C.D. member in July 2018, and Colombia became an O.E.C.D. member in April 2020. Consequently, Concentrix could not invoke the M.F.N. provision in the India-Netherlands Income Tax Treaty. The predicate condition for obtaining the requested M.F.N. benefit was not met; none was a member of the O.E.C.D. when the India-Netherlands Income Tax Treaty was signed.

The Delhi High Court, however, held that the benefit of the lower tax rate of 5% for dividend income under each of these tax treaties was available to Concentrix, a tax resident of the Netherlands. In essence, it held that the point in time when the status of a treaty partner country as an O.E.C.D. member is important is not the time of signing the income tax treaty, but rather is the time of the distribution. The Netherlands adopted that view in an earlier pronouncement, stating that the rate of withholding tax on intercompany dividends paid by a Dutch resident company to a company resident in India would be the lower tax rate of 5% that applies under the India-Slovenia Income Tax Treaty. According to the Delhi High Court, India cannot take a contrary stand in light of the decree and the principles of interpretation of tax treaties.

Nestle SA

Under the India-Switzerland Income Tax Treaty, the rate of withholding tax on intercompany dividends is 10%. Following its earlier decision in the *Concentrix* case, the Delhi High Court gave similar access to a lower tax rate of 5% for dividends paid to Nestle SA under the M.F.N. clause of the India-Switzerland Income Tax Treaty as Nestle was a resident of Switzerland.

Again, the Delhi High Court placed reliance on the position taken by India's treaty partner country. Swiss authorities announced that they would allow a lower withholding tax rate of 5% on dividends paid to Indian residents based on the M.F.N. clause and India's income tax treaties with Lithuania and Colombia, both of which became O.E.C.D. members after the India-Switzerland Income Tax Treaty was signed. Comparable treatment by India was expected by the Swiss tax authorities.

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Steria (India) Ltd.

In the *Steria (India)* case, the taxpayer referred to Clause 7 of the Protocol in the India-France Income Tax Treaty which contains an M.F.N. clause applicable to royalties, fees for technical services, and payments for the use of equipment. Steria contended that the narrower and more restrictive definition of fees for technical services under the India-U.K. Income Tax Treaty should be applied under the India-France Income Tax Treaty by reason of the M.F.N. clause. There would not be any question of withholding tax on the payment. However, the Authority of Advanced Rulings ("A.A.R.") held that unless there is a specific notification under Section 90 of the Act, the narrower restrictive clause under the India-UK Income Tax Treaty cannot be applied under the India-France Income Tax Treaty.

The taxpayer petitioned the Delhi High Court for relief. The Delhi High Court determined that a protocol is an integral component of the income tax treaty and does not require separate notification for the invocation of the M.F.N. clause.

ARGUMENTS OF THE TAX AUTHORITIES

The tax authorities first argued that Article 253 of the Indian Constitution grants the Parliament the exclusive power to legislate on any treaty or convention entered into by India. Without Parliamentary legislation, treaties are unenforceable. India follows a dualist approach, under which international treaties require legislation to be put into effect. Reliance was placed on the Supreme Court judgments in the cases of *Gramaphone Co. of India Ltd v. Birendra Bahadur Pandey & Ors*.[2] and *Union of India (UOI) & Ors. v. Azadi Bachao Andolan & Ors*[3] to support the conclusion that without enabling legislation, neither a convention nor acts flowing from a convention are operative in India.

Turning specifically to the M.F.N. in various treaties, the tax authorities argued that similar or identical treatment cannot be extended under the M.F.N. clause of the tax treaties with the Netherlands, Switzerland, and France merely because Slovenia, Lithuania, and Colombia gained membership of O.E.C.D. several years after signing beneficial tax treaties with India. Specific notification by Indian tax authorities is required before a protocol can modify an existing income tax treaty. The word "is" as used in the M.F.N. clause – *"is a member of the O.E.C.D."* – can have present, past, or future meaning, depending on the context in which it is used. Slovenia, Lithuania, and Colombia needed to be members of the O.E.C.D. at the time of entering into the respective tax treaties with India, for the Netherlands, France, and Switzerland to claim parity of treatment.

