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INSIGHTS

DEVELOPMENTS IN CROSS-BORDER TAX INVESTIGATIONS TARGET HIGH NET WORTH INDIVIDUALS

EXAMINING HIGH NET WORTH IN THE U.S.

INTERNATIONAL TAX INVESTIGATIONS IN THE U.K.

AND MORE

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TABLE OF CONTENTS

Editors' Note

Developments in Cross-Border Tax Investigations Target High Net Worth Individuals 5

Examining High Net Worth Taxpayers in the U.S. 7

International Tax Investigations in the U.K. 18

The Evolution of Tax Enforcement in Switzerland 30

Trusts in Italy: The View of Italian Tax Authorities & Recent Developments 39

Focus on H.N.W.I.'s and Offshore Structures – An Indian Perspective.............. 49

Recent Developments to Combat Tax Avoidance in Germany 56

The B.V.I., Cayman Islands, and Bermuda – Current Practice, Enforcement, and Emerging Trends...................................... 68

About Us

EDITORS' NOTE

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

- **Developments In Cross-Border Tax Investigations Target High Net Worth Individuals.** Tax collection and tax policy remain high priorities for the F.A.T.F. and the O.E.C.D. These organizations are responsible for developing and monitoring implementation of standards aimed at enhancing transparency, combatting financial crime, and ensuring effective regulation. The past decade saw adoption of accelerated reforms and ambitious deadlines. Differences between implementation and interpretation of international standards and unilateral or bilateral initiatives increase complexity and uncertainty for H.N.W.I.'s. In an introductory chapter to this edition of Insights, Joshua Mangeot, a partner of the B.V.I. office of Harneys, sets the table for the articles that follow.

- **Examining High Net Worth Taxpayers in the U.S.** Beginning in 2023, I.R.S. D.O.J. took up the call with programs of enhanced (i) I.R.S. examinations of high-net-worth individuals, large partnerships, and large corporations and (ii) D.O.J. prosecutions of persons accused of criminal tax offenses. The first initiative focused on taxpayers with income of more than $1 million and tax debt in excess of $250,000. The second initiative expanded the focus to large partnerships, which traditionally have more than $10 million in assets. Included were hedge funds, real estate investment partnerships, publicly traded partnerships, and large law firms. At the same time, D.O.J. began prosecuting a slew of recalcitrant taxpayers with significant means, whose tax schemes resulted in millions of dollars in lost tax revenue. Philip Colasanto, a senior associate in the New York Office of Withers Bergman L.L.P. (WithersWorldwide) takes a deep dive into the initiatives and the prosecutions. He goes on to explain various ways that are available to taxpayers wishing to come into compliance regarding past reporting failures.

- **International Tax Investigations in the U.K.** It is no secret that the U.K. government is anxious to raise revenue as the public sector debt is estimated to be equivalent to 98.5% of G.D.P. (approximately £2.7665 trillion). The Labour government is dead set on raising income. Non-dom taxation is gone, tax rates are on the rise, and what was capital gains for certain carried interests is ordinary income. Part of the labor program is an attack on tax evasion and avoidance. There are plans for the Labour government to invest £855m over five years in resources for H.M.R.C. to raise £2.7 billion per annum from this investment. In those circumstances, it is not unexpected that assertions of tax fraud and evasion will be raised against those caught up by the compliance initiative. Gary Ashford, a partner of Harbottle & Lewis in London, explains H.M.R.C.'s definition of tax fraud and goes on to discuss the steps that are available for those wishing to make a voluntary disclosure. It is not a pretty picture, especially for those having used offshore vehicles.

- **The Evolution of Tax Enforcement in Switzerland.** As in the rest of Europe, Swiss tax authorities have ramped up examinations of cross border transactions of Swiss residents and cooperation with tax authorities in other countries. Examinations of Swiss residents focus on the abuse of offshore

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structures and increases in the number of tax examinations and aggressiveness of tax authorities. Regarding Swiss holding companies owned by non-residents, Switzerland now has an active exchange of information program that provides administrative assistance within the framework of the more than 100 double tax treaties. Thierry Boitelle, the Founding Member of Boitelle Tax Sàrl, in Geneva, and his colleagues Sarah Meriguet and Marine Antunes, Senior Associates at the firm, explain all.

- **Trusts In Italy: The View of Italian Tax Authorities & Recent Developments.** The legal construct of a trust is a common law arrangement having features that make it suitable for a wide range of uses. Italy lacks a specific legal framework for trusts, which limits its use in a purely Italian set of circumstances. Nevertheless, Italy ratified the Hague Convention on the Law Applicable to Trusts and on their Recognition (1985) and in so doing, introduced a degree of recognition of trusts governed by foreign law. The absence of a specific civil law framework for trusts, combined with Italy's fragmented and evolving tax law regarding the treatment of trust structures has led to significant interpretative uncertainty both as to income tax matters for the settlor and the beneficiaries and inheritance and estate tax matters. Fabio Chiarenza, a partner in the Rome office of Gianni & Origoni, Francesca Staffieri, also a partner of Gianni & Origoni, and Alessandro Minniti, a managing associate of that firm explain all, including opaque trusts, transparent trusts, timing of the imposition of inheritance and gift tax, and the concept of fictitious interposition of trust as applied by the Italian tax authorities. Good read.

