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INSIGHTS

ADVENTURES IN TRANSFER PRICING – PRACTICAL EXPERIENCE IN GERMANY

ITALY INTRODUCES A PENALTY PROTECTION REGIME FOR HYBRID MISMATCHES: TRICK OR TREAT?

U.S. CITIZENS OWNING SWISS REAL ESTATE – CROSS BORDER ESTATE PLANNING IS A NECESSITY

AND MORE

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EDITORS' NOTE

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

- **Adventures In Transfer Pricing – Practical Experience in Germany.** For many years, German tax authorities suspected that M.N.C.'s transfer pricing policies were not in line with the arm's length principle. Consequently, it comes as no surprise that Germany spearheaded international regulatory developments related to the arm's length standard. International M.N.C.'s face ever increasing tax controversies in matters related to transfer pricing. In some cases, T.N.M.M. benchmarking is challenged under the view that a German sales entity makes intangible-related D.E.M.P.E. contributions in the field of marketing. In other cases ,C.U.T. benchmarking for intercompany license fees is challenged on grounds that the intangible property licensed to a German affiliate is unique by definition, thereby leading to a profit split. Restructures are attacked using inflated values for routine activities that remain in Germany. However, all is not bleak. In three case studies, Dr. Yves Herve, a Senior Managing Director in the Frankfurt Office of NERA and Philip de Homont, MSc, a Managing Director in the Frankfurt Office of NERA, illustrate in "plain language" the ways by which in-depth economic analysis has been used to overcome aggressive assertions by tax examiners.

- **Italy Introduces a Penalty Protection Regime for Hybrid Mismatches: Trick Or Treat?** Anti-hybrid legislation consistent with A.T.A.D. 2 has been in effect in Italy for fiscal years beginning on or after January 1, 2020. But towards the close of last year, legislation was enacted under which penalty relief is available as of the 2023. The key to obtaining relief is the "hybrid dossier," which is submitted to the tax authorities and provides full disclosure of the hybrid transactions, the relevant laws in Italy and the other country, and the reasoning why the anti-hybrid penalties are inapplicable. While the new rules clearly apply beginning with the 2023 fiscal year, retroactive relief back to the 2020 fiscal year is allowed, provided one hurdle is overcome. Retroactive relief is available if, and only if, Italian tax authorities "have not started a tax audit, investigation activities, or other similar actions for those fiscal years." It is understood that Italian tax authorities have already begun to notify targeted taxpayers with questionnaires. In their article, Federico Di Cesare, a Partner of Macchi di Cellere Gangemi in Rome and Milan, and Dimitra Michalopoulos, an Associate in the tax practice of Macchi di Cellere Gangemi in Rome, explain the legislation, address the content of the hybrid dossier, and address the most important issue for many taxpayers: have Italian tax authorities taken action similar to a tax audit by the circulation of the questionnaire?

- **U.S. Citizens Owning Swiss Real Estate – Cross Border Estate Planning is a Necessity.** More and more Americans are living and working in Switzerland. Today, it is common for American citizens to own assets in Switzerland, especially real estate. While impediments to acquire Swiss real estate are easily overcome, the ability to transfer real estate at death in a way that meets the expectations of the American owner requires careful planning in advance. Differences in the inheritance and tax laws of the two countries make estate planning in U.S.-Swiss inheritance cases particularly complex. The problem

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is exacerbated by differences in conflict-of-law laws. Daniel Gabrieli, a partner in the Private Clients practice group of attorneys Wenger Plattner in Zurich, and Nils Kern, an associate in the Private Clients practice group of attorneys Wenger Plattner in Zurich, explain the issues that are faced under Swiss law, provide a typical fact pattern that may create problems at death, and suggest steps that can be taken during life to avoid the issue altogether.

- **French Reporting Obligations for Foreign Financial Trusts.** In general, French information reporting obligations regarding foreign financial trusts are broad, the scope of reporting persons and transactions are broader, and the risk of penalties is severe. By definition, foreign financial trusts are formed under foreign law, have only non-French individuals as settlors and beneficiaries, and in France own only financial investment assets. French reporting obligations can be a burden for the trustees of these trusts and foreign trustees often are not aware of the full scope of the French rules. Even when the rules are known by the trustee, they are ambiguous and imprecise, leading to legal uncertainty. The problem often affects U.S. individuals who invest in French financial assets through trusts upon the recommendation of U.S. asset managers or private bankers. Programs to issue U.S. Dollar Denominated Medium-Term Notes ("U.S.D.M.T.N.'s") represent a major source of U.S. Dollar liquidity for French banks. In their article, Benoit Bailly, a partner in the Paris office of CMS Francis Lefebvre, and Carl Meak, an associate in the Paris office of CMS Francis Lefebvre, address the labyrinth of reporting obligations that exist in the guidelines issued by French tax authorities. They point out that several rulings of the the *Service de la sécurité juridique et du contrôle fiscal* appear to be helpful. Nonetheless, more work is left to be done.

- **Netherlands: New Legislation to Combat Hybrid Mismatches.** Late in 2023, the Netherlands parliament adopted a legislative proposal intended to significantly reduce the use of hybrid mismatch arrangements by companies operating internationally. While the legislative proposal reflects the policy of A.T.A.D. 2. – combatting hybrid mismatches – it does so through the adoption of a system to achieve uniform classification of entities on a cross border basis. Gerard van der Linden, a partner of Van Olde Tax Lawyers in Amsterdam, and Thijs Poelert, an associate at Van Olde Tax Lawyers in Amsterdam, explain the fixed method and the symmetric method for classifying foreign entities that are at the core of the law. Classification rules for certain domestic and foreign entities have been modified significantly. C.V.'s, L.P.'s, and L.L.C.'s will be treated as fiscally transparent. The new law is scheduled to take effect on January 1, 2025.

- **Developments in Anti-Abuse Measures And Acquisition Financing in the Netherlands.** Last year, *Insights* published an article by Michael Bennett on cases in which the Dutch tax authorities used Article 10a of Dutch tax law and the concept of *fraus legis* to challenge deductions for interest expense on certain internal borrowings. The article pointed out that many grey areas and interpretative issues remained. Since that article was published, the Dutch Supreme Court, the Advocate General for the C.J.E.U., and the Advocate General of the Netherlands have issued opinions on three separate cases. In his article in this edition of *Insights*, Michael Bennett reviews the opinions and points out the ongoing uncertainty surrounding the precise scope of Article 10a and its interaction with *fraus legis*.

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- **Information Reporting on Foreign Trusts and Gifts – New Regulations.** On May 8th, the Treasury Department and the I.R.S. proposed regulations regarding information reporting in the context of U.S. persons, foreign trusts, and gifts from non-U.S. persons. When adopted in final form, they will affect (i) U.S. persons who engage in transactions with, or are treated as the owners of, foreign trusts and (ii) U.S. persons who receive large gifts or bequests from foreign persons. The scope of the proposed regulations is broad, and many existing regulations are affected. Wooyoung Lee and Stanley C. Ruchelman take a deep dive addressing specific regulatory provisions that are affected. Many "open doors" that currently exist have been closed. The authors tell all, linking explanations in the preamble to the proposed regulations with specific regulations in the proposal.

- **Earning My Credits: Life At Ruchelman P.L.L.C.** Ruchelman P.L.L.C. actively participates in the extern program for students in the LLM Program at New York Law School. We provide real life professional experience to the extern and the extern receives two credits towards the award of a degree. Our younger lawyers benefit by providing hands-on supervision of the extern, a needed step in professional development. Recently, we expanded our extern program to include J.D. students at New York Law School who have taken enough tax courses to demonstrate a desire to pursue a tax focus in the practice of law. This spring, our extern was Vanessa Lebbos, now a law school graduate. In her article, Vanessa explains her journey in law school, her interest in taking tax courses, and her experience at our firm. Mentoring an extern can be its own reward. That certainly was our experience with Vanessa.

We hope you enjoy this issue.

- The Editors

ADVENTURES IN TRANSFER PRICING – PRACTICAL EXPERIENCE IN GERMANY

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Tags
B.E.P.S. 2
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INTRODUCTION

Among tax directors at multinational corporations ("M.N.C.'s") German tax authorities are viewed to be among the most aggressive and sophisticated tax authorities in challenging straightforward transfer pricing solutions. This article explains the reasons behind this view and highlights key takeaways from recent transfer pricing tax controversies in Germany.

GERMAN ECONOMIC AND REGULATORY LANDSCAPE

Germany is the most industrialized European economy with a broad range of large M.N.C.'s operating across major industries, in particular automotive, industrial suppliers, chemicals, and pharmaceuticals. Germany also has hundreds of mid-sized hidden champions that are globally successful under the "Made in Germany" label. These open market policies in conjunction with high G.D.P. and high per capita income make Germany an attractive market for M.N.C.'s, based in other European countries, the U.S., Japan, Korea, and China .

At the same time, Germany has remained a high tax country, with the effective corporate tax rate now close to 30%. As a consequence, Germany has experienced negative effects from a global race to the bottom in terms of international corporate tax. International tax planning in the golden age of globalization (roughly 1990-2015) put transfer pricing at the heart of tax planning by multinational corporations ("M.N.C.'s"). Tax-effective supply chains popped up, enabling M.N.C.'s to gain competitive advantages over locally based competitors.

M.N.C.'s discovered the potential to set up structures that serve the German market through low-risk, low-margin local operations. In particular, many U.S. M.N.C.'s have restructured their subsidiaries in Germany to move legacy I.P. to European affiliates established in low-tax jurisdictions. The remaining operations in Germany were converted to contract manufacturers, contract R&D centers, and low-risk distributors, allowing profits to be realized by European affiliates in low-tax jurisdictions. M.N.C.'s have also stripped German profits further through intragroup financing.

To overcome disadvantages of remaining barriers to free trade – such as customs barriers, the U.S. Inflation Reduction Act from 2022, and Chinese requirements for German M.N.C.'s to transfer technology to Chinese affiliates, and high taxation at home – German M.N.C.'s globalize their footprint to increasingly set up high-value functions in critical markets like the U.S. and China. They regularly transfer domestically developed intangibles to such territories.

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For many years, German tax authorities suspected that M.N.C.'s transfer pricing policies were not in line with the arm's length principle. Consequently, it comes as no surprise that Germany spearheaded international regulatory developments related to the arm's length standard.

This started with the German transfer of function rules established in 2008 that largely influenced the O.E.C.D. business restructuring rules. Then came the "base erosion and profit shifting" ("B.E.P.S.") initiative, which attacked traditional I.P. structuring and entrepreneurial profit capturing by principals with little economic substance established in low-tax jurisdictions. This translated into the paradigm shift of the O.E.C.D. transfer pricing guidelines in 2017. Legal I.P. and legal structuring of risk allocation within M.N.C.'s alone would no longer be acceptable identifiers to allocate consolidated group profit. In their place, functional development, enhancement, maintenance, protection and exploitation ("D.E.M.P.E.") contributions to intangible resources of company value became the key consideration. Finally, the German government is a key proponent of Pillar II and the O.E.C.D. B.E.P.S. 2 initiative, which seeks to achieve global minimum taxation and to prevent "unfair" distortion of international tax competition.

INCREASING TRANSFER PRICING CONTROVERSY IN GERMANY

Given local regulatory developments, international M.N.C.'s face ever increasing tax controversies in Germany related to transfer pricing matters across a broad range of areas. The challenges may be summarized as follows:

- **Challenges to transactional net margin method ("T.N.M.M.") for distributors.** M.N.C.'s with sales subsidiaries in Germany find that returns based on T.N.M.M. benchmarking are regularly challenged on the grounds that the German sales entity is considered to have made intangible-related D.E.M.P.E. contributions in the field of marketing. Following German administrative guidelines, the T.N.M.M. is rejected as inappropriate and the transfer pricing ("T.P.") documentation characterized as fundamentally flawed. This opens the ground for German tax authorities to make their own discretionary assessment of arm's length pricing, shifting the burden of proof to the taxpayer. In this context, it is important to know that, while the O.E.C.D. T.P. Guidelines and the related new intangible and D.E.M.P.E. concepts were first integrated into German tax law in 2022, the tax authorities maintain that the D.E.M.P.E. concept is only a clarification of previously existing rules because D.E.M.P.E. contributions were effectively already considered by German tax authorities in the past. Consequently, the analytical framework of the 2022 O.E.C.D. T.P. Guidelines is applied to auditing years prior to 2022.
- **German tax authorities regularly reject external comparable uncontrolled transactions ("C.U.T.").** When challenging the arm's length nature of intragroup license arrangements, the German tax authorities contend each intangible is unique by definition. They aim to force taxpayers to determine and disclose consolidated profit jointly generated by the licensor and the licensee in order to assess appropriate royalties through a *de facto* profit split analysis.

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- **German tax authorities have adopted a very broad definition to what qualifies as a transfer of a valuable function.** Regarding business restructurings, German transfer pricing rules entitle the transferor to be compensated for both (i) the present value of the profit potential that is relinquished and (ii) a share of business and tax synergies realized by the transferee. The transfer pricing rules in the latest regulatory update no longer require the transfer of intangible assets owned by the transferor as part of a package to apply transfer of function valuations.. When computing such valuation, an infinite time horizon is the general default rule. It is the responsibility of the taxpayer to prove that a shorter time horizon should be applicable and to demonstrate what the shorter horizon should be. Exit tax charges of double or triple digit millions USD can easily arise in such cases.

- **German tax audits involving transactions with economic principals in low-tax jurisdictions require excessive data from taxpayers.** German tax authorities regularly aim to extend requirements in the tax audit so that the taxpayer is effectively forced to document at a fairly granular level the economic substance and value contribution of the principal based in a low-tax jurisdiction. German tax authorities are widely aware that U.S. M.N.C.'s manage the group effective tax rate through use of licensing companies in low-tax jurisdictions. When the German tax authorities conclude that the profit of the licensing company is unreasonably high in comparison to its deemed value-add, they reduce the transfer price paid by the German subsidiary, even when the original distortion may be a too low transfer price / license fee from the U.S. to the European principal. In rare cases, German tax authorities have recharacterized transactions when they considered the economic substance of the principal to be inadequate, which, by definition, is a highly subjective finding.

- **On intragroup financing, German tax authorities have regularly challenged interest rates.** Interest rates charged to affiliates by a low-tax financing company are regularly determined to be too high when based on a stand-alone rating benchmark. While this position has successfully been challenged in the Federal Financial Court, the issue remains controversial.

Given this environment, it is not surprising that the number of tax disputes has increased significantly. Most tax audits end up with "horse-trading" deals involving some amount of double taxation, as field tax inspectors have become experts in applying smart "blackmailing" strategies. Taxpayers are incentivized to accept some adjustment in conjunction with a commitment to avoid mutual agreement procedures ("M.A.P."), under threat that the tax authorities will impose much higher tax assessments to achieve more favorable settlements in future M.A.P. negotiations. Still, more than 700 new M.A.P. cases are now initiated in Germany every year, roughly 50% involving transfer pricing. The Federal Tax Office has increased domestic resources for dealing with such requests, so that roughly as many cases get settled as new cases are opened, and the average settlement process time has been brought down to below two years. In parallel, the numbers of A.P.A. requests is increasing, and close to 80 new A.P.A. applications are opened each year.

Regarding tax litigation, the statistics are blurred as many cases are settled before a decision is issued. This often arises when judges assigned to a case indicate to the parties the argument they may tend to favor, pointing out remaining uncertainties,

especially when it comes to economic quantification in the grey zone of transfer pricing. Judges often recommend an out-of-court settlement in order to reduce their workload and to avoid having to make quantitative decisions for which they have no proper economic expertise. Recent Financial Court decisions primarily related to financial transactions and business restructurings are relatively favorable to the taxpayer, which is fairly good news given that the lower Financial Courts are generally presumed to have a bias in favor of the German tax authorities.

CASE STUDY I: CHALLENGING THE SWISS PRINCIPAL STRUCTURE OF A U.S. CONSUMER PRODUCT GIANT

"Recent Financial Court decisions primarily related to financial transactions and business restructurings are relatively favorable to the taxpayer, which is fairly good news given that the lower Financial Courts are generally presumed to have a bias in favor of the German tax authorities."

The client operates in a highly profitable market segment with captive customers. A specific family of products together with brand campaign attributes were developed in the U.S. many years ago, with clearly U.S.-tailored brand imaging. Around the year 2000, the U.S. headquartered M.N.C. decided to test the promotion of the product in Germany. A subsidiary in Germany ("G-Co") licensed the brand I.P. from a U.S. affiliate ("U.S.-Co") at moderate royalty rates and rolled out a local marketing campaign in line with U.S. guidelines. G-Co was tasked with determining a German-specific go-to-market approach and developing distribution channels. G-Co purchased key product input from the U.S. (invoicing on cost-plus basis) and out sourced finished product manufacturing to third party suppliers operating on its behalf. While investing little in advertising, G-Co grew decently and was highly profitable from the very beginning.

In 2006, U.S.-Co decided to expand European operations and established a European principal structure headquartered in Switzerland. G-Co was converted into a limited risk distributor ("L.R.D.") and as of 2007 only bought finished products from Swiss-Co, a related party, to resell on the German market. Swiss-Co licensed the U.S.-I.P. and became the regional entrepreneur for Europe. The U.S. transfer pricing to Swiss-Co was largely the same as previously in effect with G-Co. As an L.R.D., G-Co now earned a benchmarked operating margin of 3%, which translates into a dramatic margin reduction in contrast to previous years, while sales increased considerably.

In a German tax audit covering the financial years 2007 to 2010, the margin reduction in Germany in conjunction with the introduction of a Swiss principal structure were red flagged by the field tax inspectors. Interestingly, they did not pursue an assessment of a deemed transfer of functions, very likely because they could not identify the transfer of any valuable intangible assets from G-Co to Swiss-Co. Instead, they challenged the taxpayer to demonstrate (i) that a major change of business operations actually occurred and (ii) that Swiss-Co was entitled to earn margins that were previously earned by G-Co.