ARGUMENTS OF THE TAXPAYERS

The taxpayers argued that the tax treaties, including protocols that contain M.F.N. clauses, are already notified under Section 90(1) of the Act. Hence, no further notification is required to make M.F.N. clauses active, unless further action or bilateral negotiation is specifically called for. An example of further action that may be needed exists in a 2001 Protocol to the India-Switzerland Income Tax Treaty. It

[2] 1984 [2] SCR 664.

[3] 2003 (Supp4) SCR 222.

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specifically provides for initiation of bilateral negotiation to ensure that benefits extended to states that later became O.E.C.D. members were given to Switzerland. A later protocol in 2010 partially eliminated the need to proceed through negotiation for a lower rate of tax. The need to negotiate continued for reducing the scope of taxable income. The taxpayers argued that the phrase *"shall also apply"* as used in the M.F.N. in the 2010 protocol made the application of the M.F.N. clause automatic, without any requirement to undertake bilateral negotiations or issue any notification for a lower rate of tax.

When the word "is" appears in the M.F.N. – *"is a member of the O.E.C.D."* – the word signifies the time when the provisions of the income tax treaty are to be applied (dynamic interpretation). It does not mean that O.E.C.D. membership must exist at the time when the income tax treaty is signed.

Reliance was also placed on the Supreme Court judgment in the case of *Union of India v. Agricas LLP*,[4] which held that any state cannot breach a treaty to which it is party, referring to any domestic law, which includes legislative, executive, or judicial decision.

SUPREME COURT'S JUDGMENT

The Supreme Court, relying on various judgments and interpretations of Article 253 of the Indian Constitution and Section 90 of the Act, concluded that, when India signs a treaty or protocol, it is not enforceable until Parliament enacts legislation enforcing the agreement. It is up to Parliament to decide whether the treaty should be binding or ignored. In such latter case, the Union will be in default of its obligations. To approve a treaty or a protocol, a notification is required under section 90(1) of the Act. Without such approval, a court, authority, or tribunal has no power to give effect to an income tax treaty or any protocol changing its terms or conditions.

Consequently, an M.F.N. clause does not automatically allow integration of a tax benefit granted to another country. As a result, the power of an M.F.N. clause to amend an earlier treaty requires separate notification under Section 90 of the Act.

Moreover, for a party to claim the benefit of a "same treatment" clause based on an income tax treaty between India and another O.E.C.D. member country, the relevant date for determining when countries are O.E.C.D. member countries is the date when India entered the treaty. In other words, the list of O.E.C.D. member countries is frozen on that date. Reference to tax rates in Indian income tax treaties with Slovenia), Lithuania, and Colombia is simply irrelevant.

COMMENTS

At the outset, it is important to note that, at the date of publication, newspaper reports suggest that a review petition has been filed with the Supreme Court stating that the judgment requires reconsideration for various reasons. Since the outcome of the petition is pending, we have not commented on the possibility of the Supreme Court judgment being overturned upon rehearing or stayed or modified. Any such subsequent development would be covered by way of a follow-up article.

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[4] [2020] 14 SCR 372.

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For now, the judgment of the Supreme Court is the law of the land and provides certainty on a topic of critical importance to non-resident taxpayers in India who seek to invoke the M.F.N. clause. The M.F.N. clause is not only applied to lower the tax rate but also to reduce the scope of taxable income for certain items, such as fees for technical services, as defined broadly to include certain equipment, and royalties.

The typical position adopted by non-resident taxpayers in the past has been that the M.F.N. clause applies automatically. Given the Supreme Court's judgment, non-resident taxpayers may find that they are subject to reassessment for transactions in prior tax periods, ranging up to 10 years.

While the primary liability to pay tax is on the non-resident recipient of income, Indian authorities tend to initiate proceedings against Indian companies having withholding tax obligations. In addition to additional tax, taxpayer/withholding agents may find that they are liable for interest and penalties. While one may argue that penalties should not be levied because reasonable cause existed in the form of the M.F.N. clauses in treaties, the additional tax and interest may still be substantial.

It is evident that the outcome of the review petition is of significant importance. One of the key principles emanating from the Supreme Court judgment is that even though treaties bind the Union, Parliament's refusal to perform or give effect to such treaties can leave the Union in default. Whether this leaves the Union exposed to an international dispute, is a matter of further analysis. Even if no international dispute arises, the tax authorities of the impacted countries – notably the Netherlands and Switzerland which anticipated reciprocal tax reductions – may consider initiating dialogue with the Indian authorities to notify the M.F.N. benefit going forward, or perhaps retroactively.