- **Focus on H.N.W.I.'S and Offshore Structures – an Indian Perspective.** The topic of offshore assets held by H.N.W.I.'s based in India is a topic of substantial interest for various governmental authorities in India. It is not just the Indian Tax Authority that is interested in offshore accounts. Substantial exchange control regulations are in place in India and other regulatory authorities keep a close track of the offshore interests of Indian residents. Over the years, Indian names appeared in data leaks of offshore structures and bank accounts, triggering significant administrative focus and amendments to the law. In 2015, the Black Money Act was introduced in India, with the stated intent of enacting provisions to deal with the problem of undisclosed foreign income and assets and to impose tax on undisclosed foreign income and assets. Ashish Mehta, a partner in the Direct Tax Practice in the Mumbai office of Khaitan & Co., and his colleague, Ujjval Gangwal, a principal associate of the firm, explain in infinite detail the risks that apply to residents hiding funds abroad, the aggressive steps taken by Indian tax authorities in seeking information, the traps for returning Indian nationals stemming from the ownership foreign assets, and the steps to ensure compliance.

- **Recent Developments to Combat Tax Avoidance in Germany.** "Paper is patient." This is a common German saying, typically used to highlight the sluggishness of processes and plans of all kinds. However, paper can also catch up with you or even take you by surprise in a way that may be embarrassing or worse when your name pops up in leaked information relating to offshore accounts. Jurisdictions with preferential tax regimes are under the scrutiny of tax and investigative authorities in Germany. This affects multinational corporations, family offices, entrepreneurial families, and wealthy private individuals who invest their assets internationally in a diversified and

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international manner. Dr. Marco Ottenwälder, a partner in the Frankfurt Office of Andersen Tax, and his colleague, Andreas Gesel, a senior associate of the firm, explain recent measures taken in Germany to combat tax avoidance and follow up with recent practical experience. The tax authorities are aggressive, exit tax has a wider scope than might be commonly expected, and unhappy events occur for individuals and associated companies stemming from arrival in Germany and also departure. Not a pretty sight.

- **The B.V.I., Cayman Islands, and Bermuda – Current Practice, Enforcement, and Emerging Trends.** These three leading Caribbean international financial centers are members of the Caribbean Financial Action Task Force and have consistently implemented O.E.C.D. initiatives and E.U. requirements. They pride themselves in following international best practices. None of the regimes discussed below is a taxing regime. Consequently, their compliance focus is on information exchange, increased transparency and economic substance. Joshua Mangeot, a partner of the B.V.I. office of Harneys Celeste Aubee, an associate in the B.V.I. office of Harneys, explain the hurdles that have been overcome to remain in good standing with Europe and the U.S.

We hope you enjoy this issue.

- The Editors

DEVELOPMENTS IN CROSS-BORDER TAX INVESTIGATIONS TARGET HIGH NET WORTH INDIVIDUALS

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Tags
A.M.L.D. 5
F.A.T.F.
H.N.W.I.
T.I.E.A.

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This edition of *Insights* surveys recent developments in seven countries related to (i) tax transparency and (ii) investigation and enforcement mechanisms relevant to high-net-worth individuals ("H.N.W.I.'s"), larger multinational enterprises ("M.N.E.'s") and cross-border investment.

Tax collection and tax policy remain high priorities for government and international policy makers, most notably the Financial Action Task Force ("F.A.T.F.") and Organisation for Economic Co-operation and Development ("O.E.C.D."). These international organizations develop and monitor implementation of standards and recommendations aimed at enhancing transparency, combatting financial crime, and ensuring effective regulation in financial and tax systems. The focus of the F.A.T.F. is on money laundering and terrorist financing, while the O.E.C.D. focuses on tax transparency and information exchange.

The past decade or so has seen accelerated reforms and ambitious deadlines set by governments and international organizations in response to the 2008 global financial crisis, high levels of public debt in major economies, perceived challenges to traditional taxation models posed by digitalization and globalization (particularly "tech giants" and M.N.E.'s and latterly virtual assets). and increased pressures on governments to find ways other than the issuance of debt to fund social programs.

This is reflected in the sheer volume of ongoing domestic and international initiatives and monitoring mechanisms in this area, which include the following:

- Beneficial ownership transparency initiatives, particularly for legal persons and legal arrangements such as trust) under F.A.T.F. Recommendations 24 and 25, respectively, which have led most notably to the 5th E.U. Anti-Money Laundering Directive ("A.M.L.D. 5") and the U.S. beneficial ownership reporting requirements under the Corporate Transparency Act
- The O.E.C.D. Common Reporting Standard ("C.R.S."), following and expanding upon the approach taken by the U.S. Foreign Account Tax Compliance Act ("F.A.T.C.A.")
- Information exchanges under C.R.S. and F.A.T.C.A., the O.E.C.D. Convention on Mutual Administrative Assistance in Tax Matters (the "Multilateral Convention"), and other tax information exchange agreements ("T.I.E.A.'s") between nation states
- The O.E.C.D. Base Erosion and Profit Shifting ("B.E.P.S.") framework and the so-called "B.E.P.S. 2.0" initiatives ("Pillar One" and "Pillar Two"), which are predominantly aimed at addressing challenges posed by digitalization, globalization, and ever larger M.N.E.'s