Amazingly, despite having become the principal for the German market, Swiss-Co was loss-making in the relevant tax audit period. The reason was that, in those years, Swiss-Co invested significant amounts to expand in other European markets, while economic circumstances for the relevant products became less favorable. However, the client management information system of Swiss-Co was not able to provide a proper P&L segmentation demonstrating the segment profits Swiss-Co was making in relation to the German market. The German authorities became

completely distrustful of the submitted P&L data, and raised a general suspicion that profits had been shifted from Switzerland to some Caribbean island known to host a group subsidiary.

In the view of the tax inspectors, the taxpayer failed to demonstrate a critical amount of substance in Switzerland. For example, G-Co continued to have a direct communication and ordering process with third party manufacturers, even though the manufacturers contracted with Swiss-Co. The tax inspectors came to the conclusion that, in material terms, G-Co had the same functional profile as in its license manufacturer period through 2006. Consequently, they recharacterized the transactions between G-Co and Swiss-Co and treated the latter as an empty shell. Additionally, they rejected benchmark studies justifying G-Co's L.R.D. return as inappropriate because in their view G-Co's marketing activities went beyond those of an L.R.D. In post-B.E.P.S. language, they effectively claimed that G-Co made significant D.E.M.P.E. contributions driving the brand value in Germany.

Challenging the new model from two fundamental factual sides – supervision responsibilities for manufacturing and contribution to marketing intangibles – the field tax inspectors concluded the submitted T.P. documentation was fundamentally flawed. In line with German administrative guidelines, the field inspectors made an independent assessment of arm's length pricing. Referring to the pre-audit years and with a rather ludicrous interpretation of facts and bad economics, they assessed the arm's length return for G-Co to significantly exceed 30% of sales, more than ten times the actual results.

In view of this assessment, a M.A.P. was not an option for the M.N.C., both because (i) the starting position of the German tax inspectors made it almost impossible to expect a reasonable dispute resolution and (ii) Swiss-Co was not profitable in the period even without taking the adjustment into account. The M.N.C. selected a law firm to initiate tax litigation in Germany challenging the assessment. The law firm retained economic T.P. advisors to support the litigation.

The litigation dragged on for approximately three years. An in depth value chain and functional analysis were performed that aligned the economic environment with the factors relevant for the case. Internal documents were identified demonstrating that, notwithstanding limited headcount, (i) the leadership team in Switzerland initiated and pushed business initiatives in Germany, (ii) G-Co was no longer driving the controlling contracting activities with third parties, and (iii) G-Co was not making any D.E.M.P.E. contributions in the field of marketing.

Having substantiated that G-Co was really doing no more than an L.R.D, the M.N.C.'s T.P. advisers corroborated the results of the benchmark studies in the G-Co's T.P. documentation through three complementary sets of technical analysis based on client-specific information. Forensic analysis of the tax authorities audit trail, which was released in the course of the tax litigation, was found to contain factual and analytical errors that demonstrated a bias against the taxpayer.

Based on further financial information dating back up to 15 years, the M.N.C. was able to demonstrate that the loss-making position of Swiss-Co was not related to German business events and that the German market deteriorated during the period under examination. As a result, Swiss residual profit margins from German business

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operations fell dramatically in comparison to earlier years. The economic data demonstrated that the assessment made by German tax authorities was far beyond any reasonable range of objectivity and violated German regulatory guidelines.

In the course of the legal proceedings, tax authorities became ever more defensive, incoherent, and inconsistent in their factual and technical positions. This clearly irritated the investigating judge. Still, the tax authorities did not retreat from their initial assessment. Neither the field tax inspector nor the reviewers were impressed by the empirical evidence produced by the M.N.C. At some point, the court interrupted the proceedings, and in conference, suggested that the factual position of the M.N.C. seemed more likely to prevail than the position of the tax authorities. After eight years of dispute, the assessment was put aside, and a settlement was reached that was consistent with the position of the M.N.C.

To summarize, the taxpayer achieved a positive outcome because, apart from sloppy analysis and neglect of relevant economic factors, the tax authorities stumbled at the burden of proof hurdle in their factual interpretation. Today, however, M.N.C.'s operating in Germany should be aware that, in cases of legitimate doubt, revised German administrative guidelines facilitate acceptance of the positions of the tax authorities. As a result, it is quite likely the tax authorities would have achieved a better outcome in court if the case were to be raised today.

The key takeaway from all this is that, from a cost-benefit perspective, slim and standardized T.P. documentation that fails to address the industrial economic specifics of the underlying transaction parties is not a recommended tax compliance strategy. Indeed, it is doubtful that "canned" T.P. studies that crunch data with no context is not a winning strategy for taxpayers.

CASE STUDY II: GUIDANCE WHEN RELOCATION OF FUNCTIONS LEAD TO PITFALLS

In connection with a relocation of functions that has so far been performed by a German entity, many factors need to be considered in anticipation of a tax examination. Three main drivers for conflicts are (i) the definition of a function, (ii) identifying what was actually transferred and (iii) the determination of the value of the transferred function.

Pitfalls in the determination of the transfer price are well illustrated by an I.P.-centralization case of a U.S. M.N.C. that acquired a company in Germany. As part of acquirer's overall strategy for intellectual property, the M.N.C. held all technology patents in a Dutch entity, except for those related to North American use. The Dutch entity was responsible for the overall steering of R&D activities of subsidiaries. It also monitored potential infringements and undertook steps to protect and enforce I.P. rights. Following the acquisition of G-Co., the M.N.C. arranged for the transfer of the German patents to the Dutch entity and converted the previously independent German R&D activities into contract R&D on behalf of the Dutch entity. Other business activities were not changed, and access to the patents was licensed back to the German entity for a fixed sales-based royalty.

The M.N.C. recognized that this transaction would be considered as a relocation of function and calculated a corresponding compensation for both the patents and the entrepreneurial R&D function. The method applied closely followed the German

guidelines and was based on a "Delta Approach." This methodology examines the shifted profit potential by comparing (i) the actually expected profits of the entities following the restructuring to (ii) the hypothetical profits that would have been expected had no restructuring taken place. Both profits were calculated on a yearly basis in perpetuity and discounted to a respective present value for both cases. In this particular case, it was determined that G-Co would have earned profits with a present value of approximately €500 million, whereas after the transaction introduced the license payments and expected contract R&D payments, G-Co would expect reduced profits with a present value of €450 million from its remaining business. Consequently, the purchase price for the transfer of German technology I.P. was set at €50 million, which was paid from the Dutch to the German entity.

The M.N.C. felt relatively confident in the position, as it considered the approach to be in line with German regulations, having recognized and evaluated the transfer of functions. Nonetheless, the M.N.C. expected to be challenged about technical details, in particular the budgets for future years, discount rates, D.E.M.P.E. functions, and the capability of the Dutch entity to exercise effective control over ongoing research and development. Management of G-Co felt it had addressed these reasonably well and that no major reassessment could be made. Then, the tax audit began.

The local German tax authorities looked at the case and rather than challenging any particular technical aspect, they reinterpreted the valuation to imply that the entire business – not just the research and development – was transferred and then partially granted back. In particular, they stipulated that without the technology no other business activities could be carried on and that the German target company became fully dependent on the new licensor, even though the royalty payment actually left substantial profits in Germany. They used the valuation prepared by the taxpayer to imply that the entire business value of €500 million was transferred to the Netherlands. The tax authorities acknowledged that a value of €450 million might have been granted back to the German target company, but asserted that the transfer-back was properly categorized as a nontaxable capital contribution. They therefore increased the purchase price tenfold to €500 million.

From a technical standpoint, it was clear that the original valuation was not intended to imply that a value of €500 million was transferred; this just reflected one element of the "delta," *i.e.*, an effort to determine the value of the I.P. by looking at the business value with and without the I.P. Nevertheless, giving off this impression might have been avoided had the taxpayer first calculated the difference in profit potential per year and then taken the difference from the present value. Mathematically, the result would have been the same, but it would have helped to avoid the dispute, at least to some degree.

More critical was the following underlying economic question. Was the transfer of the technology I.P. actually a transfer of the entire business, since the other activities, such as manufacturing, distribution, etc., could not work without the patents? Access to the patents had been granted back to G-Co via the license agreement, but the tax authorities stipulated that the Dutch entity could always terminate this agreement, especially since the terms and conditions did, of course, provide termination clauses. In the circumstances, it was decided to approach the issue through a value chain analysis to establish a comprehensive analysis of the entire value creation of the company, rather than limiting the analysis to the role of the technology in isolation.

As a result, a series of interviews and comparative analyses was undertaken that allowed the main value drivers to be identified, including technology features, production processes, brand awareness, and the like. In a second step, the specific entities that contributed to specific value drivers were identified, and the value contribution of each entity to the respective value driver was computed. The end result was the determination that G-Co entity contributed significantly or exclusively to many of the value drivers that were indispensable to the business. While technology was clearly a critical success factor, it was one factor among many. Rather than a one-directional dependency by one entity on another, the study demonstrated that several entities depended on each other. As an illustration, it was determined that G-Co developed crucial and proprietary production processes, without which the products could not reasonably be produced at competitive prices. From an economic perspective, it was not realistically possible for the Dutch entity to simply terminate the license agreement without losing the entire business.

Ultimately, the comprehensive analysis showed that significant business drivers and associated intangibles had remained in Germany that were never under the effective control of the Dutch entity. Only the technology was transferred. Based on this analysis, the German tax authorities backed down and the original valuation was accepted.

CASE STUDY 3: AVERTING A MULTILATERAL TAX DISPUTE FOR A SWISS BASED GROUP WITH A GERMAN MEMBER

The M.N.C. was headquartered in Switzerland. It was far more profitable than its peer competitors. The largest market was Europe, where the M.N.C. operated a network of four manufacturers. Each specialized in distinct product categories. The manufacturers owned product related I.P. and process related I.P. Each sold directly to sales affiliates of the group.

The group developed a stringent go-to-market policy centered around the corporate brand that was rolled out consistently across European countries. It considered this to be the key differentiator that separated it from competitors, whereas the products as such have no unique selling position (“U.S.P.”) that created a competitive edge.

The Swiss headquarters of the M.N.C. licensed the relevant trademarks directly to the sales affiliates. In conjunction, product transfer pricing for intercompany product sales from manufacturers to sales affiliates was coordinated such that the sales affiliates earned an operating margin in line with a Big Four database benchmarking study (2-4%). Consultants at a second Big Four firm determined that the trademark royalty rate of 3% payable by sales affiliates to the Swiss based M.N.C. for licensing the brands was arm’s length. The advice was based on the application of a traditional C.U.T. benchmarking analysis.

G-Co operated as a sales affiliate for the German market. In a tax examination covering the 2013 to 2016 period, German tax authorities challenged the intercompany pricing setup and rejected the transfer pricing analysis of the Big Four consultants, contending that it was flawed. The tax authorities determined that the group effectively applied the T.N.M.M. method by setting a royalty rate and product transfer pricing mix that held the German operating margin at 3% of sales. As a matter of

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policy, German tax authorities accept the T.N.M.M. as the best method only if the activities of the German taxpayer are purely routine. In comparison, when a distributor operates as licensee, German tax authorities assert that the distributor effectively becomes entrepreneurial and conducts non-routine D.E.M.P.E. functions to promote the trademarks in the German market. The field tax inspectors identified several business operations supporting that view.

Consequently, the tax examiners rejected the T.N.M.M. as inappropriate and the benchmark results as too low given G-Co's value adding functions. Further, they considered that a 3% sales royalty was too high in the B2B context, and found from "experience" that a 1% royalty was more appropriate. Overall, they made an assessment lifting up G-Co's operating margin from 3% of sales to 5%. They were open to the M.N.C. seeking double taxation relief through the M.A.P. process.

"Consequently, the tax examiners rejected the T.N.M.M. as inappropriate and the benchmark results as too low given G-Co's value adding functions."

In preparing a M.A.P. strategy, the group tax department was adamant that the trademark royalty of 3% should be upheld under all circumstances, both from a business and financial point of view. If one were to agree to an increase of G-Co's operating margins, a corresponding adjustment should be obtained from the group manufacturers. However, in preparing the M.A.P. submission and holding informal preparatory talks with the German authorities, the group tax department recognized nightmarish challenges. First, it was almost impossible to provide financial information about the profitability of manufacturers with intercompany sales to the German market, as any SG&A allocations of the manufacturers seemed to be arbitrary. Second, it was apparent that some manufacturers were highly profitable, while others were less profitable or loss-making. It became clear that any approach to tax authorities in the countries where manufacturing took place contained a risk that the whole pricing policy could end up being challenged.

The puzzle was solved through the following steps:

- Based on internal management information and external market research, economic data was generated in support of (i) the M./N.C.'s narrative that the go-to-market strategy was indeed centrally developed around the group brand and (ii) the M.N.C.'s view that G-Co purely executes the centrally developed market strategy and provides no self-developed intangible value. Economic data was generated evidencing continuous price premiums that the group generated in Germany in relation to well-known German competitors selling products of similar quality. Those premiums were attributable to brand recognition and good will generated from the range of the product portfolio for which G-Co was not responsible. All this supported the high value contribution from Swiss-Co and the hypothesis that the royalty rate was not excessively high.

- The foregoing conclusions were supported by what-if corroborative economic analysis. Starting with the hypothesis that G-Co was conducting more than routine operations, a contribution-based profit split analysis was performed with Swiss-Co, G-Co, and the manufacturing network as players. Applying the industrial economics concept of Shapley Value, which is well established between unrelated parties in other economic areas of joint value creation, it demonstrated that an arm's length profitability of G-Co would not have exceeded 4% of sales even if a profit split analysis had been conducted based on the factual assessment of the Germany tax authorities.

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When the value chain and profit split analysis was submitted to the German Federal Tax Office to discuss M.A.P. implications, the responsible officer immediately recognized that the whole M.A.P. apart from creating costs would not result in the creation of additional revenue to G-Co and tax to the German fisc. As a result, the responsible officer informally urged the field tax inspectors to negotiate a compromise directly with the M.N.C.

In only one round of negotiation, a favorable outcome was achieved. The Swiss M.N.C. accepted a small adjustment of the operating margin, but below 4% of sales without resorting to a M.A.P. This small downside was offset by the following benefits:

- It achieved an agreement on the taxable income implications for the subsequent tax audit.
- It was spared significant tax compliance costs, tax examination defense costs, and costs related to a tedious M.A.P. process.
- The risk for eight years of potentially significant tax adjustments was taken off the table.

In sum, the exercise demonstrated that tax authorities are open to innovative approaches to economic analysis that help provide a balanced view on joint value creation. To the extent available, it is a much more effective approach than conflict with tax authorities arising from the arbitrary question of whether the operations of a German entity qualify as being routine or entrepreneurial. In a world where there is inevitably a grey zone area around this question, this may help reduce tax disputes in cases where the financial outcome implications are less important, allowing tax authorities to concentrate on high stake - high value cases.

OUTLOOK

The German transfer pricing landscape has a rich history, a controversy-rich presence, and likely a turbulent future. Budgetary pressures are increasing due to investments in security infrastructure, renewable energy investments, and funding ever-increasing pension payments. Simultaneously, many of the foundations of the global free trade agreements that enabled German M.N.C.'s to expand and establish global supply chains are under attack due to looming trade wars and global conflict. On top of this, public pressure to tackle perceived tax-dodging practices are mounting.

One of the challenges in this context is that while German authorities have built up impressive technical capabilities in the past, they have also to a degree become accustomed to a brute-force approach under which aggressive assessments are asserted in the expectation that global corporations will shy away from court proceedings in tax matters. This approach clashes with the realities of the post-B.E.P.S. world, in which taxpayers have terminated highly aggressive structures and have developed an understanding of the importance of transfer pricing documentation that is not canned.

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The new reality of forcibly well-prepared taxpayers means that M.N.C.'s are much less likely to a accept a halfhearted horse-trade compromise to settle an aggressive but unjustified audit assessment by aggressive tax authorities. With the backdrop of the B.E.P.S. developments and new regulations, a highly-skilled economic analysis supporting the taxpayer's filing position will become ever more important to achieve dispute resolution in line with taxpayer expectations rather than tax authorities' wishes.

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ITALY INTRODUCES A PENALTY PROTECTION REGIME FOR HYBRID MISMATCHES: TRICK OR TREAT?

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INTRODUCTION

Italian anti-hybrid were enacted by Legislative Decree no. 142/2018 (the "Italian A.T.A.D. Decree"), which transposed A.T.A.D. 1 and A.T.A.D. 2 into the Italian tax system without significant deviation. It provided rules to combat base erosion and the shifting of profits. 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.

Towards the close of last year, Italy enacted legislation identifying documentation allowing taxpayers to avoid administrative penalties and criminal charges arising from aggressive use of hybrid mismatches. The new rules apply beginning with the 2023 fiscal year. It is not clear whether the new rules will set a standard that could be applied to earlier years. In principle, an Italian taxpayer with acceptable documentation covering tax years beginning in 2020 should not be subject to penalties if a tax examination by the Italian tax authorities has not been initiated by October 15, 2024.

BACKGROUND

The Italian anti-hybrid rules were addressed in detail in an article published in *Insights* last year by the authors.[1] The following discussion summarizes the rules for purposes of context.

The Italian anti-hybrid rules prevent double nontaxation by eliminating the tax advantages of mismatches, thereby putting an end to (i) claiming multiple deductions for a single expense, (ii) allowing deductions in one country without corresponding taxation in another, and (iii) generating 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 differing tax treatment in the two jurisdictions involved in an instrument, payment, entity, or branch arrangement, irrespective of the legal labels used.

[1] For more detail, see F. Di Cesare F. and D. Michalopoulos, "Effect of Ruling no. 288/2023 – Italian anti-hybrid rules attack the 2020 Swiss Corporate Tax Reform," *Insights* Vol. 10 No. 3, (May 2023), page 28).

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- **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 jurisdiction of residence but are not subject to tax in the jurisdiction of residence of the payee.