For now, it appears that impacted non-resident investors will need to brace for higher taxes in India. Affected companies may find it prudent to examine exposure to additional tax, interest, and penalties and to formulate a strategy for dealing with Indian tax examiners. This may include examining the possibility of claiming additional foreign tax credits in the recipient's country of residence. There could be cases where the country of residence does not agree with the interpretation of the Indian tax authorities – again, the Netherlands, Switzerland, and France come to mind, plus other countries that have issued notices that the M.F.N. in a relevant treaty is applicable. In that case, taxpayers may wish to invoke the mutual agreement procedure ("M.A.P.") article under an applicable tax treaty. Whichever path is taken, a prolonged battle should be anticipated.

India has not agreed to the mandatory binding arbitration article under the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, which when applicable, applies when treaty partners are unable to resolve issues through discussions under a relevant M.A.P.

CONCLUSION

Given the number of cases that will be impacted by the decision of the Supreme Court of India, there is likely to be a surge in assessment / reassessment, and resulting MAP cases. One can only hope that the Indian authorities will issue a clarification that provides reasonable and much-needed certainty to taxpayers.

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NEWS FROM ITALY – RECENT UPDATES TO INBOUND WORKERS REGIME AND REGISTER OF BENEFICIAL OWNERS

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Tags
Flat Tax
Inbound Workers Relief
Italian Trust
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INTRODUCTION

Over the last decade, Italy introduced tax reliefs aimed at attracting inbound investment and to spur an increase in the number of individuals coming to Italy to work or simply to live in Italy.

Flat Tax Regime

The most well-known tax relief is the Flat Tax Regime, which imposes a lump-sum tax of €100,000 per year on all foreign source income of a participating individual. The relief is available to individuals who establish residence in Italy after having been resident abroad for at least nine out of the previous ten tax years. In general, the nationality of the individual is irrelevant. Once an individual qualifies for the relief, the benefit of lump sum taxation can be extended to family members. Each family member that applies pays a lump-sum tax of only €25,000.

Participants in the Flat Tax Regime benefit from several additional provisions of Italian law:

- They do not report foreign assets other than qualified shareholdings in foreign companies, which must be reported only in the first five years.
- They are exempt from the payment of wealth taxes on real estate properties and financial assets held abroad.[1]
- They are exempt from inheritance and gift tax on foreign situs assets.

Other Regimes

A lesser known tax relief is the Inbound Workers Regime. It allows for a 70% tax exemption on income derived from working activity performed in Italy. In some instances, the exemption is 90%.

Finally, Italian law provides a third form of tax relief for arriving retirees. Under the Pensioners Regime, a foreign retiree who establishes residence in Italy's southern region pays a substitute tax of 7% on all non-Italian source pension income. To qualify for the regime, the following conditions must be met:

- The individual must receive a "pension income" paid by a non-Italian entity.
- The individual must not have been a resident of Italy for the five years prior the period in which the benefit is first claimed.

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[1] I.V.I.E. is the wealth tax applicable to real estate. I.V.A.F.E. is the wealth tax applicable to financial assets.

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- During that five-year period, the individual must have resided in one or more countries having in effect an administrative cooperation agreement with Italy.
- Residence must be established in a municipality in a southern region that has a population of up to 20,000 inhabitants. Such regions include Sicily, Calabria, Sardinia, Campania, Molise, Puglia, Abruzzo, and Basilicata.

2023 ITALIAN TAX REFORM

In its session of October 16, 2023, the Italian Government approved a draft legislative decree on international taxation. The decree is now under discussion by the relevant parliamentary committees. In particular, the draft legislative decree addresses the tax regime for inbound workers. The proposed modifications do not impact the Flat Tax Regime or the Pensioners Regime.

Inbound Workers Regime – Current Provisions

As mentioned above, the Inbound Workers Regime currently provides a tax exemption of 70% of employment income, including salary and benefits, and business and self-employment income derived from personal services performed in Italy. The tax exemption is 90% when the taxpayer relocates to one of the Southern Regions previously mentioned. As a consequence, the taxable 30% or 10% share of Italian employment income is liable to ordinary personal income tax, with brackets ranging up to 43%, plus local surcharges of approximately 2%. In relation to income from self-employment and business income, the Inbound Workers Regime is subject to State Aid *de minimis* rules, which cap the tax relief €200,000 over a three-year period.