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- The O.E.C.D. Crypto-Asset Reporting Framework ("C.A.R.F."), which was introduced to address the growing use of digital assets and will operate alongside amendments to the C.R.S., requires more detailed reporting on financial assets, including those held in digital form
- Continuing updates to recommendations and standards, coupled with mutual evaluation reports and peer review processes between the members of international organizations that are required in order to monitor the implementation and effectiveness of initiatives

This is by no means an exhaustive list. In this edition, the authors do not discuss BEPS 2.0 or regulation of crypto or virtual assets to any great extent.

CHALLENGES

Differences between the status of implementation and interpretation of international standards, as well as unilateral or bilateral initiatives involving specific jurisdictions, such as the U.S. adoption of F.A.T.C.A. but not C.R.S., create challenges and increase complexity and uncertainty for H.N.W.I.'s and the financial services industry. Ongoing peer reviews and monitoring reports have revealed inconsistencies in implementation and operational effectiveness across jurisdictions.

There is a marked focus on transparency, reducing avoidance, and strengthening enforcement by and between tax authorities. However, the practicalities of navigating the complex interplay between financial regulation, tax compliance, and an increasingly digital and global economy pose challenges to governments and businesses alike.

In addition to domestic implementation, peer reviews and mutual evaluations have become critical mechanisms for ensuring that countries not only enact the required legislation but also enforce it effectively. From a government's perspective, meeting international standards is important for reputational purposes, investor confidence, and maintaining access to international capital. From the perspective of H.N.W.I.'s and M.N.E.'s and their advisors, implementation of a system to ensure efficient compliance and keeping abreast of developments undoubtedly adds complexity and costs to cross-border business. Globally, the authors continue to see many domestic tax authorities focus their collection efforts on H.N.W.I.'s and M.N.E.'s, and generally predict an increase in tax investigations and controversies as information exchange initiatives are enforced.

EXAMINING HIGH NET WORTH TAXPAYERS IN THE U.S.

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Tags
Abusive Partnerships
Adjacent Issues
Basis Shifting
High Net Worth
I.R.S. Dirty Dozen
I.R.S. Form 15103
Notice C.P. 59
Streamlined
Tax Gap
V.D.P.

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INTRODUCTION

In September 2021, U.S. Representative Alexandria Ocasio-Cortez (Dem. New York) famously made a fashion statement at the Met Gala Ball when she wore a dress with the message "tax the rich" emblazoned on the back. Beginning in 2023, the Internal Revenue Service ("I.R.S.") and the Department of Justice ("D.O.J.") took up the call with programs of enhanced I.R.S. examinations of high-net-worth individuals, large partnerships, and large corporations, and D.O.J. prosecutions of persons accused of criminal tax offenses.

This article explores the key components of these initiatives, their implications for compliance, and the strategies that tax professionals should employ while navigating the evolving landscape of tax enforcement.

I.R.S. INITIATIVES

IR-2023-166 (Sep. 8, 2023) – High Net Worth[1]

In the fall of 2023, the I.R.S. announced an initiative to focus its tax compliance efforts, including examination and collections activities, on high-net-worth individuals. This initiative focused on taxpayers with income of more than $1 million and tax debt in excess of $250,000. The I.R.S. ensured that while H.N.W.I.'s would be subject to additional scrutiny, taxpayers who earned less than $400,000 per year would not be subject to an increased chance of examination.

IR-2024-09 (Jan. 12, 2024) – Large Partnerships[2]

This initiative didn't just focus on high-net-worth individuals, it also focused on large partnerships. The original initiative focused on examining the largest and most complex partnerships, which traditionally have more than $10 million in assets. These large partnerships include hedge funds, real estate investment partnerships, publicly traded partnerships, and large law firms. Other areas of focus include corporate compliance, transfer pricing initiatives, and self-employment tax initiatives for partnerships.

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[1] "IRS Announces Sweeping Effort to Restore Fairness to Tax System with Inflation Reduction Act Funding; New Compliance Efforts Focused on Increasing Scrutiny on High-Income, Partnerships, Corporations and Promoters Abusing Tax Rules on the Books." Internal Revenue Service, September 8, 2023.

[2] "IRS Ramps up New Initiatives Using Inflation Reduction ACT Funding to Ensure Complex Partnerships, Large Corporations Pay Taxes Owed, Continues to Close Millionaire Tax Debt Cases." Internal Revenue Service, January 2, 2024..