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 this respect, 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 notions of control[2] and structured arrangements[3] are in line with the definitions under A.T.A.D. 1 and A.T.A.D. 2. Consequently, the concept of "associated enterprise" is broader than the concept under Italian laws. Consequently, material control is covered even when caused by participations voluntarily "divided" between two or more entities of the same group.

The Italian tax authorities have furnished a general set of administrative clarifications with Circular Letter 2/2022. They also published Ruling 833/2021, providing limited guidance on a cross-border royalty payments arrangement, and Ruling 288/2023 on the effects of the Italian anti-hybrid rules involving a Swiss principal and an Italian limited risk distributor. Many advisers believe that the conclusions in the second is questionable from a technical point of view.

SCOPE

Mismatches Covered

The only types of mismatches targeted by the Italian anti-hybrid rules are those that rely on a hybrid element to produce favorable outcomes for controlled parties or for participants in structured transactions. As a result, cross-border transactions that do not involve a hybrid element are not covered. An example is a transaction in which the payment is (i) deductible, (ii) characterized as interest, and (iii) paid to a tax-exempt entity).

In addition, distortions caused by (a) domestic law or (b) the availability of preferred tax regimes, or (c) under tax rulings in certain tax jurisdictions should not be subject

[2] Reference is made to Council Directive (EU) 2016/1164 of July 12, 2016, Article 2, paragraph 1, no. 4.

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

to challenge under the Italian anti-hybrid rules. Nonetheless, the negative conclusion reached by the Italian tax authorities in Ruling 288/2023 cannot be underestimated.

Taxes Covered

The Italian anti-hybrid rules apply to all persons subject to Italian corporate income tax ("*Imposta sul reddito delle società – I.R.E.S.*"). Generally, the tax is imposed at the rate of 24%. In addition to Italian corporations, taxpayers include Italian permanent establishments of nonresident companies, partnerships treated as fiscally transparent under the Italian tax law, and individual entrepreneurs.

Regional tax ("*Imposta regionale sulle attività produttive – I.R.A.P.*") is 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 or highest level (*e.g.*, at the federal level in Switzerland).

Nature of Anti-Hybrid Rules

The Italian anti-hybrid rules qualify as tax system rules and not as anti-avoidance rules. This means that, if a hybrid mismatch is identified in the course of a tax audit, the Italian tax authorities can impose administrative penalties on the I.R.E.S. tax return ranging from 90% to 180% of the increased I.R.E.S. assessed.[4] On the other hand, if the adjustment is characterized as tax evasion, and if the relevant thresholds[5] are met, the matter could be referred to the Public Prosecutor for prosecution of potential criminal violations.

PENALTY PROTECTION

The Hybrid Dossier

Article 61 of Legislative Decree no. 209/2023,[6] implemented international tax reform in Italy. It introduces[7] penalty protection for asserted violations of the anti-hybrid rules. The protection is similar to the regime in place for more than a decade involving underpayments of tax arising from intercompany transactions that are carried on by related parties at values that are not arm's length.

The new penalty protection regime provides that administrative penalties will not be imposed if the taxpayer timely prepare a specific set of qualified documentation (so-called "hybrid dossier") illustrating the internal analyses that was performed at group level justifying the cross-border transactions from the perspective of the anti-hybrid rules.

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[4] Reference is made to Article 1, paragraph 2 of Legislative Decree no. 471 of December 18, 1997.

[5] Reference is made to Article 4 of Legislative Decree no. 74 of March 10, 2000.

[6] Legislative Decree no. 209 of December 27, 2023, effective from December 29, 2023.

[7] Reference is made to the newly introduced paragraph 6-bis in Article 1 of Legislative Decree no. 471 of December 18, 1997

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The Reason Behind the Policy

The policy behind the penalty protection is the promotion of timely and complete disclosure by taxpayers. Protection applies when Italian tax authorities are provided with a preventive disclosure of any potential hybrid mismatch. Disclosure is preventive when it provides

- an accurate description of the material terms of the transaction,
- the relevant laws in Italy and the other country involved, and
- the rationale behind the assertion that anti-hybrid are inapplicable.

Content and Format

As a rule, the content and the format of the hybrid dossier should have been detailed in a decree of the Italian Ministry of Economy and Finance to be issued within 60 days from the date of entry into force of Legislative Decree no. 209/2023. Considering that the new legislation entered into force on December 29, 2023, the term expired on February 28, 2024. Because the 60-day rule was missed by the Ministry of Finance, taxpayers have at least 6 months from the date of publication to prepare the hybrid dossier.

In the absence of regulations of the Ministry of Economy and Finance, it is anticipated that some form of guidance will be issued more or less stating the following:

- The hybrid dossier must be prepared and electronically locked and signed with a time stamp by the legal representative of the Italian entity prior to the submission of the I.R.E.S. tax return for fiscal year 2023.
- The availability of the hybrid dossier must be communicated to the Italian tax authorities in the same I.R.E.S. tax return, perhaps by checking a box in the return as in the case of the transfer pricing documentation.
- The hybrid dossier must be made available to the Italian tax authorities in the event of a tax audit.

Fiscal Years Covered by the Penalty Protection

The first fiscal year that can be covered by the penalty protection regime is fiscal year 2023. Subsequent fiscal years will also be included in scope.

There is the possibility to backdate the effects of the penalty protection regime to fiscal years from 2020 to 2022 provided that – at the time of the submission of the I.R.E.S. tax return for fiscal year 2023 – currently October 15, 2024 – the Italian tax authorities have not started a tax audit, investigation activities, or other similar actions for those fiscal years.

COMMENTS AND TAKEAWAYS

Tax Benefit

The introduction of the new penalty protection regime for hybrid mismatches represents a significant forward step in Italy for promoting cooperation between taxpayers and Italian tax authorities. While the hybrid dossier may be viewed as an

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additional compliance burden, its preparation generates significant advantages both in terms of penalty elimination and tax risk management.

Nonetheless, the legal framework is incomplete as of the date of publication of this article. The publication of the implementing rules by the Ministry of Economy and Finance has not yet taken place. This adversely affects taxpayers intending to extend coverage of the hybrid dossier to cover fiscal years from in the 2020-2023 period.

Finally, the due date remains October 15, 2024, which is not far away, if not extended.

"The introduction of the hybrid dossier is not a 'pure novelty,' considering that the new legislation copies the previous guidance furnished by the Italian tax authorities. . ."

Is This Big News?

The introduction of the hybrid dossier is not a "pure novelty," considering that the new legislation copies the previous guidance furnished by the Italian tax authorities with Circular Letter no. 2/2022. There, the authorities recognized the preparation of ad hoc documentation represents:

> * * * a good practice to manage the relevant tax risk for taxpayers that perform, before the submission of the tax return, appropriate investigations on any potential case of hybrid mismatches also requesting the assistance of associated enterprises, in order to prepare appropriate documentation to be used as evidence.

Nonetheless, if the dossier is not big news, it is definitely the formalization of a good practice.

Groupwork

The preparation of the hybrid dossier is expected to require coordination between various departments of all the companies of the group involved in the "hybrid" transactions. Information regarding relevant intercompany operations will need to be gathered and presented according to a uniform standard.

It will be essential to map the transactions originating in covered fiscal years that may have potential impact on the determination of the taxable base in all countries involved. Relevant information should cover items such as tax loss carryforwards, depreciation, excess interest expense, and other similar items.

Limitations for Prior Fiscal Years

Article 61 of Legislative Decree no. 209/2023 expressly states at paragraph 3 as follows:

> With regard to precedent fiscal years * * * [the penalty protection regime applies] if the documentation listed under paragraph 6-bis of Article 1 of Legislative decree no. 471/1997 is prepared, with certified date, within the term for the submission of the IRES tax return * * * [for fiscal year 2023] and if the violation has not been already ascertained and anyhow provided that no accesses, inspections, tax audit or any other administrative activities of assessment have been started * * *.

This means that the effect of the hybrid dossier for covered fiscal is precluded where the Italian tax authorities have already initiated a tax audit, investigation activities,

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or similar actions. This means that the deadline for Italian tax authorities to begin an examination of the years 2020-2022 is the date for the submission of the I.R.E.S. tax return for fiscal year 2023, currently set at October 15, 2024.

The formulation of the statute is composite and complicated. While audit activities have been specifically identified in the law, the law does not specify the contents of other administrative activities that may adversely affect the years in the 2020-20233 time period. Is that intentional or an oversight?

The point is crucial. The Italian tax authorities have already begun to notify targeted taxpayers with questionnaires pursuant to Art. 32 of Presidential Decree no. 600/1973[8] requesting explanatory information and supporting documentation for items such as tax calculations, copies of financial statements and trial balances, and accounting registrations in connection with the possible existence of hybrid mismatches for years in the 2020-2022 fiscal period. This begs the following question: Does a questionnaire represent an administrative activity of assessment?

The available guidance is silent in this respect, and the precedent administrative clarifications on similar tax rules is contradictory in some cases, unsatisfactory in others, and negative in still others.[9]

A prudent interpretation suggests that the questionnaires may limit the effect of the penalty protection for the years in the 2020-2022 period. On the other hand, it is also logical that the notification of these of requests should not jeopardize the benefit from the penalty protection regime in case of duly and timely preparation of the hybrid dossier. In essence, the devil is in the details, and it cannot be excluded that, lacking official stance, different interpretations may be given by the local offices of the Italian tax authorities in charge of the audits.

Criminal Shield

The wording of the relevant legislation does not automatically extend the penalty protection regime to criminal infringements. Nonetheless, considering that the complete and truthful description of the transactions in the hybrid dossier and the voluntary disclosure in the tax return constitute undoubted material evidence of the taxpayer's intent to cooperate, it seems reasonable to expect that criminal liability should be "off the table."

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8 Presidential Decree no. 600 of September 29, 1973.

9 See, for example, Circular Letter no. 180/1998 commenting on old tax rules with similar wording.

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U.S. CITIZENS OWNING SWISS REAL ESTATE – CROSS BORDER ESTATE PLANNING IS A NECESSITY

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INTRODUCTION

The U.S. and Switzerland have maintained successful economic and trade relations for decades. This is reflected in the two-way trade volume of goods and services between the two countries and in the ever increasing exchanges of employees and executives.

Because more and more Americans are living and working in Switzerland, it is common for American citizens to own assets in Switzerland, especially real estate. In this environment, competent estate planning is needed to ensure that American citizens can leave Swiss assets to the next generation in accordance with their will, and to do so in an economical manner. This is especially true for U.S. citizens owning Swiss real estate. This article explains the principles, possibilities, and necessities of proper estate planning when Swiss real estate is owned by American citizens.

DIFFERENT LEGAL SYSTEMS

The U.S. and Switzerland have fundamentally different legal systems. While American law is derived from English common law, Swiss law is based on the Roman legal system. Differences in the inheritance and tax laws of the two countries make estate planning in U.S.-Swiss inheritance cases particularly complex. The complexity is exacerbated by the fact that each state in the U.S. and the District of Columbia has its own inheritance law and applies its own conflict-of-laws law.

One of the most fundamental differences between American and Swiss inheritance law is that Switzerland generally follows the principle of "unity of the estate" in international inheritance cases, whereas under U.S. law applicable law regarding transfers at death may "divided" depending on the type of property that is transferred. Under the unity of the estate principle, the entire estate of a decedent is governed by the law of a single state – the state of domicile of the decedent – regardless of where particular assets are located. In comparison, the rule in the U.S. regarding real estate[1] is that law of the state in which real estate is located controls transfers at death. In Latin, this is referred to as "*lex rei sitae*." In the case of personal property, the controlling law in the U.S. is that of the place where the deceased last resided. In Latin, this is referred to as "*lex domicilii*."

A further key difference between American and Swiss inheritance laws is a person's right to control who will receive assets owned at death through the mechanism of a properly executed will. Whereas in the U.S.A. there is generally extensive freedom

[1] In Switzerland, real estate is referred to as immovable property. In this article, the term "real estate" is used exclusively. The terms have the same meaning.

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to make wills,[2] in Switzerland statutory entitlement must be respected, such as forced heirship rights of spouses and descendants.

PRIVATE INTERNATIONAL LAW AND THE TREATY OF 1850 BETWEEN SWITZERLAND AND THE U.S.

In international succession matters, the relevant conflict-of-laws law of a country must be consulted. According to this law, international treaties – if applicable – generally take precedence over domestic law (see paragraph 2 of Article 1 of the Federal Act on Private International Law ("P.I.L.A.")).[3]

Way back on November 25, 1850, the U.S. and Switzerland concluded the Convention of Friendship, Commerce and Extradition between the United States and Switzerland (hereinafter "F.C.E. Treaty"), which is still in force today. Among other things, the F.C.E. Treaty applies in the event of the death of an American citizen resident in Switzerland or a Swiss citizen resident in the U.S. It also applies to dual citizens. In particular, it is applicable if a U.S.-Swiss dual citizen dies having his or her last place of residence in the U.S. Articles V and VI of the F.C.E. Treaty control the responsibilities and the applicable law in U.S.-Swiss probate matters. With regard to the inheritance of real estate, the F.C.E. Treaty stipulates that *lex rei sitae* applies to real estate. Consequently, the law and jurisdiction of the place where the real estate is located controls.

However, if a U.S. citizen who was last resident in the U.S. owns property in Switzerland at the time of death, it is not always clear whether the F.C.E. Treaty will be applied in a challenge brought in probate court. Several U.S. courts that have considered the issue have far disregarded the F.C.E. Treaty and applied the conflicts-of-law law of the U.S. state where the decedent was domiciled at death.

Either way, the transfer of real estate owned by a U.S. citizen who is resident in the U.S. at the time of death is controlled by Swiss law. In Switzerland, Swiss law applies by reason of paragraph 2 of Article 87[4] and paragraph 1 of Article 91[5] of the

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[2] In some U.S. states, children and spouses may have a right to receive a certain percentage of a decedent's estate, notwithstanding the will. The balance of the estate may pass by will. Other states have community property laws. The laws vary from state to state. A listing of state laws on this point is beyond the scope of this article.

[3] In English translation, paragraph 2 of Article 1 provides that international treaties are reserved.

[4] In English translation, paragraph 2 of Article 87 provides that the authorities at the place of origin always have jurisdiction when a Swiss citizen having the last domicile abroad submits, in a will or a contract of succession, the decedent's entire estate or the portion thereof located in Switzerland to Swiss jurisdiction or Swiss law. However, paragraph 2 Article 86 is reserved. Paragraph 1 of that article provides that the Swiss judicial or administrative authorities at the last domicile of the deceased have jurisdiction to take the measures necessary to settle the estate and to hear disputes relating thereto. Nonetheless, paragraph 2 provides that exclusive jurisdiction claimed by a state where immovable property is located is reserved.

[5] In English translation, paragraph 1 of Article 91 provides that the estate of a person who had a last domicile abroad is governed by the law referred to by the private international law rules of the state of domicile.

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P.I.L.A. In the U.S., courts will look to Swiss law to control the transfer of real estate located in Switzerland.

For U.S. citizens having a last place of residence in the U.S.A. or U.S.-Swiss dual citizens having a last place of residence in the U.S.A., it is essential for to undertake estate planning in accordance with Swiss law with regard to real estate located in Switzerland. This is the only way to ensure the orderly and efficient settlement of estates involving real estate in Switzerland.

ESTATE PLANNING OPTIONS AND INSTRUMENTS

"In the U.S.A., there are several ways to plan for a person's estate."

In the U.S.A., there are several ways to plan for a person's estate. As American probate proceedings are generally public and can quickly become time-consuming and cost-intensive, will-substitute arrangements are often used. the aim of these arrangements is to exclude as many assets as possible from subsequent probate proceedings. Life insurance policies, joint bank accounts and revocable or irrevocable trusts are commonly used for this purpose.

Switzerland has two main instruments for estate planning. One is a will and the other is an inheritance contract. The latter generally is not found under U.S. law. The concept of a trust is fundamentally foreign to Swiss law, even though it is widely used in the U.S.A. In early 2022, a draft bill proposing the adoption of a trust law in Switzerland was published, triggering a consultation period for the submission of comments. Comments were mostly negative and in January 2024, the proposal was dropped from further consideration.

Nonetheless, Switzerland has ratified the Hague Trust Convention, which, among other things, allows for the recognition of trusts formed under U.S. law. Even so, estate planners in the U.S. must continue to take into account restrictions under Swiss inheritance law that may invalidate certain trust provisions that take effect at the death of the settlor. Examples include statutory entitlement to Swiss real estate, transfers of Swiss real estate to a remainderman, transfers pursuant to a surviving spouse's marital property rights, and transfers yielding favorable results for the decedent under U.S. tax law.

In addition, problems may be encountered at an earlier point in time, when a U.S. trust – whether foreign or domestic for U.S. income tax purposes – attempts to acquire Swiss real estate. Swiss law contains a statutory authorization requirement when it comes to the acquisition of real estate in Switzerland. The law, known as *lex Koller*,[6] must be respected both at the time of purchase and the time of transfer at the death of the settlor.

In sum, use of a U.S. trust as an estate planning instrument may be subject to significant difficulty when real estate in Switzerland is owned by a trust as part of a will substitute.

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[6] Among other things, *lex Koller* provides that persons who do not have Swiss citizenship and are not resident in Switzerland generally require a permit to purchase real estate in Switzerland.

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PRACTICAL EXAMPLE

A practical example illustrates the scope of estate administration issues that may need to be resolved when a U.S. citizen and resident owns real estate in Switzerland at the conclusion of life.

Facts

Married couple A and B are U.S. citizens. At some point in the course of their marriage, the couple moved to Switzerland when A took up a senior position at a Swiss subsidiary of A's employer. While living in in Switzerland, the couple purchased an apartment in Switzerland. As they were resident in Switzerland at the time, they did not require a permit to purchase real estate.

After a few years, couple A and B returned to the U.S.A. They kept the apartment in Switzerland and partly rented it out or used it as a vacation home.