Tax relief granted by the Inbound Worker Regime is available under existing law where the following requirements are met:

- The individual transfers tax residence to Italy.[2]
- The individual has not been resident in Italy during the two tax periods preceding a transfer of tax residence to Italy.
- The worker commits to maintain Italian tax residence for a minimum period of two years.
- The taxpayer performs the working activity mainly in Italy.

The tax benefit is available for up to five consecutive years. If certain additional requirements are met and tax residence in Italy is maintained for an additional five-year period, scaled back benefits are allowed for the additional five tax years. The additional scaled back benefits are available if, and only if, the individual remains tax resident in Italy for the full additional period of five years.

If the individual meets the additional residence requirement and the other conditions regarding dependent children or full ownership of a residence, the following percentages of income will be subject to personal income tax[3] in years six through ten:

[2] Article 2, par. 2 of the Italian Income Tax Code ("I.T.C.").

[3] I.R.P.E.F.

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- 50%, if the worker has a minor or dependent child, including if in pre-adoptive care
- 50%, if the worker acquires full ownership of at least one residential real estate unit in Italy following their transfer to Italy or in the twelve-month period prior to the transfer to Italy
- 10%, if the worker has at least three minor or dependent children, including children in pre-adoptive care

Inbound Workers Regime – Proposed Amendments

The proposal provides for a 50% reduction in taxable income on an amount of income not exceeding €600,000 if the following conditions are met:

- The worker establishes a tax residence in Italy, as under existing law.
- The benefit is limited to employment income, income that is assimilated to employment, and self-employment income. Business income other than self-employment income is excluded.[4]
- The individual has not been resident in Italy during the three tax periods preceding a transfer of tax residence to Italy.
- The individual commits to remain tax resident in Italy for at least five years. If the five-year residence requirement is not met, the tax authorities will take steps to recover the tax benefit in full. Penalties and late payment interest will also be applied.
- More than 50% of the workdays each year must take place in Italy.
- The reduction in tax does not apply to days worked outside Italy.
- The employee cannot work in Italy for the same company that employed the individual prior to the move to Italy or for a company in Italy that is a member of the same group of companies as the prior employer. The workers must meet the requirements of high qualification or specialization.
- In case of self-employment income, the state aids *de minimis* rules remain applicable. The relief is capped at €200,000 over a three-year period after arrival in Italy.
- The duration of the tax benefit is limited to five years, with no extensions.

The new regime applies to individuals taking Italian tax residence beginning with tax year 2024. However, a grandfathering rule likely will apply the more favorable existing relief for individuals who became Italian residents by enrolling in the Register of the Resident Population in Italy (*Anagrafe della Popolazione Residente*) not later than December 31, 2023.

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[4] Pursuant to Italian law, self-employment and business income are two different kinds of income. Each case usually requires a specific analysis. Generally speaking, self-employment income is made from arts and professions, while business income is made from commercial activities.

ITALIAN REGISTER OF BENEFICIAL OWNERS: TRUSTS

The Register of Beneficial Owners (the "Register") of enterprises with legal personality, private legal entities, trusts, and similar legal arrangements has become operational at the Italian Chamber of Commerce.

The Register is held by the local Chamber of Commerce and consists of two sections. The ordinary section holds the data of the Ultimate Beneficial Owners of companies with legal personality and private legal entities. Companies with legal personality include limited liability companies, joint-stock companies, limited partnerships limited by shares, and cooperative companies. Private legal entities include foundations and recognized associations. The special section contains the data of the Ultimate Beneficial Owners ("U.B.O.'s") of trusts and similar legal arrangements.

"The Register of Beneficial Owners of enterprises with legal personality, private legal entities, trusts, and similar legal arrangements has become operational at the Italian Chamber of Commerce."

U.B.O.'s of Trusts and Similar Entities

Pursuant to Italian Anti-Money Laundering ("A.M.L.") Rules, the U.B.O. is the individual or individuals in whose interest a professional service is rendered, or a business relationship is held. In the specific case of a trust, the U.B.O.'s are the Settlor during his lifetime; the trustee; the protector, if any; the beneficiaries or the living individuals who are included among the beneficiaries; other individuals holding the power to control the trust as well as any other person who ultimately, directly or indirectly, controls the assets transferred to the trust.