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IR-2024-56 (Feb. 29, 2024) – Reach Out[3]

Earlier this year, the I.R.S. took a big step by reaching out to over 125,000 high-net-worth taxpayers who had not filed income tax returns since 2017. Of these returns, 25,000 were sent out to taxpayers with $1 million or more in income and the additional 100,000 were sent to taxpayers whose income was between $400,000 and $1 million. The I.R.S. sent taxpayers a Notice CP59, sending approximately 20,000 to 40,000 Notices per week for several weeks. The Notice CP59 instructed taxpayers with delinquencies to either immediately file the delinquent returns, or if the return was previously filed or the taxpayer did not have a filing obligation, to file Form 15103 (Form 1040 Return Delinquency).

IR-2024-130 (May 2, 2024) – Focus on Wealthy[4]

The I.R.S.'s focus on high-net-worth individuals began heating up in May of this year, when the I.R.S. announced that it was going to increase audits of the wealthiest taxpayers, including large corporations and large partnerships:

- Setting its eyes on 2026, the I.R.S. plans on tripling the audit rate for large corporations, defined as those with more than $250 million in assets, going from 8.8% of large corporation (the 2019 audit rate) to 22.6%.
- Large partnerships, those with assets over $10 million, will see their audit rate increase from 0.1% (the 2019 rate) to 1.0% (the proposed 2026 rate).
- The I.R.S. also proposed a 50% increased audit rate of high-net-worth individuals, defined as individuals having positive income over $10 million, thereby taking the audit rate from 11% (2019 rate) to 16.5% (proposed 2026 rate).

IR-2024-233 (Sep. 6, 2024) – Initial Results[5]

Although the initiative is in its infancy, it has already been quite successful. Of the 125,000 notices sent to high-net-worth taxpayers, more than 21,000 of these taxpayers have filed their returns. These 21,000 returns have led to more than $172 million in additional tax revenue. Similarly, the I.R.S.'s ramped up collection efforts for high-net-worth individuals has led to over $1.1 billion in recovered tax liabilities. The I.R.S. pursued more than 1,600 high-net-worth individuals—those who earned more than $1 million per year and who had at least $250,000 in tax debt—and was able to obtain some form of payment from nearly 80% of these taxpayers.

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[3] "IRS Launches New Effort Aimed at High-Income Non-Filers; 125,000 Cases Focused on High Earners, Including Millionaires, Who Failed to File Tax Returns with Financial Activity Topping $100 Billion." Internal Revenue Service, February 29, 2024.

[4] "IRS Releases Strategic Operating Plan Update Outlining Future Priorities; Transformation Momentum Accelerating Following Long List of Successes for Taxpayers." Internal Revenue Service, May 2, 2024.

[5] "U.S. Department of the Treasury, IRS Announce $1.3 Billion Recovered from High-Income, High-Wealth Individuals under Inflation Reduction Act Initiatives." Internal Revenue Service, September 6, 2024.

IR-2024-284 (Oct. 29, 2024) – New Task Force[6]

As part of this initiative, the I.R.S. formed a new office, which focuses on Passthroughs, Trusts, and Estates. Recently, the I.R.S. selected Jeffrey Erickson, formerly of Ernst & Young, as the first Associate Chief Counsel for its newly formed Passthroughs, Trusts, and Estates Office. This office will focus exclusively on passthrough entities, including partnerships and S-corporations, and trusts and estates, ensuring that these entities are, become, and remain compliant.

IR-2024-46 (Feb. 21, 2024) – Adjacent Issues[7]

In addition to increased examinations of individuals and entities, the I.R.S. began examining issues adjacent to high-net-worth individuals, which is expected to open the door to other issues involving high-net-worth taxpayers. To illustrate, the I.R.S. began examining the personal use of business aircraft. More specifically, whether business aircraft are used for more than just business activities. These activities presumably impact high-net-worth individuals only, and, therefore, any adjustments in tax would be in line with the current initiative.

IR-2024-166 (Jun. 17, 2024) – Abusive Partnerships[8]

Another high-net-worth adjacent issue involves "abusive" partnership transactions involving "basis shifting." Basis shifting involves related-parties stripping basis from a non-tax generating asset to a tax-generating asset.

According to an I.R.S. Field Service Advice issued contemporaneously,[9] these transactions may employ several steps over a period of years and use highly sophisticated planning to ensure that little or no tax is paid while large amounts of tax basis is "stripped" from certain assets and shifted to other assets to generate tax benefits for the individual partners. These partnerships and the people engaging in these transactions may be high-net-worth individuals.

ARE I.R.S. INITIATIVES WORKING AS PLANNED?

The I.R.S.'s new initiatives reflect new funding for the I.R.S. arising from the Inflation Reduction Act ("I.R.A."). Enacted in 2022, the I.R.A. provided the I.R.S. with nearly $80 billion in additional funds, to be doled out through 2031.[10] Although this amount was reduced by more than $20 billion, it still provided much needed funds to the I.R.S. Most of the available funds have been earmarked for enforcement, including examination and collection. These funds made it possible for the I.R.S. to focus on

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[6] "IRS Hires New Associate Chief Counsel to Focus on Partnerships and Other Passthrough Entities." Internal Revenue Service, October 29, 2024.

[7] "IRS Begins Audits of Corporate Jet Usage; Part of Larger Effort to Ensure High-Income Groups Don't Fly under the Radar on Tax Responsibilities." Internal Revenue Service, February 21, 2024.