Close to A's retirement, couple A and B determined it was time to pay attention to estate planning. They sought the advice of an American lawyer for their estate planning. He recommended the use of a revocable trust to own the bulk of their estate. This provided the greatest degree of flexibility as to ownership of assets and the transfer of assets to a revocable trust would not be treated as a completed gift during lifetime. The plan did not address the apartment in Switzerland, which continued to be owned as co-owners.

Couple A and B are the beneficiaries and trustees of the trust. The couple are childless. Consequently, a nephew of B was appointed as the beneficiary who would take after the death of the surviving spouse.

Pursuant to the plan, assets were transferred to the trust during the couple's lifetime. Upon the death of the second to die, remaining assets actually owned by the surviving spouse were to be transferred to the trust.

Problems That May Be Encountered

When A dies, no probate proceedings would be carried on in the U.S. for the bulk of his assets in the U.S. that are held in the trust or that are owned as joint tenants with rights of survivorship. Regarding the latter, because A and B are married, the survivor automatically takes over the interest of the deceased spouse. However, Swiss law must be examined with regard to the apartment owned in Switzerland as co-owners in the land register.

Upon A's death, B wants to transfer A's share of the apartment to herself. This will allow her to easily sell the apartment. In order to remove A as owner and to take sole title in the apartment, B must register as a new owner in the land register with regard to the share that was previously owned by A. This requires a so-called disposal transaction and an obligation transaction. The latter registration forms the basis of the transfer of ownership. It may take the form of purchase agreement, a gift agreement or, in the case of inheritance, the certificate of inheritance with an inheritance partition agreement. The certificate of inheritance is the equivalent of probate. In the example, no document of transfer or inheritance exists. Consequently, the land registry in Switzerland likely will refuse to transfer ownership.

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In Switzerland, the decedent's estate must be formally opened, limited to the real estate. Opening the estate in Switzerland can be authorized separately under the F.C.E. Treaty, as previously mentioned, or as an ancillary proceeding of the U.S. estate. In either event, the goal is to obtain a certificate of inheritance. For this purpose, an American must be submitted to the Swiss probate authority. The existing trustee (here B) must be appointed as heir in a U.S. will. An extensive translation of the will must be submitted to the Swiss probate authority accompanied by a legal opinion from an American lawyer as to the provisions of the will. If the U.S. will contains detailed dispositive provisions separate and apart from the trust, the process may be straight forward. However, if the will merely provides for a transfer to the trust, additional difficulties may be encountered with the entry in the land register due to the provisions of *lex Koller*.

Steps To Be Taken During Lifetime

This example illustrates that the process of transferring ownership of one-half of the apartment from the deceased spouse to the surviving spouse is much simpler if, during lifetime, each spouse executed a separate Swiss property only will. The problem could pop-up a second time when the surviving spouse dies. B's nephew is a beneficiary of the revocable trust. Again, there is no will. This illustrates that, in the Swiss property only will, each will should appoint B's nephew as heir to take only if, at the time of death, the other spouse is not alive. Such wills are one page or so in length. Nonetheless, they serve as a magic key that eliminates headaches regarding the transfer at death of real estate owned in Switzerland.

Other Issues

Once the transfer of ownership is addressed, Swiss counsel will typically address Swiss inheritance tax at the time of transfer at death. Depending on the degree of consanguinity of the heir, inheritance tax may be charged in Switzerland. The tax base is limited to the property located in Switzerland. Spouses are exempt from inheritance tax. However, depending on the canton, B's nephew will incur inheritance tax of up to 45%, unless the property is located in the cantons of Schwyz and Obwalden, neither of which imposes inheritance tax.

It should also be noted that most people who own real estate in Switzerland typically have a Swiss bank account that is used to pay ancillary costs, taxes, and maintenance in Switzerland. The assets in this bank account constitute movable assets and would therefore not be covered by the F.C.E. Treaty or the jurisdiction in Switzerland for the opening of the estate in Switzerland. The Swiss certificate of inheritance is limited to real estate in Switzerland.

If, in our example, A maintained a separate Swiss bank account, the account would be subject to the inheritance laws of his state of residence in the U.S. An order of a U.S. probate court would need to be provided to the bank in order for the balance in A's bank account to be released. With planning, two alternative paths forward could be followed in order for funds to be released by the Swiss bank. The first is that an executor has been appointed and a certificate of executorship is provided to the bank. The second is that the bank account takes the form of a joint account between A and B during their lifetime. This allows the surviving spouse to dispose of this Swiss bank account even after the death of the other spouse because it is in the name of both spouses.

FORMAL REQUIREMENTS FOR A SWISS WILL

In addition to the contract of inheritance, Swiss law provides for a will, which generally can take two forms. The first is that it is handwritten from beginning to end and signed and dated with the month, day, and year. Alternatively, the will can be made in the form of a public deed. In this case, the will must be witnessed and notarized.

In addition to these two forms of ordinary wills, Swiss law provides for an emergency will, which is used in the event of extraordinary circumstances involving imminent danger of death. In broad terms, the emergency will entails an oral communication to two witnesses who immediately write down the contents and submit them to court authorities or record them with those authorities.

Switzerland also recognizes testamentary dispositions under certain conditions if foreign formal requirements are met. Switzerland is a party to the Hague Convention on the Conflicts of Laws relating to the Form of Testamentary Dispositions (hereinafter "Convention"). According to Article 1 of the Convention, testamentary dispositions are considered valid with regard to their form if they comply with the internal law of any of the following jurisdictions:

- The place where the testator executed the will.
- The place of the testator's nationality, either at the time when the will was executed or at the time of his death.
- The place in which the testator had his domicile either at the time when he made the disposition or at the time of his death.
- The place in which the testator had his habitual residence either at the time when he made the disposition or at the time of his death.
- So far as real estate is concerned, the place where the real estate is situated.

As the foregoing indicates, Switzerland recognizes a broad set of forms of will. In the specific case of Swiss-U.S. estate planning discussed above, either the form of a handwritten will authorized by the place where the property is located (Switzerland) or the form at the testator's last place of residence in the U.S. could be chosen.

RECOMMENDATIONS

The instrument that is best suited to planning a U.S.-Swiss estate depends on the facts involved in the particular matter. The instrument that transfers title to real estate in Switzerland should be a separate will that is limited to the property in Switzerland. As in all cross border matters, legal advice should be taken from legal counsel admitted to practice in the relevant jurisdiction. In the case at hand, that means a competent Swiss lawyer. It is also advisable to appoint a Swiss executor who will take care of the tax declaration for the real estate at the date of death, any assessment and payment of inheritance tax, and the general handling of the estate in Switzerland. Swiss wills are usually rather brief, but their benefits to heirs inheriting Swiss real property can be huge when measured against the costs of cleanup.

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FRENCH REPORTING OBLIGATIONS FOR FOREIGN FINANCIAL TRUSTS

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INTRODUCTION

This article provides a general overview of the French information reporting obligations regarding foreign financial trusts. In general, the obligations are broad, the scope of reporting persons and transactions is broader, and the risk of penalties is severe.[1]

This article also addresses relatively recent rulings issued by French Tax Authorities ("F.T.A.") that provide some relief. After explaining the rulings, the article concludes that more formal general guidance is required in order to provide consistent assurance to foreign investors that use foreign trusts to pool funds that are used to acquire only financial assets in France.

BACKGROUND

In order to provide a legal and tax framework for trusts, several laws have been enacted since 2011 that address the filing obligations of trusts in France. These include (i) the implementation of a Trust Register, (ii) the imposition of French Income Tax and French inheritance and gift taxes, and (iii) the imposition of French real estate wealth tax to French tax-resident beneficiaries of assets held by a trust.

These laws also include reporting obligations regarding trusts pursuant to Articles 1649 AB and 369 of Appendix II of the French Tax Code ("F.T.C."). Two major tax returns must be filed:

- One return implements an event-based reporting obligation related to the constitution, modification, or dissolution of a trust, including amendments to its terms (F.T.C., art. 1649 AB, 1° and 2°) and
- The second return implements an annual trust obligation to report the market value as of January 1 of each year regarding assets and rights placed in a trust and their capitalized income (F.T.C., art. 1649 AB, 3°).

In addition, the F.T.A. issued guidelines[2] ("F.T.A. Guidelines") aimed at clarifying the application of these rules. In particular, the F.T.A. Guidelines address foreign financial trusts, which are (i) trusts formed under foreign law, (ii) having only non-French individuals as settlor and beneficiaries, and (iii) financial investment assets as the only assets located in France.

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[1] See D. Hadjiveltchev, A. Meidani, L. Soubeyran-Viotto, "French Treatment of Foreign Trusts," in *Insights*, Vol. 8 Number 1, 2021-01.

[2] BOI-DJC-TRUST-30/03/2022.

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French reporting obligations can be a burden for the trustees of foreign financial trusts. Often, foreign trustees are not aware of the full scope of the French rules. Even when the rules are known by the trustee, the rules are ambiguous and imprecise, leading to legal uncertainty.

The problem often affects U.S. individuals who invest in French financial assets through trusts upon the recommendation of U.S. asset managers or private bankers. Programs to issue U.S. Dollar Denominated Medium-Term Notes ("U.S.D.M.T.N.'s") represent a major source of U.S. Dollar liquidity for French banks. Typically, the U.S.D.M.T.N.'s are pooled through a U.S.-based trust considered to be an investment trust for U.S. income tax purposes. These U.S.D.M.T.N.'s are issued by the head office of French banking institutions rather than U.S. offices. Consequently, they are considered to be French assets under the F.T.C.[3]

Because the U.S.D.M.T.N.'s are French assets and the trusts are U.S. domestic trusts, U.S. banking institutions face French reporting issues in connection with their U.S. clients and customers at the time reporting events occur.

SCOPE AND CONTENT OF FRENCH REPORTING OBLIGATIONS REGARDING TRUSTS

The first step in understanding the reporting obligations in France is to identify the different actors under French law.

- **The trustee:** The trustee is not explicitly defined by the French tax law. Nevertheless, French tax law considers that the trust is under the control of the trustee.
- **The settlor:** The settlor is referred to in the statute as follows:[4]

> 1. Either the natural person who set it up [*i.e.*, the trust], or, where it was set up by a natural person acting in a professional capacity or by a legal entity, the natural person who placed assets and rights in it.[5]

- **The beneficiary:** The beneficiary is the person designated as the recipient of the trust income paid by the trustee and/or as the beneficiary of the trust assets or rights, during the life of the trust or at the time of its termination.

Pursuant to Article 1649 AB of the F.T.C., the trustee is subject to several reporting obligations in France The reporting obligations are described in the statute as follows:

> I.- The trustee of a trust defined in article 792-0 *bis* whose settlor or at least one of whose beneficiaries is domiciled for tax purposes in France or which includes an asset or a right located therein, the trustee of a trust defined in article 792-0 *bis* established or resident outside the European Union when acquiring real estate or entering into a business relationship in France pursuant to

[3] Art. 750 ter.

[4] F.T.C., art. 792-0 bis, I-2.

[5] All English language recitations of provisions of the F.T.C. are unofficial.

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> *"Thus, in principle, only a trustee falling within the scope of one or more of the above reporting obligations is required to comply and file a report."*

Article L. 561-2-1 of the French Monetary and Financial Code, as well as directors whose tax domicile is in France, are required to declare the following information:

1° The creation, modification or termination of the trust, as well as the content of its terms;

2° Information concerning the surname, first names, address, date, place of birth and nationality of the beneficial owners of the trusts, defined as all natural persons having the capacity of administrator, settlor, beneficiary and, where applicable, protector, as well as any other natural person exercising effective control over the trust or performing equivalent or similar functions;

3° The market value on January 1st of the year.

To illustrate, the following trustees are subject to the reporting obligations related to trusts:

- A trustee of a trust for which (i) the settlor or at least one of the beneficiaries is resident for tax purposes in France or (ii) property or rights located in France are included in the trust assets
- A trustee whose tax residence is in France
- A trustee of a trust established or resident outside the European Union when the trust acquires real estate or enters into a business relationship in France pursuant to Article L 561-2-1 of the French Monetary and Financial Code

Thus, in principle, only a trustee falling within the scope of one or more of the above reporting obligations is required to comply and file a report. If such covered trustee fails to comply with one of the reporting obligations, penalties are imposed. See Article 1736, IV *bis* of the F.T.C., which provides that

> IV bis. Infringements of article 1649 AB are punishable by a fine of €20,000.

Furthermore, Article 1754, V-8 of the F.T.C. provides that

> 8. The settlor and the beneficiaries subject to the levy under article 990 J are jointly and severally liable with the trust administrator for payment of the fine provided for in IV *bis* of article 1736.

In line with F.T.A. Guidelines[6] and referring to the origins of the French tax law on trusts as intended by the legislature, the French Supreme Administrative Court[7] ("*Conseil d'Etat*") has ruled that the term "beneficiaries" refers to "deemed settlor" beneficiaries. Thus, § 80 of the F.T.A. Guidelines identifies covered beneficiaries in the following terms:

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[6] BOI-CF-INF-20-10-50-26/05/2021, #80.

[7] *Conseil d'Etat*, 11 déc. 2020, no 442320, Sté Sequent (North America).

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> * * * the beneficiary who, following a transfer, is substituted to the initial settlor, or to the person who previously acted as settlor (*i.e.* the previous "deemed settlor" beneficiary).[8]

However, F.T.A. Guidelines related to trusts[9] specify the definition of the settlor of a trust in the following way:

> Article 792-0 *bis* of the F.T.C. provides that the settlor of a trust is the individual who set it up. Where the trust has been set up by an individual acting in a professional capacity, or by a legal entity (in the case of trusts created by the trust administrator alone, for example), the settlor is the individual who has directly or indirectly placed assets or rights in the trust.
>
> The application of this definition is limited to the provisions of the F.T.C. related to registration duties, the French real-estate wealth tax and the sui generis levy pursuant to article 990 J of the F.T.C.
>
> For further information on this point, please refer to BOI-PAT-IFI-20-20-30-20.
>
> §90
>
> This definition of the settlor makes it possible to grasp the economic reality of a trust without being able to oppose a legal appearance. In practice, it is necessary to identify the "true" settlor in cases where the settlor of a trust, who is the only person to appear in the trust deed, is a legal entity - for example, an asset management company or a credit institution - or a natural person acting in a professional capacity who is, in reality, acting as the agent of a natural person from whose assets the assets placed, directly or indirectly through one or more legal entities, in the trust originate.

F.T.A. GUIDELINES – CURRENT AND PRIOR TO 2018

In the latest version of the official F.T.A. Guidelines, a paragraph related to event-based trust reporting obligations has been inserted. It provides as follows:

> In the case of trusts whose settlor and beneficiaries are all non-French residents, and whose assets located in France within the meaning of article 750 *ter* of the F.T.C. consist exclusively of financial investments, this obligation applies as follows:
>
> - the trustees of the trusts in which these financial investments have been placed at the time of their creation or at the time of subsequent modifications are bound by the reporting obligation;

[8] Ccl. Karin Ciavaldini under CE, Dec. 11, 2020, no 442320, Sté Sequent (North America).

[9] BOI-DJC-TRUST-30/03/2022, #80.

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- in other cases, the trusts' administrators are only bound by this reporting obligation when the settlor or one of the beneficiaries becomes resident in France within the meaning of article 4 B of the F.T.C.

In the part of the latest version of the F.T.A. Guidelines related to the annual trust reporting obligation, the following paragraph has been inserted:

> The annual return includes the following information: * * *
>
> - if none of the settlors, deemed settlors or beneficial owners is domiciled in France for tax purposes, a detailed inventory of the assets, rights and capitalized income located in France and placed in the trust, as well as their market value on January 1 of the year."

Previous F.T.A. Guidelines as to annual trust reporting obligation which were repealed in 2018 excluded trusts holding French financial assets as their only French assets. The F.T.A. Guidelines stated that the reporting obligation was "*excluding financial investments pursuant to Article 885 L of the F.T.C.*"

Following the reform of French wealth tax in 2018, article 885L was removed from the F.T.C. and the related F.T.A. Guidelines were repealed. As a result, there no longer is any explicit exclusion from the annual reporting obligation for foreign trusts holding only French financial assets as their sole French assets. The trustee of a trust holding French financial assets is therefore now required to comply with the reporting obligation.

However, the new paragraph related to the event-based reporting obligation seems to provide a broader exemption from the reporting obligations. It provides that if none of the settlor/beneficiaries of a trust is a French tax-resident, a reporting obligation exists only upon (i) the constitution of the trust, if French financial assets are held from the beginning and (ii) upon every modification of the trust resulting in the acquisition of a new investment of French financial assets or a sale of French financial assets. This rule limits the reporting obligations of such trusts when no settlors/beneficiaries are French tax-residents, while allowing the F.T.A. to be aware of any change in the French assets held by the trust.

Maintaining the annual reporting obligation when the event-based reporting obligation is not required seems illogical.

RECENT RULINGS ISSUED BY THE F.T.A.

Pursuant to article L.80 B, 1° of the French Tax Procedure Code ("F.T.P.C."), taxpayers can request a ruling from the F.T.A. regarding the interpretation of the F.T.C. When issued, the ruling represents a formal position that can be relied upon by taxpayers.

Based on this provision, two rulings have been issued by the F.T.A. to clarify the French reporting obligations regarding foreign trusts owning French financial

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assets.[10] One ruling request was filed with the *Service de la sécurité juridique et du contrôle fiscal* (the "Service") on January 4, 2022, asking for more precise guidance about the scope of the reporting obligation related to the event-based trust return in the case of a trust whose settlor and beneficiaries were not French tax residents and whose assets consisted exclusively of French financial investments. On February 7, 2022, the Service ruled that the procedures for filing an event-based trust return were not affected by the repeal of the French wealth tax guidelines. As a result

> the administrators of the trusts [, *i.e.*, the trustees,] in which these financial investments were placed at the time of their creation or at the time of subsequent modifications [are required to file a report regarding the acquisition of assets];
>
> - in other cases, the trusts' administrators are only bound by this reporting obligation when the settlor or one of the beneficiaries becomes resident in France within the meaning of article 4 B of the F.T.C.