If the settlor, the trustee, or other persons who have the control over the Trust are companies or similar entities, the listed U.B.O.'s of the trust are the same persons who are U.B.O.'s of such entities.

Persons Obliged to Communicate the Relevant Data

In the case of a trust or an equivalent arrangement, the trustee is the person responsible for providing information on all U.B.O.'s to the Register of Enterprises at the Italian Chamber of Commerce. A self-declaration is all that is required when the trust is set up or is resident in Italy and the trust carries out activities that have legal effect in Italy or leads to consequences for Italian tax purposes, such as when the trust derives income from Italy, owns assets in Italy, or is liable to Italian taxation for any reason.

Pursuant to current Italian Tax Law and clarifications provided by the Italian Tax Authority, a trust is deemed to be a tax resident in Italy if any of the following conditions is met for the greater part of the year, meaning 183 days:

- The trustee is an Italian resident individual or company.
- The trustee's employees, offices, or operating structure is located in Italy.
- The main purpose of the trust is carried out in Italy.

It is worth noting that the draft legislative decree on international taxation revises the criteria used to determine residence for corporate entities and trusts. In particular, two of the current criteria – seat of administration and main purpose – will be repealed and replaced with the following criteria:

- The place of effective management, which is defined as the place of the continuous and coordinated taking of strategic decisions concerning the company or entity as a whole.

- The place of routine management, which means the place of continuous and coordinated performance of day-to-day management acts concerning the company or entity as a whole.

These new criteria could also affect the tax residence of trusts and thus the reporting obligations to the Register.

Relevant Information to be Filed

The following information must be filed:

- The identity of the U.B.O., including (i) name, (ii) surname, (iii) place and date of birth, (iv) places of residence and domicile, if different from the registered residence, (v) details of the identification document, and (vi) the Italian tax identification number, if any.

- Information regarding the trust, including its (i) the tax identification number, (ii) name, (iii) the date, place, and details of the deed of trust.

Access to the U.B.O. Register

Access to the data held by the special section of the U.B.O. Register is restricted to the following:

- Public entities (including tax and judicial authorities)

- Entities and individuals obliged to carry out A.M.L. procedures, due to their particular activity; examples include banks, public notaries, chartered accountants, lawyers, and other professionals who are required by law to identify the beneficial owner before starting their professional or commercial relationship

- Other persons demonstrating a legitimate interest at protecting or defending their legal position, in case a discrepancy between beneficial ownership and legal title arises

Access to the information contained in the U.B.O. Register may be denied if the beneficial owner is exposed to a disproportionate risk of fraud, harm, kidnapping, blackmail, extortion, harassment, violence, or intimidation, or if he or she is a minor or incapacitated person (so-called "counter-interested parties"). In this case, relevant information in order to determine such exceptional circumstances must be communicated to the U.B.O. Register.

Access to the U.B.O. Register used to be open to the public pursuant to E.U. A.M.L. rules. However, by issuing its ruling of November 22, 2022, the Court of Justice of the European Union limited the access to data on beneficial ownership of companies and private legal entities to those individuals who have a relevant and actual legitimate interest.

Access by parties that carry out A.M.L. procedures must apply for accreditation to the relevant Chamber of Commerce office in order to have access to the data on beneficial ownership. Other entities and individuals wishing to access information

must submit a request explaining the reason justifying the request for access to the information. The final decision is made by the relevant Chamber of Commerce office.

Deadlines

The deadline for the filing of the relevant data to the U.B.O. Register is December 11, 2023. The filing must be made by the (i) directors of companies; (ii) the founder, if alive, or legal representative for private legal entities; and (iii) the trustees for trusts and similar legal arrangements.

For companies, private legal entities, trusts, and similar legal arrangements set up after October 9, 2023, the first filing is made within 30 days of formation.

Any changes in data and information regarding the beneficial owner must be filed within 30 days following the relevant deed.

Penalties

A failure to file data of the U.B.O. triggers the imposition of administrative penalties ranging from €103 to €1,032. In addition, a person who intentionally provides false statements is subject to criminal punishment.

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Our firm provides a wide range of tax planning and commercial legal services to clients across the Americas, Asia, Europe, and the Middle East. Clients include global investors, multinational corporations expanding into the U.S., and U.S. businesses with international operations. Our core practice focuses on cross-border transactions.

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