[8] "IRS Announces New Steps to Combat Abusive Use of Partnerships; Agency's Focus Intensifies as New Guidance Closes Loopholes Worth Tens of Billions." Internal Revenue Service, June 17, 2024.

[9] "New IRS, Treasury Guidance Focuses on 'Basis Shifting' Transactions Used by Partnerships." Internal Revenue Service, June 17, 2024.

[10] "How Did the Inflation Reduction Act of 2022 Affect the IRS's Budget?" Tax Policy Center, January 2024.

enforcement by hiring additional personnel and acquiring additional technology to assist agents in enforcement.[11]

We briefly discussed the I.R.S.'s initiatives and their successes, but the question is how are these initiatives really fairing? The initiatives are bringing in taxpayer dollars and seem to be having an impact on the bottom line. Collecting $1.3 billion of additional tax during the initial stages of these initiatives is quite an accomplishment. However, it has not been entirely smooth sailing.

> ***". . . the I.R.S. has not yet succeeded in creating a methodology to target high-net-worth individuals while also excluding taxpayers making less than $400,000 per year."***

Although the I.R.S. is not supposed to focus on taxpayers with incomes below $400,000, which was not just an I.R.S. policy but rather a Treasury directive, the Treasury Inspector General for Tax Administration ("T.I.G.T.A.") has found that the I.R.S. has made limited progress in developing a methodology to comply with this directive. In other words, the I.R.S. has not yet succeeded in creating a methodology to target high-net-worth individuals while also excluding taxpayers making less than $400,000 per year.[12]

This is significant because the Treasury's directive instructed that the I.R.A. funds were not to be used for examination of anyone making under $400,000 per year, which does not discriminate between married and unmarried households. Another potential setback involved the I.R.S.'s goal to audit 8% of high-net-worth individuals, which is defined as those who make more than $10 million per year. T.I.G.T.A. found that the I.R.S. began auditing these high-net-worth individuals but then turned away from focusing solely on those making $10 million or more per year,[13] and began focusing more on other high-net-worth individuals, because the no-change rate for the truly high-net-worth taxpayers was quite high. Therefore, although there is usually a larger monetary benefit when auditing taxpayers with more than $10 million per year in income – examining individuals making over $10 million per year yields four times more dollars assessed per return and two times more dollars assessed per man hour than other examined returns – the return rate was insufficient to continue to justify the focus on these taxpayers.

OTHER I.R.S. INITIATIVES

Although the focus has been on the I.R.S.'s recent initiatives, other initiatives appear on the "Dirty Dozen" list of tax scams[14] that include, or normally include, high-net-worth taxpayers. For instance, the I.R.S. has gone after syndicated conservation

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[11] Office, U.S. Government Accountability. "Artificial Intelligence May Help IRS Close the Tax Gap." U.S. GAO, June 6, 2024.

[12] "The IRS Has Made Limited Progress Developing the Methodology to Comply with the Treasury Directive to Not Increase the Audit Rate for Taxpayers with Incomes below $400,000 Due to Planning and Implementation Challenges." U.S. Treasury Inspector General for Tax Administration, August 26, 2024.

[13] "The IRS Ceased Compliance with the $10 Million Taxpayer Treasury Directive in Favor of an Overall Focus on High-Income Taxpayer Noncompliance." U.S. Treasury Inspector General for Tax Administration, June 20, 2024.

[14] "Dirty Dozen." Internal Revenue Service. Accessed December 2, 2024.

easements,[15] micro-captive insurance arrangements,[16] alleged misuse of the Maltese-U.S. tax treaty,[17] digital assets (coins and tokens, etc.), and improperly using charitable remainder annuity trusts ("C.R.A.T.'s").[18] These arrangements primarily are marketed to high-net-worth taxpayers. Put another way, only those with means use these tax-avoidance strategies. The I.R.S. has focused on many of these issues for years, and recently final regulations were issued deeming syndicated conservation easement transactions as listed transactions, requiring disclosure. The I.R.S.'s new funding and personnel have assisted in all-around enforcement, including items that have made it to the Dirty Dozen list.

These are not an exhaustive list of the I.R.S.'s recent enforcement strategies and focal points, but they are the most prevalent. The I.R.S. will continue to use its I.R.A. funding to ramp up enforcement and to examine high-net-worth taxpayers.

D.O.J. CRIMINAL PROSECUTION

Every year, the D.O.J. prosecutes all manner of tax crimes. Not all of these crimes involve high-net-worth individuals, but they often deal with large tax losses. D.O.J. prosecutions serve as a deterrent for taxpayers who might consider crossing the line separating aggressive tax planning from criminal activity. At the end of the day, taxpayers tend to reconsider their actions when freedom is on the line. To wit, if the penalty for tax evasion is merely financial, taxpayers may view the risk as a cost of doing business, but when freedom is at stake, they may think differently.