". . . the F.B.F. requested guidance concerning the scope of the reporting obligation related to the annual declaration in the case of a trust whose settlor and beneficiaries were not French tax-resident and whose assets consisted exclusively of French financial assets."

On March 30, 2022, this position of the Service was officially included in the F.T.A.'s Guidelines related to the trusts reporting obligations, in the section related to event-based reporting obligation:[11]

> With regard to trusts whose settlor and set of beneficiaries are all non-French residents and whose assets located in France within the meaning of article 750 *ter* of the F.T.C. consist exclusively of financial investments, this obligation is understood as follows:
>
> - the trustees of the trusts in which these financial investments have been placed at the time of their creation or at the time of subsequent modifications are bound by the reporting obligation;
> - in other cases, the trusts' administrators are only bound by this reporting obligation when the settlor or one of the beneficiaries becomes resident in France within the meaning of article 4 B of the F.T.C.

The second ruling request was filed with the Service on January 4, 2023, by the *Fédération Bancaire Française* ("F.B.F."), a professional association of French banking institutions. In it, the F.B.F. requested guidance concerning the scope of the reporting obligation related to the annual declaration in the case of a trust whose settlor and beneficiaries were not French tax-resident and whose assets consisted exclusively of French financial assets.

On June 28, 2023, the Service replied that the annual declaration obligation does not apply in the context described, stating:

> It will be accepted that the annual trust return provided for in Article 1649 AB of the CGI does not apply when, on the one hand, the trust has no settlor, beneficiary deemed to be a settlor or beneficiary resident in France for tax purposes and, on the other hand, the trust

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10. To the exception of any other type of French assets (*i.e.*, French real estate assets) which would lead to filing obligations in France.

11. BOI-DJC-TRUST-30/03/2022, #190.

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> only includes in its assets as property located in France financial investments within the meaning of former Article 885 L of the F.T.C. in force on December 31, 2017.

OUTSTANDING ISSUES

In light of the answers provided by the Service in respect to the event-based declaration and the annual declaration, it seems that additional questions need to be addressed by the Service on the application of the event-based trust reporting obligation where (i) the trust settlor and beneficiaries are not French tax residents and (ii) the assets of the trust consist French financial assets, exclusively.

F.T.A. Guidelines[12] that reflect article 369 Appendix II of the F.T.C. specify the following with regard to the definition of the term "modification" made to the trust:

> [M]odification means any change in its terms, mode of operation, settlor, beneficiary deemed to be settlor, beneficial owner, administrator, any death of one of them, any new entry into the trust, or any exit from the trust of property or rights, any transmission or allocation of property, rights or proceeds of the trust and more generally, any modification of rights or facts likely to affect the economy or operation of the trust concerned.

In comparison to the ruling, the F.T.A. Guidelines[13] do not exclude from the reporting obligation modifications that merely reflect successive purchases and sales of securities contained in the trust portfolio. Event-based declarations are not required given the repetitive and continuous rhythm of these purchase and sale transactions.

In line with the same logic, it seems that this general definition of the term "modification" should cover the specific and restricted case of foreign trusts (i) set up by foreign settlors, (ii) for the benefit of persons who are not residents of France, and (iii) for the purpose of investing solely in French financial assets. By their very nature, those trusts limit French transactions to purchase and sale transactions of French securities.

PATH FORWARD

It is suggested that the F.T.A. Guidelines should be clarified to take into consideration the origins and logic of the exception[14] that successive purchases and sales of securities contained in the portfolio do not constitute modifications that must be declared by the trust administrator (*i.e.*, the trustee), provided that all sums deriving from the sales of securities remain in liquid assets in the portfolio or are reinvested in portfolio securities. In particular, the following two modifications should be made to the F.T.A. Guidelines.

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[12] Paragraph #180 of the BOI-DJC-TRUST-30/03/2022.

[13] Paragraph #320 of the BOI-DJC-TRUST-30/03/2022.

[14] Already provided for in paragraph #320 of the BOI-DJC-TRUST-30/03/2022.

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- In the case of a trust whose settlor and beneficiaries are not French tax-resident and whose assets consist exclusively of French financial assets, the Guidelines should provide that the transfer or acquisition of French securities by this specific type of trust in the context of regular and successive purchase/sale operations do not constitute a modification[15] requiring the filing of an event-based trust reporting obligation each time a French security is acquired/sold.
- In the case of a trust whose settlor and beneficiaries are not French tax-resident and whose assets consist exclusively of French financial assets, the Guidelines should provide that interest and dividends arising from the management of the securities portfolio by this specific type of trust does not give rise to an obligation to file an event-based declaration.

CONCLUSION

The F.T.A. have issued two rulings which are a good starting point to allow trustees to escape from the burdensome filing obligations for trusts with no French tax-resident settlors/beneficiaries owning French financial assets.

Nonetheless, additional guidance from the F.T.A. is needed to clarify that event-based filing is not required to report the turnover of French securities as part of ongoing management of portfolios managed by a trust that has neither a French resident settlor nor a French resident beneficiary.

[15] Pursuant to Article 369 of Appendix II of the F.T.C.

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NETHERLANDS: NEW LEGISTLATION TO COMBAT HYBRID MISMATCHES

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INTRODUCTION

On December 19, 2023, a legislative proposal was adopted in the Netherlands with the goal of significantly reducing the use of hybrid mismatch arrangements by companies operating internationally. The new law will take effect on January 1, 2025, although transitional rules will apply in 2024. The hybrid mismatch rules address entity classification disparities between countries that can lead to certain income being taxed twice or escaping taxation entirely.

A key aspect of the proposed *Wet fiscaal kwalificatiebeleid rechtsvormen* (Law on Fiscal Classification Policy of Legal Forms) is the elimination of the "consent requirement" for Dutch limited partnerships (*commanditaire vennootschappen*, or "C.V.'s") having a member wishing to transfer all or a portion of the investment held in the C.V.

This legislative change is expected to substantially decrease the occurrence of entity hybrid mismatches and enhance the flexibility of organizations that utilize tax transparent structures involving the Netherlands. Taxpayers with existing structures should review the effect of the new law in order to prevent adverse tax consequences in the Netherlands.

This article discusses these changes and analyzes the implications of these legislative changes as to the classification of U.S. entities for Dutch tax purposes.

BACKGROUND OF THE PROPOSAL

The proposal reflects parliamentary discussions on hybrid mismatch measures transposed into Dutch tax law following the enactment of the E.U.'s second Anti-Tax Avoidance Directive ("A.T.A.D. 2"). Those discussions culminated in recommendations to revise its existing Dutch classification policy for legal entities that deviate from international norms.

The core issue involves classification differences between tax systems involving two countries where one country classifies an entity as transparent for tax purposes, so that tax is imposed at the level of its owners, while another country classifies the same entity as taxable in its own right. Hybrid mismatches also apply to the classification of instruments, permanent establishments, and headquarters across various tax systems. These mismatches can result in economic double taxation where the same income is taxed simultaneously in different jurisdictions. They can also result in scenarios where expenses are deducted in one country by the payor, but not recognized as income in another country by the recipient.

While the hybrid mismatch regulations of A.T.A.D. 2 address the consequences of these mismatches, they do not resolve the underlying cause, which is that differences exist in the classification of entities, payments, permanent establishments, and corporate residence. In response, the Dutch government committed to examining the challenges posed by the classification policy of the Netherlands. The Ministry of Finance, the Dutch Tax Authorities, and various stakeholders engaged in discussions that led to a preliminary proposal for modifying the classification policy. Feedback from this consultation are reflected in the current legislative proposal.

Key elements of the proposal include the following:

- Codification of the Dutch classification policy for foreign legal forms using a comparative method with domestic forms, supplemented by the fixed method and the symmetric method for cases where a foreign entity's legal form lacks a Dutch equivalent.
- Eliminating the consent requirement and the open limited partnership ("Open C.V."). These changes will terminate the Open C.V.'s independent tax liability under corporate tax laws and other related tax obligations, aligning it with entities recognized as partnerships having capital divided into shares, under existing law. Transitional provisions are included to facilitate the implementation of these changes.

These legislative adjustments will impact various types of taxes where the classification of legal forms is relevant, including income tax, corporate tax, dividend tax, source tax, inheritance tax, gift tax, and transfer tax.

CURRENT CLASSIFICATION RULES

The current Dutch classification policy for tax purposes compares the civil law characteristics of an entity established under foreign law with the legal form of entities formed in the Netherlands, such as a public limited company (*naamloze vennootschap*, or "N.V."), a private limited company (*besloten vennootschap met beperkte aansprakelijkheid* or "B.V."), a cooperative (*coöperatie*), an association (*vereniging*), a foundation (stichting), a commercial or professional general partnership without legal personality (*maatschap*), a general partnership (*vennootschappn onder firma*, or "V.O.F."), and a limited partnership (*commanditaire vennootschap*, or "C.V."). A foreign entity is treated for tax purposes in the same manner as its counterpart under Dutch law.

This approach includes a mutual fund (*fonds voor gemene rekening*, or "F.G.R."), an entity that does not have a legal form requirement. The F.G.R. is included in the comparison to maintain simplicity. In recent years, criticisms have emerged around the "consent requirement" aspect of this policy. This requirement has prevented certain foreign entities from being classified as transparent for Dutch tax purposes, causing those entities to be standalone taxpayers, notwithstanding home country tax treatment as transparent entities. Hybrid mismatches can occur.

Feedback from practice has shown that maintaining the current Dutch comparison method for classifying foreign entities is preferred because it aligns with E.U. case law and effectively addresses classification issues in most situations. Nonetheless, there are instances where the classification method falls short, particularly when the legal form of a foreign entity does not match any existing Dutch legal forms. This discrepancy can lead to complex disputes or hybrid mismatches.

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NEW RULES: TWO SUPPLEMENTARY METHODS

To address situations that do not properly match under the classification method, the fixed method and the symmetric method are applied. The former method applies to entities formed abroad but tax resident in the Netherlands. The latter method applies to entities that are formed abroad and tax resident abroad.

The supplementary methods are intended to result in consistent and equitable tax treatment of foreign legal entities when structural complexities of a particular type of entity formed can lead to hybrid mismatches when the comparison method is applied.

Fixed Method

Under this method, an entity formed abroad, but maintaining its tax residence in the Netherlands is never considered to be transparent for Dutch tax purposes when it fails to be comparable to any legal form of an entity formed in the Netherland. The entity is a standalone taxpayer in all circumstances.

Symmetric Method

Under this method, an entity formed abroad that maintains its tax residence outside the Netherlands is not considered to be transparent for Dutch tax purposes if it is treated as a standalone taxpayer in its country of residence for tax purposes. Where the entity is formed in one country but becomes tax resident in another country, the tax classification in the latter country controls. And if the entity moves its tax residence to a third country, the classification in the third country becomes controlling. This method is particularly relevant if the foreign entity generates income from Dutch sources.

APPLICATION

The following discussion provides a comprehensive overview of the application of the new rules, proposed legislative adjustments, and their impact across personal income tax, corporate income tax, dividend tax, and withholding tax in the Netherlands.

Personal Income Tax (*Inkomstenbelasting*)

The legislation aims to codify the existing tax treatment of transparent Dutch entities within the Dutch personal income tax framework. The goal is to ensure that the income of a transparent entity is directly included in the tax base of its participants, eliminating double nontaxation. If an entity is deemed to be a taxpayer in its own right, the imposition of income tax on its members is avoided.

Corporate Income Tax (*Vennootschapsbelasting*)

Currently, partnerships other than C.V.'s – a *maatschap*, a V.O.F., or a comparable foreign legal form such as an L.L.P. – can structured as transparent or not transparent for tax purposes. Such partnerships are taxpayers in their own right where the following facts exist:

- The partnership interests are akin to share in a corporation.[1]
- The transfer of the participations does not require the consent of all other partners.

> *"Once an entity resident in the Netherlands is viewed to be a taxpayer in its own right, distributions by the entity to its owners may be subject to Dutch withholding tax."*

It follows that a Dutch C.V. is deemed a Dutch corporate taxpayer in its own right if the admission or replacement of partners is possible without the unanimous consent of all partners, including both managing and limited partners. This situation describes what is generally referred to as an "Open C.V."

As of January 1, 2025, all C.V.'s will be treated as fiscally transparent, thereby standardizing their classification as partnerships. Dutch corporate income tax is eliminated. This change also applies to U.S. L.P.'s.

Also as of January 1, 2025, a foreign entity that is resident in the Netherlands for Dutch tax purposes without a comparable Dutch legal form defaults to corporate status, and becomes a Dutch taxpayer in its own right.

Finally, as of January 1, 2025, a foreign entity based abroad for which no comparable Dutch legal form of entity can be identified will have its Dutch tax status controlled by its status as transparent in its country of residence. If transparent in its country of residence, it is transparent in the Netherlands. If not transparent in its country of tax residence, it is not transparent for Dutch tax purposes. A foreign entity is not transparent when its assets, liabilities, revenue, and costs are taken into account at the entity level under the tax laws of its home country.

Dividend Tax (*Dividendbelasting*)

Once an entity resident in the Netherlands is viewed to be a taxpayer in its own right, distributions by the entity to its owners may be subject to Dutch withholding tax. Briefly, dividend withholding tax is levied at the time profits are distributed to shareholders. The same standard discussed above is used to determine whether the recipient of the dividend or its members are taxable. The answer may affect the rate of withholding tax that must be collected.

Withholding Tax (*Bronbelasting*)

The Dutch Withholding Tax Act of 2021 mandates a withholding tax on specified interest, royalties, and dividend payments. The withholding tax reflects the highest corporate tax rate imposed in the Netherlands. In 2024, the highest corporate tax is 25.8%.

Withholding tax applies when a Dutch-based entity makes payments to a related entity based in a low-tax jurisdiction or under certain conditions considered to be abusive.

Related Party

A payment is deemed to be made to a related party if one entity holds a significant interest in the other or if a third party holds a significant interest in both the paying and receiving entities. An interest is considered to be significant when it exceeds 50%.

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[1] Dutch Supreme Court 2006, nr. 40919, ECLI:NL:HR:2006:AX2034, BNB 2006/288.

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Low Tax Jurisdiction

The recipient of a payment is considered to be based in a low-tax jurisdiction in three fact patterns. The first is that the jurisdiction imposes no income tax. The second is that tax is imposed, but the tax rate is below 9%. The third is that the country is included in the E.U.'s list of noncooperative jurisdictions for tax purposes.

Coordination with Dividend Tax

In certain scenarios, both dividend and withholding taxes may be levied on the same dividends. In computing the amount of withholding tax, an offset is allowed for the amount of dividend tax previously withheld. The offset is allowed only if both the dividend tax and the withholding tax are payable by the same entity. In the context of potentially hybrid entities, the appropriate classification method discussed above is used to determine both the recipient of the income and the person responsible for withholding and remitting the tax.

Effect on Offshore Funds

Many fund structures currently are subject to Dutch withholding tax because they are resident in no-tax jurisdictions such as the Cayman Islands and are formed as limited partnerships that are treated as the equivalent of Open C.V.'s. When the new rules become effective in 2025 onwards, the pass-through nature of a limited partnership will allow it to be viewed as a transparent entity for Dutch tax purposes. Consequently, the focus will shift towards the (ultimate) investors, who typically are not based in tax havens.

TESTING COMPARABILITY OF FOREIGN ENTITIES

Through a general administrative order (*algemene maatregel van bestuur* ("A. Mv.B.")), frameworks have been set up to assess when a foreign entity's legal form is comparable in nature and structure to an entity established under Dutch law.

Draft Decree

On February 5, 2024, a brief consultation period for the draft Decree on the Comparison of Foreign Legal Forms began. The decree was intended to establish frameworks to evaluate how foreign entities compare to Dutch entities based on their structure and nature. It is applicable to various Dutch legal forms, as discussed above.

The consultation ended on March 18, 2024. It faced significant criticism, which focused on the following concerns:

- There is a lack of clarity in the criteria and weighting for comparing foreign entities to Dutch equivalents.
- The list of pre-classified foreign entities is too short. For example, in the U.S., only three states are covered: Delaware (in which the entities are a corporation, an L.L.C., and an L.P.), Massachusetts (in which the only entity is a G.P.), and Ohio (in which the only entity is an L.L.C.).
- A real risk exists of potential reclassification errors that could lead to hybrid mismatches and double taxation, thereby falling short of the goal of the

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legislation.

IMPACT ON STRUCTURE

The table below provides an overview of common American business structures and their closest Dutch equivalents, outlining how each U.S. legal form is currently classified under Dutch tax law and the upcoming changes set for 2025. Please note that the table below is based on the expected outcome of the definitive legislation and can be subject to changes before it is implemented.

U.S. Legal Form	Dutch Legal Form	Current Dutch Fiscal Classification	New Dutch Fiscal Classification (Effective 2025)
Sole Proprietorship	*Eenmanszaak*	Transparent	Transparent
General Partnership	*Vennootschap onder Firma* (V.O.F.)	Transparent	Transparent
Limited Partnership	*Commanditaire vennootschap* (C.V.)	Nontransparent if Open C.V.; otherwise, transparent	Always transparent
Limited Liability Company (L.L.C.)	*Besloten Vennootschap* (B.V.)	Nontransparent	Nontransparent
C Corporation	*Naamloze Vennootschap* (N.V.)	Nontransparent	Nontransparent
S Corporation	Not available	Typically, it would be compared to a B.V. or N.V., nontransparent	Typically, it would be compared to a B.V. or N.V., nontransparent
B Corporation	Not available	It would be compared to a B.V. or N.V., nontransparent	It would be compared to a B.V. or N.V., nontransparent
Nonprofit Corporation	Not available	Typically nontransparent unless specific conditions are met	Typically nontransparent unless specific conditions are met
Professional Corporation	*Maatschap* (for certain professions)	Transparent	Transparent
Limited Liability Partnership (L.L.P.)	Not available	Nontransparent	Nontransparent if resident in the Netherlands; otherwise, it depends on the U.S. tax classification

On a very general note, all of the entities listed above should not be affected by these new rules, except for L.P.'s and L.L.P.'s that are transparent from a U.S. tax perspective. Those entities will be considered to be transparent for Dutch tax

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purposes, while pre-2025, these entities would almost always be considered to be nontransparent.

DUTCH TAX CONSEQUENCES FOR CHANGES IN TRANSPARENCY

For Dutch C.V.'s and comparable foreign entities currently treated as nontransparent for Dutch corporate tax purposes, transitioning to fiscal transparency means they are deemed to have transferred their assets and liabilities to their participants, who may be subject to tax in the Netherlands on the change of status. Generally, the deemed transfer of assets and liabilities results in a tax charge deriving from hidden reserves, fiscal reserves, and goodwill sitting in the entity.

To prevent immediate taxation on these components, the legislative proposal introduces transitional measures:

- **Rollover Relief:** The fiscal claim related to the hidden and fiscal reserves along with the goodwill is transferred to the underlying limited partners.
- **Share Merger Relief:** Underlying limited partners may move the fiscal claim to a holding company. This transfer is exempt from transfer tax when real estate is involved.
- **Rollover Relief for Business Use:** When assets are utilized by the business, underlying limited partners can relocate the fiscal claim on these assets.
- **Deferred Payment Options:** Payment can be spread over a maximum of ten years.

"To prevent immediate taxation on these components, the legislative proposal introduces transitional measures . . ."

The new law will take effect on January 1, 2025. However, taxpayers can opt to exercise transitional rights starting in 2024, providing a year to prepare and potentially benefit from these measures.

DUTCH TAX IMPLICATIONS FOR U.S. INVESTORS

The forthcoming changes in Dutch tax legislation aimed at combatting hybrid mismatches will necessitate a thorough review by U.S. entities with investments in or through Dutch structures, particularly those involving C.V.'s, L.P.'s, and L.L.C.'s. Starting January 1, 2025, the new legislation will treat these entities as fiscally transparent, altering their tax status or those of their investors and potentially the taxation of the income derived from these investments.

U.S. structures that currently benefit from or are structured around the nontransparent status of Dutch entities may face significant changes. This shift could lead to tax consequences that might not have been anticipated under the previous regulatory framework.

Entities affected by these changes should consider adopting the following action steps:

- Analyze the specific impacts of these legislative changes on the current tax positions and structures.
- Evaluate the transitional measures provided in the legislation, such as roll-over relief and deferred payment options, to mitigate immediate tax impacts.
- Prepare early by taking advantage of the transitional rights available from 2024 to align their strategies with the new tax regime effectively.

This proactive approach will help ensure compliance with the new Dutch tax laws and potentially leverage any transitional facilities to optimize tax outcomes.

DEVELOPMENTS IN ANTI-ABUSE MEASURES AND ACQUISITION FINANCING IN THE NETHERLANDS

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Tags
Advocate General Emiliou
Advocate General Wattel
Anti-Abuse
Article 10a
C.J.E.U.
Fraus legis
Interest Expense Deduction
Netherlands

INTRODUCTION

The financing of acquisitions involving Dutch companies has come under increased scrutiny in the Netherlands in recent years. The Dutch Tax Authority ("D.T.A.") has challenged the ability of Dutch acquisition companies to deduct interest on intercompany loans deemed to be abusive. Article 10a of the Dutch Corporate Income Tax Act ("C.I.T.A.") denies interest expense deductions if the financing structure artificially erodes the Dutch tax base. If organizations circumvent the direct application of Article 10a, the D.T.A. has successfully invoked the principle of *fraus legis* to deny interest expense deductions. *Fraus legis* may be applied if an arrangement is contrary to the intent of the law and its decisive purpose is to obtain a tax benefit.

A 2023 Insights article discussed cases in which the D.T.A. challenged the deductibility of interest under Article 10a and *fraus legis*.[1] However, many grey areas and interpretative issues remained. In the period since the article was published, new developments regarding the denial of interest expense deductions on intercompany acquisition loans have emerged. This year, the Dutch Supreme Court, the Advocate General for the C.J.E.U., and the Advocate General of the Netherlands have issued opinions on three separate cases. This article reviews the opinions and their potential impact on Dutch acquisition financing. While the saga of Article 10a and *fraus legis* continues to unfold, taxpayers welcome the recent guidance as it provides further insight into this evolving area and the extent to which *fraus legis* may be applied.

ARTICLE 10A AND FRAUS LEGIS

The Netherlands applies many specific anti-abuse rules of Dutch tax law, including Article 10a of the Corporate Income Tax Act 1969. Article 10a denies a taxpayer interest expense deductions in respect of debts insofar as these debts are related to the acquisition or increase of an interest in an entity that is or becomes affiliated with the taxpayer.[2] An acquired entity is considered affiliated with a taxpayer when (i) the taxpayer holds at least a one-third interest in the entity, (ii) the entity holds at least a one-third interest in the taxpayer, or (iii) a third-party holds at least a one-third interest in both the taxpayer and the acquired entity.[3] As of 2017, the affiliated entity

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1 M. Bennett, "Anti-Abuse Developments: A New Normal in the Netherlands," *Insights*, Volume 10, No. 1, (January, 2023), page 52.

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

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

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definition extends to a cooperating group, whereby the cooperating group's total interest taken together is at least one-third.[4]

Two exceptions exist to this rule. A deduction of interest is permitted where (i) the taxpayer demonstrates that the loan and transaction are based predominantly on business considerations or (ii) the interest income is taxed at a rate of at least 10% in the hands of the direct recipient or a direct or indirect shareholder of the recipient.[5]

A presumption exists that a loan and transaction entered into for the acquisition or expansion of an interest in an entity are predominantly based on business considerations when the target first becomes associated with the taxpayer after the acquisition or expansion. Nonetheless, the presumption does not apply if the loan is deemed to be a wholly artificial arrangement.

The D.T.A. has successfully applied Article 10a in combination with *fraus legis* to deny interest expense deductions on intercompany loans within typical acquisition structures. The Netherlands applies the common law doctrine *fraus legis*, which is akin to the E.U. G.A.A.R. *Fraus legis* allows tax consequences of certain arrangements to be ignored if (i) the decisive purpose for entering into an arrangement was to realize a tax benefit (considering the artificiality of an arrangement lacking a business motive) and (ii) the arrangement is contrary to the object and purpose of the law. *Fraus legis* can be applied only if no specific anti-abuse rule is applicable to challenge the *bona fide*s of a transaction.

Fraus legis has been applied as a backstop to anti-abuse legislation, making for a win-win situation for the D.T.A. More specifically, in cases where Article 10a is inapplicable due to the entities involved not meeting the affiliation threshold (generally for arrangements preceding the 2017 cooperating group provision), the D.T.A. has applied *fraus legis* to sidestep the issue and deny interest expense deductions.

The extent to which *fraus legis* may be applied to deny interest expense deductions remains unsettled, as evidenced by the numerous cases litigated in Dutch courts over the years. However, new guidance has emerged in 2024, helping to clarify some of the blurred lines that define what is and is not considered abusive.

DUTCH SUPREME COURT OPINION

On March 22, 2024, the Dutch Supreme Court ruled on a case involving interest expense deductions and financing costs in a private equity acquisition.[6] In this case, a Swedish private equity firm used a Dutch acquisition vehicle ("X B.V.") to purchase a Dutch company.

The investment fund initially consisted of four limited partnerships ("L.P.'s"), which were non-transparent for Dutch tax purposes. Each L.P. established a sub-fund in Guernsey. The sub-funds were subject to a 0% tax rate in Guernsey. Sub-fund 1 was the only sub-fund with an interest in X B.V. that exceeded the one-third affiliate threshold of Article 10a. A fifth L.P. and Gurnsey sub-fund were established one

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[4] Article 10a(6) C.I.T.A.

[5] Article 10a(3) C.I.T.A.

[6] Supreme Court, 21/01534, ECLI:NL:HR:2024:469 (March 22, 2024).

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month before the acquisition was finalized in order to reduce L.P 1's interest in X B.V. to a level below the affiliate threshold. The limited partners in L.P. 1 were the same as those in L.P. 5. During the takeover, 15% of X B.V. shares were transferred to a family company of the sellers ("FamBV"). The acquisition was financed with a combination of debt and equity from the sub-funds and FamBV. The sub-fund financing originated from equity contributed to the L.P.'s by the limited partners.

On its tax return, X B.V. deducted only interest paid on the FamBV loan, designating the remaining interest expense as nondeductible on the basis of Article 10a. Following an audit, the D.T.A. challenged the deductibility of interest paid on the FamBV loan. X B.V. objected and took the position that the full amount of interest may be deducted, including the interest paid on the sub-fund loans that had originally been excluded on the tax return.

Both the district court and the appellate court allowed the deduction for interest paid on the FamBV loan since the lender did not belong to the private equity group, but disallowed the deduction for interest paid on the sub-fund loans. The courts acknowledged that Article 10a was not directly applicable since the affiliate threshold was not met between the sub-funds and X B.V. Nonetheless, they held that *fraus legis* applied to deny the interest expense deductions because the structure was set up to artificially circumvent Article 10a and pay zero tax on the interest income in Gurnsey. The loans were deemed to be an unbusinesslike diversion of equity.

X B.V. appealed to the Supreme Court. Advocate General Wattel concurred with the lower courts. However, the Supreme Court partially overturned the lower courts' decisions. The Supreme Court held that only the interest expense deduction paid on the loan from sub-fund 5 could be denied since the sub-fund was solely created to bypass the affiliate threshold of Article 10a.

The interest paid on the loans from the other sub-funds and FamBV was deductible since the entities were not one-third affiliated with X B.V., and there was no series of transactions between affiliated entities aimed at circumventing the Article 10a affiliate threshold. The Supreme Court referred to the legislative history of Article 10a, which provides that although *fraus legis* may still apply if Article 10a does not directly apply, it must concern exceptional cases, which are rare in practice given the extensive codification of such cases.

The Supreme Court also clarified a consideration from its March 3, 2023, decision. In the 2023 decision, the Court noted that if a taxpayer can convincingly demonstrate that the debt and associated transaction were primarily business motivated, then *fraus legis* is not applicable. The Court explained in the 2024 decision that this is the case only if the lender associated with the taxpayer fulfills a pivotal financial function and does not act as a conduit. The Court noted this was not the case for the relevant entities in the 2024 decision; thus, the application of *fraus legis* was properly assessed.

In an interesting turn of events, the D.T.A. ultimately ended up in a worse position after challenging the FamBV loan interest expense deduction. Not only was the taxpayer allowed to deduct that interest as a result of the Supreme Court decision, but it could also deduct interest on the majority of the sub-fund loans.

While the Article 10a story continues to play out, this decision at least demonstrates there are limits to *fraus legis* when challenging acquisition financing. A case must

represent an exceptional circumstance clearly crossing the boundary of permissible tax savings. The Court also made it clear that if a structure attempts to artificially evade the one-third affiliate threshold, there may be a limitation on interest expense deductions under *fraus legis*.

C.J.E.U. ADVOCATE GENERAL OPINION

In 2022, the Dutch Supreme Court considered a case where the primary issue was whether Article 10a can be applied to interest arising under a loan where the agreed loan conditions are arm's length.[7] The Supreme Court sought clarification from the C.J.E.U. on this issue, particularly in regard to the *Lexel* decision and the treatment of intragroup loans under anti-abuse provisions. The Dutch Supreme Court acknowledged that the country's anti-base erosion rules generally align with E.U. law. However, post-*Lexel*, there is uncertainty about whether limiting interest expense deductions for deemed artificial transactions conducted at arm's length violates E.U. law.

"In 2022, the Dutch Supreme Court considered a case where the primary issue was whether Article 10a can be applied to interest arising und a loan where the agreed loan conditions are arm's length."

The C.J.E.U. in *Lexel* ruled that transactions between affiliated entities conducted at arm's length are not purely artificial. Additionally, the C.J.E.U. emphasized that under E.U. law, if a particular legal structure lacks a commercial reason, the proportionality principle mandates limiting an interest deduction to the extent that it is not considered at arm's length.

The *Lexel* decision has sparked mixed reactions in the Netherlands. Some practitioners view the C.J.E.U.'s decision as an affirmation of the arm's length standard as a safe harbor for taxpayers. Others exercise caution, arguing that the decision, rendered by a lower E.U. court, does not align with the C.J.E.U.'s general anti-abuse stance, which tends to apply a principal purpose test.

On March 14, 2024, Advocate General Emiliou of the C.J.E.U. delivered his opinion in response to the request by the Dutch Supreme Court.[8] A.G. Emiliou first identified the freedom of establishment under Article 49 T.F.E.U. as the relevant fundamental freedom affected by the case. A.G. Emiliou found that Article 10a C.I.T.A., in principle, restricts that freedom by potentially treating intragroup loans differently based on the location of the lender within the group. This may disadvantage cross-border situations, creating a *de facto* restriction. However, he concluded that the restriction is justified by an overriding public interest in the fight against tax avoidance.

A.G. Emiliou reasoned that the arm's length nature of a loan is irrelevant in determining its business justification. A.G. Emiliou recommended disregarding the emphasis on arm's length conditions in the *Lexel* decision, suggesting that a loan's economic and commercial justifications are paramount. He contended that artificial debts targeted by Dutch rules should not be shielded by arm's length compliance, noting that national provisions targeting such loans are necessary to prevent artificial profit transfers to low-tax jurisdictions.

The forthcoming decision from the C.J.E.U. is expected to provide clarity on the application of Dutch anti-base erosion rules within the framework of E.U. law. The

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[7] Supreme Court, 20/03948, ECLI:NL:HR:2022:1121 (September 2, 2022).

[8] Opinion of Advocate General Emiliou in *X B.V. v. Staatssecretaris van Financiën*, C585/22, ECLI:EU:C:2024:238 (March 14, 2024).

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judgment should also address whether an arm's length safe harbor applies. The outcome of this case could hold considerable implications for Dutch taxpayers.

NETHERLANDS ADVOCATE GENERAL OPINION

On January 26, 2024, Advocate General Wattel of the Netherlands issued an opinion in a case that was submitted to the Dutch Supreme Court.[9] The primary issue is whether *fraus legis* applies to disallow interest expense deductions paid on an intercompany loan if the interest deduction falls outside the scope of Article 10a.

The case concerns a private equity takeover structure where a Dutch BidCo financed the acquisition of a Dutch target with a loan from its parent company in Luxembourg. The funds were obtained through preferred equity certificates ("P.E.C.'s") issued to six sub-funds and two partnerships of private equity funds, where each holds less than a one-third interest in the Dutch BidCo. Following the acquisition, the target was included in a fiscal unity with the Dutch BidCo, enabling interest on the shareholder loan to be charged against the target's profits. The D.T.A. disallowed this interest deduction.

This District Court of The Hague found that the shareholder loans fell under Article 10a, rendering the interest nondeductible. The district court regarded the P.E.C.'s as a contribution of capital, considering their yields to be profit distributions rather than interest. The district court did not find it relevant that the P.E.C.'s were considered debt in Luxembourg. Moreover, the interest income was not subject to a minimum 10% tax since it could be deducted against profits in Luxembourg. The district court held that the P.E.C.'s were an unbusinesslike diversion of equity.

The Amsterdam Court of Appeals found that the group entities were not affiliated for the purposes of Article 10a since they did not meet the one-third affiliate threshold. Nonetheless, the Court of Appeals held that the shareholder loan was an unbusinesslike diversion and denied the interest expense deduction by way of *fraus legis*.

In his opinion, A.G. Wattel highlighted that the legislative history of Article 10a indicates that interest deduction can be denied due to *fraus legis* in situations where Article 10a does not apply directly due to the failure to meet the one-third affiliate threshold. This is especially true if the tax savings clearly exceed permissible limits. A.G. Wattel stated that there is a presumption that the parties are acting in good faith when they are not affiliated but clarified that this does not preclude the application of *fraus legis* when there is a clear motive for tax avoidance.

A.G. Wattel noted that the *Hunkemöller* ruling established broader grounds for applying *fraus legis* than those that exist under Article 10a. A.G. Wattel also compared the case to the pre-Article 10a case, *Bovag*, where a restructuring was financed in such a way that deductible interest flowed to a nontaxable entity and was deemed artificial. He stated that while a lack of one-third affiliation under Article 10a leads to the inapplicability of Article 10a, one-third affiliation is not a requirement for *fraus legis*, as demonstrated in *Hunkemöller* and pre-Article 10a case law.

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[9] Opinion of Advocate General Wattel, 23/02746, ECLI:NL:PHR:2024:85 (January 26, 2024).

A.G. Wattel recommended confirming the decision of the appellate court, but also urged the Supreme Court to provide further clarity on the application of *fraus legis* to the anti-abuse rules. The matter now lies with the Supreme Court for resolution.

CONCLUSION

The recent ruling by the Dutch Supreme Court and the opinions of the advocate generals highlight the ongoing uncertainty surrounding the precise scope of Article 10a and its interaction with *fraus legis*. As the saga continues to unfold in the courts, only time will reveal the full extent to which these rules will apply. In the interim, international taxpayers should carefully evaluate their structures and acquisition financing arrangements when targeting a Dutch entity, taking into account the potential implications of the Dutch anti-base erosion rules.

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INFORMATION REPORTING ON FOREIGN TRUSTS AND GIFTS – NEW REGULATIONS PROPOSED

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BACKGROUND

Due to concerns about the potential use of foreign trusts and gifts as a means to access the proceeds of unreported income, the Internal Revenue Code (the "Code") and related regulations issued by the Treasury Department ("Treas. Reg.") impose extensive reporting obligations for U.S. persons who have an interest in or transactions with foreign trusts. New regulations have been proposed to provide clarity on the application of the rules and relief to taxpayers in some cases.

Many of the rules in the proposed regulations are not new, but they describe and consolidate rules gleaned from statutes, I.R.S. notices, I.R.S. rulings, and instructions for I.R.S. forms.