There have been several recent indictments that involve either high-net-worth individuals or significant tax loss. The following examples illustrate:

- A Washington, D.C. accountant who despite earning more than $7.7 million over the better part of a decade did not file income tax returns, and falsified documents to obtain a mortgage.[19]

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[15] A syndicated conservation easement is essentially a scheme by which investors acquire an interest in a partnership that owns the land and claim a charitable contribution deduction when a portion of the land is donated as a conservation easement to a charitable organization.

[16] Micro-captive insurance companies are an indirect form of self-funded insurance and alleged by the I.R.S. to be less than legitimate insurance arrangement principally because of a lack of risk-shifting. Promoters tout that investment income of a micro-captive insurance company can use incurred but not reported losses to shield investment income of the company.

[17] The Maltese pension plan scheme allegedly involves taxpayers putting appreciated assets in a Maltese pension plan and then claiming treaty benefits to avoid gain on the assets based on the broad wording of the pension article of the Malta-U.S. Income Tax Treaty, Article 17 (Pensions, Social Security, Annuities, Alimony, And Child Support.)

[18] "Dirty Dozen: High-Income Filers Vulnerable to Illegal Tax Schemes; Face Risk from Improper Art Donation Deductions, Charitable Remainder Annuity Trusts, Monetized Installment Sales." Internal Revenue Service, April 10, 2024.

[19] D.O.J. Press Release No. 24-1201 (Sep. 25, 2024).

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- A Texas couple who obtained more than $23 million in false refund claims, including reporting false interest income and income tax withholdings for several trusts and estates.[20]
- A film producer who concealed income and assets offshore, including the sale of his company for approximately $25 million, resulting in $5 million in tax loss.[21]
- A Colorado dentist who purchased a tax shelter and used it to conceal over $3.5 million in income over several years, resulting in over $1 million in tax loss.[22]
- A chiropractor who filed false tax returns and impeded I.R.S. collection efforts of the $2.4 million tax liability he initially self-reported.[23]
- A doctor and her husband who defrauded the health care system and filed false tax returns, resulting in receipt of over $10 million in fraudulently obtained funds.[24]
- A former defense contractor who, along with his wife, evaded taxes on more than $350 million in income.[25]
- A Washington business owner who earned $4.8 million from real estate that was not reported on his income tax returns.[26]
- A Florida woman who filed $2 million in false refund claims, receiving approximately $500,000.[27]
- A New Jersey man who owed more than $2 million in tax, but impeded collection efforts, and who hid other real estate assets from the I.R.S.[28]
- Another New Jersey man, a tax preparer, who received $40 million in refunds from 1,600 false income tax returns, which improperly claimed Covid-19 employment-related tax credits.[29]
- A Los Angeles attorney who owed more than $1.7 million in tax, who impeded collection efforts.[30]

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[20] D.O.J. Press Release No. 24-1180 (Sep. 19, 2024).

[21] D.O.J. Press Release No. 24-1144 (Sep. 13, 2024).

[22] D.O.J. Press Release No. 24-1056 (Aug. 26, 2024).

[23] D.O.J. Press Release No. 24-955 (July 31, 2024).

[24] D.O.J. Press Release No. 24-911 (July 22, 2024).

[25] D.O.J. Press Release No. 24-558 (July 3, 2024).

[26] D.O.J. Press Release No. 24-506 (April 24, 2024).

[27] D.O.J. Press Release No. 24-441 (April 12, 2024).

[28] D.O.J. Press Release No. 24-403 (April 5, 2024).

[29] D.O.J. Press Release No. 24-395 (April 3, 2024).

[30] D.O.J. Press Release No. 24-337 (March 22, 2024).

- A Florida man who hid more than $20 million in assets in two dozen secret Swiss accounts.[31]
- A Texas man whose returns did not reflect $4 million in Bitcoin sales, resulting in significant gain.[32]
- A Minnesota man who evaded tax on nearly $5 million of income.[33]

While these are not exhaustive, they represent that the D.O.J. is prosecuting taxpayers with significant means and whose tax schemes include millions of dollars in lost tax revenue.

In addition to criminal prosecutions, the D.O.J. also has initiatives that are focused on potentially high-net-worth individuals, including the offshore compliance initiative and the recent voluntary disclosure initiative. Earlier this year, the D.O.J. released an internal memorandum regarding a pilot program where the D.O.J. offers a non-prosecution agreement to an individual for original information related to a corporate bad actor.[34] The non-prosecution agreement comes with the requirement that the individual repay all previously-recieved ill-gotten gain or proceeds.[35]

This pilot program looks for

- violations by financial institutions, including their insiders or agents,
- violations related to the integrity of financial markets,
- violations related to foreign corruption and bribery,
- violations related to health care fraud,
- violations related to fraud against the U.S. in the context of government contracts, and
- violations related to the payment of bribes and kickbacks.[36]

The reporting party must provide truthful, complete, and original information, and must agree to fully cooperate.[37]

Another such initiative is the whistleblower initiative, which provides an award for corporate whistleblowers.[38] Once again, the information provided must be original and truthful, and it must lead to successful forfeiture of $1 million or more in net proceeds. The whistleblower may be entitled to an award up to a certain amount ($55 million), which is discretionary and based upon the proceeds collected by the

[31] D.O.J. Press Release No. 24-332 (March 21, 2024).