LOANS TO AND USES OF FOREIGN TRUST PROPERTY

Basic Rule

Code §643(i) focuses on foreign trusts lending money to U.S. persons or allowing U.S. persons to use property without adequate compensation. An example of the latter is the free use of a condominium apartment in New York City or a vacation home in Palm Beach. If a foreign trust allows for the uncompensated use of its property by (i) its U.S. grantor or beneficiary or (ii) a U.S. person who is related to the grantor or beneficiary, the trust is deemed to have made a distribution equal to the value of the property to the grantor or the beneficiary. If the user of the property is a related U.S. person, the distribution is deemed to have been made to the U.S. grantor or beneficiary, not the related U.S. person. The U.S. person must report this transaction on Line 25 of Part III of Form 3520 (Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts).

Exceptions

This rule does not apply if the trust is compensated for the use of its property. The proposed regulations[1] detail the type of compensation that will create an exception. Loans of cash will not create a §643(i) distribution if the trust is compensated through a "qualified obligation." An obligation must meet the following criteria to be a qualified obligation:

- The obligation must be in writing.
- The term of the obligation must not exceed five years.

[1] 89 FR 39440; Prop. Reg. §1.643-2.

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- All payments must be made in cash in U.S. dollars.
- The obligation must be issued at par and provide for stated interest at a fixed rate or a "qualified floating rate" (broadly, a rate where variations in the rate reasonably track the cost of borrowing U.S. dollars).
- The yield to maturity must be at least 100% of and not greater than 130% of the applicable federal rate as of the date of the obligation's issuance.
- All stated interest must be qualified stated interest (stated interest that is unconditionally payable in cash or property (other than debt instruments of the issuer) at least annually over the term of the debt instrument at a single fixed rate).[2]

Additionally, the obligation must meet the following requirements throughout the obligation's existence:

- The U.S. grantor or beneficiary must extend the statute of limitations for the I.R.S. to assess the tax on the deemed distribution to three years after the obligation's maturity date.
- The U.S. grantor or beneficiary must report the status of the obligation (including any payments made) on Part III of Form 3520.
- The obligor must pay principal and interest according to the terms of the obligation.[3]

The I.R.S. has requested comment on whether a similar exception should be made available for loans of marketable securities. Such an exception was left out because the I.R.S. does not believe that this fact pattern is not common.

For loans of property other than cash or marketable property, distribution treatment will not apply if the trust receives compensation equal to the fair market value of the use within reasonable time (defined as 60 days or less) after the U.S. person starts using the property.[4] The proposed regulations also provide a *de minimis* exception under which Code §643(i) will not apply if the loan is for a period of 14 days or less. [5]Lastly, cash loans made by foreign corporations to a U.S. beneficiary are not treated as distributions to the extent they are attributable to the corporation's undistributed earnings that have been included in the U.S. beneficiary's income under either the controlled foreign corporation or qualified electing fund. This exception presumably only applies to an indirect loan where a foreign corporation is a C.F.C. or a P.F.I.C. and the beneficiary is deemed to own the shares of the foreign corporation by attribution from a foreign trust.[6]

The reporting requirement also does not apply to the extent that the foreign trust is a grantor trust. A foreign trust can become a grantor trust to the extent that a U.S. person transfers property to the trust and Code §679 consequently applies to make at least a portion of the trust a foreign grantor trust. The preamble explains that this

[2] Prop. Reg. §1.643-2(b)(2)(iii)(A).

[3] Prop. Reg. §1.643-2(b)(2)(iii)(B).

[4] Prop. Reg. §1.643-2(a)(2)(ii).

[5] Prop. Reg. §1.643-2(a)(3).

[6] Prop. Reg. §1.643-2(a)(4).

means §643(i) will rarely apply to a U.S. grantor of a foreign grantor trust. This is also confirmed by proposed regulations under Code §679.[7]

Other Information

Indirect loans fall under the purview of this reporting requirement. The proposed regulations provide three examples of indirect loans:

- A loan made by anyone to the U.S. grantor or beneficiary where the trust guarantees the loan.
- A loan made by a person related to the trust to the U.S. grantor or beneficiary.
- A loan made by the trust to a foreign person related to the U.S. grantor or beneficiary (unless the foreign related person is a grantor or beneficiary of the trust).[8]

However, under the latter two examples, the U.S. grantor or beneficiary can avoid the Code §643(i) distribution treatment if a statement is attached to his or her tax return demonstrating that the loan would have been made even if the U.S. grantor or beneficiary were not related to the trust.[9]

The proposed regulations also contain an anti-abuse provision. A foreign individual who receives a loan from a foreign trust and becomes a U.S. person within two years will be subject to Code §643(i) to the extent of the outstanding amount of the loan as of the date the borrower becomes a U.S. person.[10]

Tax Consequences

If a loan is recharacterized as a distribution, there are tax consequences to both the trust and the U.S. grantor or beneficiary. The trust is given a deduction for making a distribution.[11] If the deemed distribution involves marketable securities, the trust is further deemed to have elected under Code §643(e)(3) to recognize gain on the distribution.[12] Consequently, any capital gain recognized on the securities is included in the trust's distributable net income.

The trust may provide a Foreign Nongrantor Trust Beneficiary Statement to the U.S. grantor or beneficiary, although the proposed regulations imply that this is not necessary.[13] The issuance of the statement determines how the U.S. person will treat the deemed distribution. If a U.S. person receives the statement from the trust, the U.S. person can opt for the actual calculation method, under which the U.S. grantor or beneficiary treats the deemed distribution as an amount that is required to be distributed under Code §662(a)(2).

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7 Prop. Reg. §1.679-2(a)(v)(5).

8 Prop. Reg. §1.643-1(b)(2).

9 Prop. Reg. §1.643-1(b)(2)(ii).

10 Prop. Reg. §1.643-1(b)(3).

11 Prop Reg §1.643(i)-3(a).

12 Prop Reg §1.643(i)-3(c)(2)(ii).

13 Prop Reg §1.643(i)-3(c)(2)(iii).

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If the U.S. person does not receive a statement, he or she must use the "default calculation method," including for all subsequent distributions from the same trust (even if later distributions are not Code §643(i) distributions). Under the default calculation method, the distribution is treated as current income to the extent of 125% of the average amount of distributions received by the U.S. person in the prior three years. Any amount of the distribution in excess of that is treated as an accumulation distribution, which is generally considered a less taxpayer-friendly form of a distribution.

FOREIGN TRUSTS TREATED AS HAVING A U.S. BENEFICIARY

Under Code §679, if a U.S. person transfers property to a foreign trust, the U.S. person is treated as the owner of portion of foreign trust attributable to the transferred property to the extent that the terms of the trust allow for income or corpus to be paid to or accumulated for the benefit of a U.S. person.[14] An exception exists if the trust transfers fair market value consideration in exchange.[15] However, if the trust issues obligations in exchange, the exchange will only qualify for this fair market value exception if the obligation is a "qualified obligation." This information is all reported on Schedule A of Part I of Form 3520.

In determining whether the trust is allowed to make payments to or accumulate income on behalf of a U.S. person, the statute allows the I.R.S. to make presumptions. First, a foreign trust is treated as having a U.S. beneficiary unless none of the trust's principal and income can be paid to or accumulated for the benefit of the U.S. person.[16] Second, a foreign trust that receives a transfer of property from a U.S. person is presumed to have a U.S. beneficiary unless otherwise demonstrated to the I.R.S.[17] Third, a trust that loans cash or marketable securities to any U.S. person (whether or not that person is a beneficiary under the trust's terms) is treated as having a U.S. beneficiary, except to the extent that the United States person repays the loan at a market rate of interest (or pays the fair market value of the use of such property) within a reasonable period of time.[18]

The proposed regulations make several amendments. First, the proposed regulations remove language that explicitly states that a foreign individual who elects to be treated as a U.S. taxpayer under Code §6013(g)[19] or (h)[20] is considered a U.S.

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[14] Code §679(a)(1).

[15] Code §679(a)(2)(B).

[16] Code §679(c)(1).

[17] Code §679(d).

[18] Code §679(c)(6).

[19] Code §6013(g) allows a nonresident alien individual who is married to a U.S. citizen to be treated as a U.S. resident, thereby allowing the married couple to file a joint income tax return.

[20] Code §6013(g) allows an individual who was a nonresident alien at the beginning of a calendar year but a U.S. resident at the close of the year to be treated as a resident for the full year in order for the married couple to file a joint income tax return.

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person for this reporting purpose.[21] This should not be interpreted as changing the substantive law; rather, the I.R.S. simply felt the language was unnecessary.

However, dual-resident taxpayers (those who are residents of the U.S. and another country) who are treated solely as foreign taxpayers under the residence tiebreaker rule of an income tax treaty are not considered U.S. persons for purposes of Code §679. According to the preamble that accompanied the issuance of the proposed regulations, the Treasury Department and the I.R.S. are of the view that it is not necessary to treat a dual resident taxpayer in these circumstances as a U.S. person for purposes of Code §679. This approach departs from the general rule that appears in Treas. Reg. §301.7701(b)-7(a)(3) that a dual resident individual is treated as a U.S. resident for tax purposes other than the computation of that individual's income tax. Nonetheless, it is consistent with a recent case in which a court held that a green card holder residing in a treaty jurisdiction and treated solely as a resident of that jurisdiction under a treaty tiebreaker provision was not a U.S. resident required to file FinCEN Form 114 (*Report Foreign Bank and Financial Accounts*).[22]

With respect to the presumption of the existence of a U.S. beneficiary for purposes of Code §679, the proposed regulations contain several exceptions that mirror those under Code §643(i). A loan of cash will qualify for an exception if the U.S. person provides a qualified obligation. The definition of qualified obligation is amended for consistency with the proposed regulations under §643(i) (see above). A loan of trust property other than cash or marketable securities is also excepted from the general rule if the U.S. person provides fair market value consideration.

If either exception applies, the trust will not automatically be treated as having a U.S. beneficiary.

FOREIGN GIFTS

Code §6039F requires U.S. persons to report the receipt of a foreign gift in excess of $10,000 from a foreign donor. For administrative purposes, the I.R.S. increased the reporting threshold to $100,000 from a foreign donor.[23] Once the $100,000 threshold is met, the donee must report each gift in excess of $5,000 but is not required to identify the donor on the form. To determine if a U.S. person received gifts in excess $100,000 from a particular foreign individual, the U.S. person must aggregate gifts from foreign persons that the U.S. person knows or has reason to know are related to each other, such as husband and wife or father and grandfather. The report is made on Part IV of Form 3520.

Filing Deadlines

The proposed regulations describe filing deadlines for Form 3520. By default, Form 3520 must be filed by the 15th day of the fourth month after the close of the taxpayer's tax year. Extensions that are applicable to income tax returns also apply to Form 3520. For example, U.S. persons residing abroad are given automatic extension to the 15th day of the sixth month after the tax year in question.[24] This extension

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[21] Prop. Reg. §1.679-1(c)(2)(ii)A).

[22] *Aroeste v. U.S.,* 655 F. Supp. 3d 1053 (S.D. Cal. 2023).

[23] Notice 97-34, Section VI.B.1.

[24] Prop. Reg. §1.6039F-1(a)(2).

also applies to reporting foreign gifts on Form 3520. Likewise, Form 3520's filing deadline is extended to the 15th day of the 10th month after the tax year if the taxpayer has been granted the same extension for his or her income tax return. If a discretionary extension is granted for filing a tax return beyond the 15th day of the 10th month, the due date for filing Form 3520 is not extended.

If the taxpayer died during the taxable year, the executor of the taxpayer's estate must report the foreign gift by the 15th day of the fourth month after the taxpayer's final tax year or by the 15th day of the 10th month if the executor has been granted an extension.

Definitions

The definition of "U.S. person" is consistent with the use of the term elsewhere in the Code. Consequently, a dual resident taxpayer who is treated as a nonresident, non-citizen taxpayer for purposes of U.S. tax liability is not treated as a U.S. person for purposes of these reporting provisions.[25] In comparison, a dual status taxpayer will not be treated as a U.S. person for purposes of Code §6039F with respect to the portion of the taxable year during which the taxpayer is treated as a nonresident, noncitizen individual for purposes of computing U.S. income tax liability.[26] A dual-status taxpayer is one who is a U.S. person for only part of a tax year because, for example, U.S. citizenship or residence was acquired or abandoned during the year.

". . . a dual resident taxpayer who is treated as a nonresident, non-citizen taxpayer for purposes of U.S. tax liability is not treated as a U.S. person for purposes of these reporting provisions."

A "foreign gift" is defined as any amount received from a non-U.S. person that the recipient treats as a gift, bequest, devise, or inheritance for income tax purposes.[27] Qualified transfers for educational or medical expenses within the meaning of Code §2503(e)(2), related to transfers excluded from being characterized as gifts for gift tax purposes, are excluded.[28] An anti-avoidance rule provides that the I.R.S. can re-characterize a transfer (such as a loan) as a gift that is exempt from gross income,[29] if facts and circumstances indicate that the transfer is in substance a gift.[30]

Reporting Threshold Amounts

The proposed regulations also restate and expand upon exceptions to this reporting requirement. First, as mentioned above, gifts received by a U.S. donee from foreign individuals or estates are not reportable unless the aggregate amount of foreign gifts from any one transferor (including persons related to the transferor) exceeds $100,000, modified by cost-of-living adjustments.[31] If this threshold is met, each foreign gift in excess of $5,000 must be separately identified. In a change from the current Form 3520 instructions, the U.S. recipient of the gift must also provide identifying information about the transferor.

A separate reporting threshold applies to covered gifts and bequests from covered expatriates (U.S. persons who expatriated from the U.S. and are subject to the exit

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25 Prop. Reg. §1.6039F-1(f)(1).

26 Prop. Reg. §1.6039F-1(f)(2).

27 Prop. Reg. §1.6039F-1(b)(1).

28 *Id.*

29 Code §102.

30 Prop. Reg. §1.6039F-1(b)(2).

31 Prop. Reg. §1.6039F-1(c)(2)(i).

tax by reason of high income, high net worth, or a failure to certify U.S. tax-compliant status).[32] The threshold is $18,000 for 2024.[33]

Foreign gifts from a foreign corporation or partnership do not have to be reported by a U.S. donee if the aggregate amount of transfers received from a particular entity does not exceed $10,000, adjusted for cost of living.[34]

For spouses who file a joint tax return, these reporting thresholds apply separately to each spouse.[35]

Valuation

A foreign gift is valued as of the time of the transfer. The value is defined at the price at which the property would changes between a willing buyer and seller, and it is determined in accordance with principles under the gift tax.[36]

Penalties

A U.S. donee who fails to report a reportable foreign gift will pay a penalty equal to 5% of the amount of the foreign gift for every month that the taxpayer is noncompliant, up to a maximum of 25% of the amount of the gift.[37]

Tax Treatment

The tax consequences of noncompliance by a U.S. donee are determined based on facts and circumstances.[38] The I.R.S. may take into account the purported-gift rules of Treas. Reg. §1.672(f)-4. These rules generally require purported gifts from a partnership or foreign corporation, generally defined as transfers to a U.S. individual who is not a partner or shareholder of the transferor, to be included in the recipient's gross income. In general, those rules provide as follows:

- If the transferor is a foreign partnership, the amount included is treated as ordinary income, and if the transferor is a foreign corporation, the amount included is treated as a distribution.
- If the foreign corporation is a P.F.I.C., the rules of Code §1291 apply.
- For purposes of Code §1012, relating to basis in property, the U.S. donee is not treated as having any basis in the stock of the foreign corporation.
- For purposes of Code §1223, the United States donee is treated as having a holding period in the stock of the foreign corporation on the date of the deemed distribution equal to the weighted average of the holding periods of the actual interest holders.[39]

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32 Prop. Reg. §1.6039F-1(c)(2)(ii).

33 Rev. Proc. 2023-34, Section 3.43.

34 Prop. Reg. §1.6039F-1(c)(2)(iii) and (v).

35 Prop. Reg. §1.6039F-1(c)(2)(iv).

36 Prop. Reg. §1.6039F-1(d).

37 Prop. Reg. §1.6039F-1(e)(1)(ii).

38 Prop. Reg. §1.6039F-1(e)(1)(i).

39 Treas. Reg. §1.672(f)-4(a)(2).

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Exceptions

The foregoing tax treatment does not apply to the extent the U.S. donee can demonstrate to the satisfaction of the I.R.S. that either of the following two fact patterns are applicable in the circumstances in the circumstances of the U.S. donee and the person owning the foreign corporation or partnership.

- The foreign corporation or partnership is directly or indirectly owned by a U.S. citizen, or by a resident individual who is not a citizen. The owner reported the purported gift or bequest for U.S. tax purposes as a two-step transaction involving the receipt of a distribution by the owner followed by the subsequent gift or bequest to the U.S. donee.[40]

- The foreign corporation or partnership is directly or indirectly owned by a nonresident, noncitizen individual with regard to the U.S. The foreign individual treated and reported the purported gift or bequest for purposes of the tax laws of the owner's country of residence as the receipt of a distribution and a subsequent gift or bequest to the U.S. donee. The U.S. donee timely complied with the U.S. reporting requirements regarding foreign gifts.[41]

FOREIGN TRUSTS

Code §6048 creates three reporting obligations in transactions involving a U.S. persons and foreign trusts. First, U.S. persons must report the occurrence of "reportable events." Second, U.S. persons who own foreign trusts within the meaning of the grantor trust rules must ensure the trust files and issues certain statements. Third, U.S. persons must report the receipt of distributions from foreign trusts.

Reportable Events

Code § 6048(a) requires a "responsible party" to file information returns when certain "reportable events" occur. A responsible party is any person who is

- a U.S. grantor of an *inter vivos* foreign trust,
- a U.S. person who transfers property to a foreign trust, or
- the executor of a U.S. decedent's estate.

Reportable events include

- the creation of a foreign trust by a U.S. person,
- the direct or indirect transfer of any money or property to a foreign trust by a U.S. person (including a transfer by reason of death), and
- the death of a U.S. person who either was the owner of any portion of a foreign trust or had any portion of a foreign trust included in the estate.[42]

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40 Treas. Reg. §1.672(f)-4(b)(1)(i).

41 Treas. Reg. §1.672(f)-4(b)(1)(ii).

42 Prop Reg §1.6048-2(b).

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"This effectively means that a foreign grantor trust without a U.S. agent is subject to the I.R.S. estimating its tax liability."

The proposed regulations add that a reportable event includes a transfer to a domestic trust that becomes a foreign trust.[43] The fact that the transferor might receive a qualified obligation in exchange for the transferred property (which would create an exception to certain other types of reporting, as described earlier) does not affect whether the transfer is a reportable event. But transfers to certain trusts, such as foreign charitable trusts or retirement trusts, are not reportable events.

A reportable event is reported on Part I of Form 3520.

U.S. Owners of Foreign Trusts

Code §6048(b)(1) applies to a U.S. person who is treated for purposes of the grantor trust rules as the owner of any portion of a foreign trust. The grantor is required to ensure that the foreign grantor trust files an annual information return (Form 3520-A (*Annual Information Return of Foreign Trust With a U.S. Owner*))[44] and furnishes an annual information statement to each U.S. owner and to any U.S. person who receives a distribution from the trust during the tax year (the Foreign Grantor Trust Owner Statement and Foreign Grantor Trust Beneficiary Statement, respectively).[45] Form 3520-A is due by the 15th day of the third month after the close of the tax year (unlike Form 3520), and the maximum extension available is six months. A failure by the trust to file Form 3520-A means the U.S. owner must file it with his or her own Form 3520.[46]

The provision also states that unless a foreign trust with a U.S. owner appoints a U.S. agent whom the I.R.S. can contact for the provision of records or production of testimony related to the trust and upon whom a summons may be served in relation to the trust,[47] the I.R.S. has discretion to determine the amounts that must be taken into account under the grantor-trust rules.[48] This effectively means that a foreign grantor trust without a U.S. agent is subject to the I.R.S. estimating its tax liability.

Reporting of Distributions

Code §6048(c)(1) requires a U.S. person who receives a distribution from a foreign trust to file an information return (Part III of Form 3520).[49] Additionally, the proposed regulations treat all loans that might potentially be recharacterized as §643(i) distributions as distributions under Code §6048(c)(1), regardless of whether they are actually and simultaneously distributions under Code §643(i).[50]

For reporting purposes, Code §6048(d) explains that even if the foreign trust is a grantor trust, the distribution is treated as a transfer from the trust and not from the grantor.

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[43] Prop Reg §1.6048-2(b)(2).

[44] Prop Reg §1.6048-3(a)(1)(i).

[45] Prop Reg §1.6048-3(a)(1)(ii) and (iii).

[46] Prop Reg §1.6048-3(a)(2)(i) and (ii).

[47] Prop Reg §1.6048-3(d).

[48] Prop Reg §1.6048-3(c).

[49] Prop Reg §1.6048-4(a).

[50] Prop Reg §1.6048-4(b)(5).

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Distribution Defined

The proposed regulations define a distribution as any transfer of property from a trust to a U.S. person related to the trust to extent that the value of the transfer exceeds the value of property or services received by the trust in exchange.[51] Distributions include those received through an intermediary, nominee, or agent.[52] This also includes transfers made directly from an entity owned by the trust.[53] In the latter case, the transfer is considered to be part of a step transaction. The first step is a distribution from the entity to the trust and the second step is from the trust to the U.S. person, unless it is demonstrated to the satisfaction of the I.R.S. that the first distribution is attributable to the U.S. person's direct ownership interest in the entity.[54]

A domestication of a foreign trust is considered to be a distribution from the foreign trust to the new domestic trust.[55] Finally, as mentioned above, loans of property from a foreign trust as described in Code §643(i)) are treated as reportable distributions for purposes of Code §6048. Both the actual recipient of the loan and the grantor or beneficiary of the trust must report the loan.[56]

Tax Consequences

The tax consequences are determined by the type of beneficiary statement that is timely received by the distributee from the foreign trust (if any). If the statement is a Foreign Grantor Trust Beneficiary Statement or Foreign-Owned Grantor Trust Beneficiary Statement, the beneficiary can treat the distribution as that from a grantor trust, which typically is tax-free to a beneficiary that is not the grantor.[57] If the statement is a Foreign Nongrantor Trust Beneficiary Statement that is issued on a timely basis, the beneficiary calculates tax liability under the rules for foreign nongrantor trusts.[58] When a statement is issued, either of two methods can be chosen. These are the default calculation method and the actual calculation method.. Beneficiaries who do not receive statements on a timely basis must use the default calculation method to determine U.S. tax.[59] This is the method that is described under the Code §643(i) regulations and the Form 3520 instructions, where a portion of the distribution is deemed current income based on previous distributions, and the balance is treated as an accumulation distribution. The method is adopted in the proposed regulations as well.[60]

If a U.S. person fails to provide adequate records to the I.R.S. for purposes of determining the tax consequences of a distribution from a foreign trust other than a loan of trust property that is not treated as a Code §643(i) distribution, the I.R.S. will

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[51] Prop Reg §1.6048-4(b)(1).

[52] Prop Reg §1.6048-4(b)(2).

[53] Prop Reg §1.6048-4(b)(3).

[54] *Id.*

[55] Prop Reg §1.6048-4(b)(4).

[56] Prop. Reg. §1.6048-4(b)(5)(iii).

[57] Prop. Reg. §1.6048-4(d)(1)(i).

[58] Prop. Reg. §1.6048-4(d)(1)(ii).

[59] Prop. Reg. §1.6048-4(d)(1)(iii).

[60] Prop. Reg. §1.6048-4(d)(3).

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characterize the entire distribution as an accumulation distribution, which generally has much harsher consequences for a taxpayer.[61] But if the trust appoints a U.S. agent, the I.R.S. can examine records through the U.S. agent and more precisely determine the tax consequences of the distribution.

Exceptions

There are several exceptions derived from statutory language. The following transfers to foreign trusts are not reportable events:

- A transfer made in return for fair market value, with limitations if the transfer is made by a person related to the trust and the trust or a person related to it issues an obligation
- A transfer to certain compensatory foreign trusts
- A transfer to a trust that is a Code §501(c)(3) organization[62]

The proposed regulations add several more exceptions[63] from reporting:

- Transactions with tax-favored foreign retirement trusts, non-retirement savings trusts, and *de minimis* savings trusts
- Distributions from certain foreign compensatory trusts
- Distributions received by certain domestic charitable organizations
- Certain trusts in mirror code possessions (broadly jurisdictions where tax liability is calculated as though the jurisdiction were the U.S.)[64]

Tax-favored foreign retirement trusts are foreign trusts to provide or earn income for retirees. Certain additional requirements must be met, including those related to contribution limits, withdrawal conditions, and information reporting.[65]

Non-retirement savings trusts are those meant to provide medical, disability, or educational benefits. They must meet similar additional requirements as retirement trusts described above.[66]

Finally, a tax-favored foreign *de minimis* savings trust is a foreign trust that is meant to operate as a savings vehicle and whose value is under a *de minimis* threshold.[67]

Other Rules

As with Code §6039F, dual-resident and dual-status taxpayers are not treated as U.S. persons for these reporting purposes.[68] Married taxpayers filing jointly who

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[61] Prop. Reg. §1.6048-4(e).

[62] Prop. Reg. §1.6048-5(a).

[63] Prop. Reg. §1.6048-5(b).

[64] Prop. Reg. §1.6048-5(e).

[65] Prop. Reg. §1.6048-5(b)(1).

[66] Prop. Reg. §1.6048-5(b)(3).

[67] Prop. Reg. §1.6048-5(b)(4).

[68] Prop. Reg. §1.6048-6(a).

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each have reporting obligations can combine their information on a single Form 3520.[69]

Trusts can be either grantor trusts or nongrantor trusts. In many contexts, a grantor trust is ignored for tax purposes, and the assets and income of a grantor trust are attributed directly to the grantor. The proposed regulations restate the rule in the statute that for purposes of §6048, a trust's status as a grantor trust is ignored, and transfers to or distributions from foreign grantor trusts are viewed as transactions with the trust, and not the grantor.[70]

Finally, the proposed regulations reserve space for the statutory rule that a domestic trust is treated as a foreign trust under Code §§6048 and 6677 if it has substantial activities or property outside the U.S.[71]

Penalties

Code §6677 creates a penalty for failure to comply with §6048(a) or (c). The penalty is equal to the greater of $10,000 or 35% of the reportable amount (generally the value of the property transferred or received). Additionally, a failure to comply with Code §6048(b) will lead to a penalty equal to the greater of $10,000 or 5% of the reportable amount (in this case, the value of the trust corpus). For both penalties, continued noncompliance for more than 90 days after the date on which the I.R.S. notifies the taxpayer will lead to an additional $10,000 penalty. However, if the I.R.S. has sufficient information to determine the reportable amount, the aggregate amount of the penalties cannot exceed the reportable amount.

As with many penalties in the Code, the §6677 penalty can be abated if the taxpayer shows that noncompliance was due to reasonable cause and not willful neglect. The statute states that the threat of penalties from a foreign jurisdiction does not constitute reasonable cause. The proposed regulations mirror the statute and expressly state that a trustee's refusal to provide the taxpayer with information is not considered reasonable cause.[72]

As to other matters, the proposed regulations provide that deficiency procedures do not apply in respect of the assessment or collection of any penalty that may be imposed.[73]

The proposed regulations also specify that married taxpayers filing jointly are considered a single taxpayer for purposes of the penalty. Joint filers are subject to joint-and-several liability for the penalties.[74]

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[69] Prop. Reg. §1.6048-6(d).

[70] Prop. Reg. §1.6048-6(b).

[71] Prop. Reg. §1.6048-6(c).

[72] Prop. Reg. § 1.6677-1(d)(2).

[73] Prop. Reg. § 1.6677-1(e).

[74] Prop. Reg. § 1.6677-1(f).

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CONCLUSION

The proposed regulations add some exceptions to reporting and expand reporting obligations in some cases. They also provide the convenience of compiling rules from several sources of authority into one location. As these are only proposed regulations, comments and possible revisions are to be expected. Comments are requested by this July. A public hearing is also planned for August.

"Comments are requested by this July. A public hearing is also planned for August."

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EARNING MY CREDITS: LIFE AT RUCHELMAN P.L.L.C.

Author
Vanessa Lebbos

Tags
Extern
Learning Experience

Vanessa Lebbos served as an extern at Ruchelman P.L.L.C. during her last semester at New York Law School. For two days each week, she assisted attorneys in researching issues while learning about the practice of law. Currently, she is studying for the New York State Bar Examination and has a position lined up at PwC.

INTRODUCTION

Credits and externship credits co-mingled during my time at Ruchelman P.L.L.C. While I sought to gain externship credits and learn about the tax world, I spent a lot of time learning about tax credits and the legal field through my mentors at the firm.

In this article, I will share my initial experiences in the tax world. As I look back, I realize how much I benefited from working alongside the team at Ruchelman, P.L.L.C.

WHO AM I?

My name is Vanessa Lebbos, and I'm originally from Detroit, Michigan. Having studied international relations and political economics at Michigan State University, I knew I wanted to pursue the practice of international law when I came to New York City and entered law school.

In August 2021, I began my legal education at New York Law School. Although I am focused on pursuing tax law now, coming in I thought I wanted to pursue IP law, specifically the fashion facet of it all. The experience in my first year looked much like that of any other law student; torts, contracts, property (something I did not think I'd ever have to deal with again, that is, until I began my tax career), Criminal law and other prep courses.

After making it through the first year of required courses, I dove headfirst into I.P.-specific courses. Copyrights, Intellectual Property, Entertainment Law, Fashion Law and Technology – you name it, I took it. And what I encountered was one big disappointment. I learned pretty quickly that none of what I learned prepared be for the intersection of international law and intangible property.

At this point, I finished the first semester of my second year, and I thought pretty much what everyone thinks . . . "Oh no, what now?" Then it hit me. I loved my class on Corporation Law and expected that Mergers and Acquisitions would not be too different from that, right?

Wrong. It was way different, but it led to me tax. I was lucky enough to discover that I really enjoyed learning about the tax aspects in that course and spoke to an esteemed professor (who is now my mentor). He led me on the right track to pursue a career in tax law through his courses. I've taken Individual Tax, Corporate Tax, International Tax and even Tax Research and Writing, all of which have led me to work as an extern at Ruchelman P.L.L.C.

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EXPECTATIONS

My externship at Ruchelman P.L.L.C. gave me the opportunity to put my legal education into practice, especially in regard to cross-border tax matters.

Beginning this externship brought on many emotions – excitement, worry, anxiety (though I'm happy to say only the excitement has stuck with me). I was excited to learn how U.S. tax planning intertwined with cross-border tax matters. The diverse client base at Ruchelman P.L.L.C. gave me a unique opportunity to learn these intricacies first-hand.

Aside from the client base, the experience that each individual attorney brought to the office made for a very exciting day at the firm. They bring experience from different countries and nationalities, expanding the client base, and bringing their expertise to matters. Whether the clients are a U.S. based company or a foreign individual, the team always knows how to the matter and taught me as I assisted on projects.

As an extern, my goal was to contribute to the operations of the team and help them with research, while also bringing my knowledge from the tax courses I've taken. I hoped that my knowledge in French, Arabic, and English could also contribute to the firm and be an asset. Aside from contributing my research skills, legal education, and language skills, I hoped to learn how to use these skills in unison to make me a strong extern and future attorney.

WHAT WAS MY EXPERIENCE LIKE?

I got to the office 45 minutes early on my first day and just waited in the lobby waiting for a good time to go upstairs without seeming too eager. I received an email before starting that there would be an office lunch where I'd meet everyone. I remember being too nervous to eat but the attorneys were so friendly that it immediately made the mood lighter. The chairman of the firm, Stanley, took the time to sit down with me and explain the ins-and-outs of the office, what their mission is, and what I can expect from this externship. Then he asked me what I wanted to learn, what my expectations were, and what I hoped to gain from this experience.

Everyone was welcoming and introduced themselves to me. My first day ended up being one of my favorite days at the firm because of how friendly and welcoming the attorneys and staff are here. I felt like an actual colleague and not just an extern while working at Ruchelman P.L.L.C.

Every day on the job brought something new and allowed me to explore the Internal Revenue Code in practice, while observing – and working on – U.S. inbound and outbound financial transactions and tax planning. My first assignment was given to me on my first morning – a memo on the Limitation of Benefits Article in a tax treaty between the United States and Barbados. The Limitation on Benefits Article in an income treaty prevents residents of third countries from treaty shopping and trying to assume favorable U.S. tax treatment that may not be intended for them. This was something I became familiar with more and more as I worked at Ruchelman as proper resort to income tax treaties was an important part of the practice conducted in the office.

Another exciting project was looking into the exchange of information between other nations and the United States. The I.R.S. has the right to exercise its summons power, and it was my job to research cases, citations, and other court holdings to determine when the summons power is likely to be granted. My research didn't stop there, I looked into what is considered U.S. Situs for non-resident/non-citizens, what the exit tax and a covered expatriate are, foreign estate issues, and even newer, complex areas of tax law such as the G.I.L.T.I. tax. Through this work, I was able to learn about new topics I was not exposed to in a classroom setting.

I was lucky enough to join conferences and meetings with external attorneys that were participating in various tax panels to hear about the way U.S. tax law interacts with cross-border tax laws, particularly one about family offices and the ways in which they operate in the U.K. and U.S., and how to help those clients obtain the best tax treatment.

Above all else, my daily work at Ruchelman P.L.L.C. taught me the best ways to do legal tax research and improved my writing skills. I was able to support the team by preparing documents, drafting conference notes, conducting research, and helping write memos. While I mainly worked under one attorney, I was lucky enough to learn from all attorneys at the firm and was given assignments from most of the team. Everyone took the time to explain what they were looking for in my work, went over it with me to supply me with feedback, and allowed me to ask as many questions as necessary to complete the assignment. These same colleagues are the ones I know I will be able to reach out to when I have questions once I begin work after I sit for the Bar exam. I feel very lucky to have been able to work with the team at Ruchelman P.L.L.C., after all, how great it is to have found a place that makes saying goodbye so hard!

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

Following this externship, I graduated from New York Law School in May, and am studying to take my bar exam in July. Then I will begin working for Price Waterhouse Coopers (PwC) as an international tax associate come August. I would like to give a very special thank you to Stanley, who welcomed me with open arms and taught me the ins and outs of tax law. No question was ever too dumb, and he was always willing to teach me. I would also like to give a special thanks to Professor Alan Appel, my mentor who taught me all about the tax world, and to thank him for introducing me to the firm. Thank you to everyone in the office (named in no particular order) Neha Rastogi, Michael Bennett, Wooyoung Lee, Nina Krauthamer, Simon Prisk, Gilda Bueno, Chayene Ross, and Josefa Corpuz for being so welcoming and helpful during my time at Ruchelman. Also, thanks to Galia Antebi who heads our overseas office.

Leaving Ruchelman P.L.L.C., I feel ready to take on the tax world and bring my knowledge to PwC and beyond. The experience of this externship is one I hold in such high regard, and I know it has truly served in making me a more well-rounded lawyer and individual overall. The writing, research, and critical thinking skills I gained are the same skills I will use to further my career no matter what path it may take.

About Us

Ruchelman P.L.L.C. is a boutique law firm based in New York City. It was founded in 1989 by an alumnus of a legacy firm that is now Deloitte's. It maintains an affiliate, Ruchlman Advisory Ltd., that provides U.S. Tax advice from its base in Tel Aviv, Israel.

Whether in New York City or Tel Aviv, a wide range of tax planning and commercial legal services is provided 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.

About Insights

Insights, the tax journal of Ruchelman P.L.L.C., provides in-depth reporting on the evolving landscape of U.S. and international taxation. It offers complex analysis of current issues, legislative updates, and practical introductions to the tax law from leading tax professionals in their respective countries.

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

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