[32] D.O.J. Press Release No. 24-150 (February 7, 2024).

[33] D.O.J. Press Release No. 24-88 (January 25, 2024).

[34] "The Criminal Division's Pilot Program on Voluntary Self-Disclosures for Individuals." U.S. Department of Justice, April 15, 2024.

[35] *Id.*

[36] *Id.*

[37] *Id.*

[38] *Id.*

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D.O.J.[39] Thus, in order to go after some potentially high-net-worth bad actors, the D.O.J. has provided immunity and an award for original information.

While the D.O.J. is not solely focused on tax-related aspect of high-net-worth individuals, it has provided significant incentives and deterrents that impact high-net-worth individuals who are either not paying their correct share of tax, are impeding tax collections, or who have engaged in some form of scheme to defraud the government.

PATH FORWARD IF COMPLIANCE IS UNCERTAIN

Although these initiatives may have acted as a catalyst, the pragmatic tax professional should have already been reaching out to high-net-worth clients to discuss compliance expo areas in filed tax returns. Even if this was not standard practice, the initiatives offered tax advisers a reason to reach out to clients. However, reaching out to clients is just the beginning. The tricky part is determining whether clients are compliant and, if not, identifying the best path forward, including whether to correct prior noncompliance.

Initial Action Steps

The inquiry begins with the taxpayers' compliance. Unfortunately, not all taxpayers are 100% knowledgeable or truthful about all compliance issues. In these situations, it is important to take certain actions. The first action occurs after the client executes a valid Form 2848 (Power of Attorney and Declaration of Representative) that is filed with the Centralized Authorization File unit. It is to obtain the I.R.S. transcripts of account. These transcripts of account, which can be obtained from the I.R.S. directly or through a third-party provider, such as Tax Help Software, will often show whether a return was filed, when it was filed, and if there has been any I.R.S. action, such as whether an examination has been initiated by the I.R.S., even if the client has not yet been contacted. In addition to the account transcripts, it is also important to obtain both the income tax return and wage and income transcripts. Having both of these will determine whether the income reported on the income tax return, if there was a return, was correct, and if no return was filed then these transcripts will be a good starting point for reporting the taxpayer's income. Transcripts of account should almost, if not always, be the first step in any representation.

Next, the tax adviser should file a Freedom of Information Act ("F.O.I.A.") request. While the information will not be as readily available as I.R.S. transcripts, the information obtained from the F.O.I.A. request is often necessary. In these situations, the tax practitioner can request, *inter alia*, information regarding the filing of information returns, whether there has been any activity regarding the taxpayer's account with the I.R.S., and whether there has been any correspondence sent or received by the I.R.S. Often a significant period of time passes before the F.O.I.A. response is received from the I.R.S. Technically, the I.R.S. has 20 working day to respond but often the F.O.I.A. office will send a letter requesting additional time to respond, depending on the volume and complexity of the request. It is not uncommon for the I.R.S. to require several months to respond to the F.O.I.A. request. While it is always a good practice to get transcripts and submit the F.O.I.A. request, it is of crucial importance in cases of high-net-worth clients whose compliance record is uncertain.

[39] *Id.*

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Choice of Program

Once the extent of any noncompliance is determined, fashioning a path forward is the next step. Stated simply, does the taxpayer focus on correcting past noncompliance or does he or she correct moving forward. Ethically, tax advisers are not obligated to inform taxpayers to correct prior noncompliance. Their obligation is to inform taxpayers of the noncompliance and the consequences of not correcting their noncompliance.[40] Whether to correct is a judgment call and depends on the client. Regardless, if the taxpayer does decide that correcting prior noncompliance is the correct option, several options should be considered.

Quiet Disclosure

The first potential option is commonly known as a "quiet disclosure." A quiet disclosure includes filing the delinquent returns absent participation in an I.R.S. program. In a quiet disclosure, the client will submit the returns and essentially hope that they are accepted without incident. Quiet disclosures offer no protection against penalties, including (i) failure-to-file and failure-to-pay penalties and (ii) penalties associated with delinquent international information returns, if applicable. Because there are no protections associated with submitting a quiet disclosure, it is often considered the riskiest of the options.

"Ethically, tax advisers are not obligated to inform taxpayers to correct prior noncompliance. Their obligation is to inform taxpayers of the noncompliance and the consequences of not correcting their noncompliance."

Streamlined Procedures

While quiet disclosure does not focus on the reason for the compliance shortfall, taxpayers whose failure to file was non-willful may want to consider the streamlined offshore procedures. There are two streamlined offshore procedures, being the domestic procedure and the foreign procedure. Whether a taxpayer is eligible for one procedure or the other depends on a multitude of factors, but the initial focus is on where the taxpayer resides (or has resided in the past three years). These streamlined procedures traditionally deal with unreported foreign income and assets. While foreign participants in the foreign procedure are not subject to a penalty, participants in the domestic procedure face a 5% penalty on unreported foreign assets. Streamlined submissions may provide more protection than a quiet disclosure, but that protection comes with strict eligibility criteria and its own domestic penalty structure.

Voluntary Disclosure

The final way taxpayers can correct noncompliance is through the voluntary disclosure practice ("V.D.P."). This is for taxpayers who have not reported income or foreign assets and whose failure to file or report was willful.[41] The V.D.P. offers the highest level of protection, where there will be a non-prosecution recommendation and a closing agreement, giving finality to the tax periods at issue. The cost of finality, however, can be steep. Taxpayers in the V.D.P. are liable for a 75% fraud penalty for the year with the highest tax liability and a 50% penalty for the highest account balance, if there is a foreign account involved. Although the penalties are stiff, this program offers real and definitive protection. At this point, the V.D.P. is best reserved for taxpayers who have either engaged in fraud or criminal activity.

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[40] I.R.S. Circular 230 §10.21.

[41] The V.D.P. requires a Form 14457 to be completed (both parts I and II), and the Form, as of recently, specifically requests that the taxpayer check a box indicating that the failure was willful.

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Discovery by the I.R.S.

The programs described above are all essentially focused on pre-I.R.S. interaction.[42] Once the I.R.S. reaches out to the taxpayer, the taxpayer has limited options. For instance, once the taxpayer is sent a Notice CP59, which is the notice issued to high-net-worth taxpayers informing them that they have outstanding tax returns that cannot be filed, the taxpayer may: file income tax returns, not file returns and accept the substitute for returns filed by the I.R.S., or submit a Form 15103 (Form 1040 Return Delinquency) challenging either the failure to file the return or the requirement to file a return. The general view of advisers having a tax controversy focus in its practice is that it is better to resolve delinquent income tax returns before the I.R.S. contacts the taxpayer.

Examination Initiatives

In addition to the failure to file initiatives, examination initiatives are available. These examinations are not dissimilar from traditional examinations, where an I.R.S. agent begins the examination by sending an information document request ("I.D.R.") and the I.R.S. and the taxpayer's representative discuss and resolve the issues.

From experience, two significant differences appear to exist between the new high-net-worth examinations and traditional examinations. First, the I.D.R.'s issued in the high-net-worth examinations seem to be significantly broader than traditional I.D.R.'s. The I.D.R.'s request broad information on multiple issues and may request information on numerous entities. Moreover, the I.D.R.'s often do not have a focus but rather ask for numerous potentially unrelated items. While calling these I.D.R.'s a fishing expedition may be extreme, they appear to be broader than normal and often require voluminous responses or clarifications of the documents and information being requested. The end result is that the initial I.D.R.'s will be broad, while follow-up I.D.R.'s will be more focused until the I.R.S. makes a determination. Dealing with the process can be time consuming and frustrating.

The other noticeable difference between traditional and high-net-worth examinations is the presence of attorneys from the I.R.S. Office of Chief Counsel. It appears that Chief Counsel attorneys are more involved at the onset of these high-net-worth examinations. In a typical I.R.S. examination, an I.D.R. will be sent and there will be a response by the taxpayer, or a series of I.D.R.'s will be sent and responded to by the taxpayer. Ultimately, there are discussions between the examiner and the taxpayer's representative regarding the issues. In comparison, with the high-net-worth examinations, Chief Counsel is involved from early on, so initial conferences will include an I.R.S. attorney, who will respond to or discuss I.D.R. responses directly with the taxpayer's representative. While unexpected, it is often reassuring to discuss issues directly with an I.R.S. attorney so that the issues can be resolved earlier in the process. Nonetheless, examinations can drag on when the I.D.R.'s are too broad, or the issues have not yet been determined by the I.R.S.

These differences do not necessarily change the manner or course of representation. It may behoove the taxpayer's representative to have a call early on with the I.R.S. examiner or attorney to discuss the nature of the examination. Even if there

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[42] While there is some debate as to what constitutes prior contact by the I.R.S. or rather what prior contact disqualifies taxpayers from utilizing a program, that discussion is beyond the scope of this article.

is no way to limit the scope of the I.D.R. in a particular examination, it is a good practice to discuss the potential issues as early as possible in order to determine the relevancy of the I.D.R. requests.

As always, make sure to observe the normal formalities of practice. If your I.D.R. response is voluminous, make sure that the response is Bates stamped. Always keep a full and complete copy of the response for your records. Respond as completely but narrowly as possible, neither the client nor the I.R.S. want documents exchanged that are not relevant to the inquiry or were not specifically requested. And, when responding, always be sure to protect and assert any privileges that may apply. When in doubt, feel free to overuse privilege, the privilege can always be waived later but once waived then the privileged information is out there.

The final important point of representing high-net-worth taxpayers during examination is to ensure that these clients are kept informed, and their expectations managed. High-net-worth individuals like to be kept in the loop and heard.

CONCLUSION

The I.R.S. has invested considerably in examination related resources to identify noncompliant taxpayers and collect taxes due in order to reduce the tax gap. One of their top priorities has been making sure that high-net-worth taxpayers report all income and pay the proper amount of tax that is due. For those noncompliant taxpayers wishing to come forward, various procedures are available to come into compliance. Some procedures have no cost other than the cost of compliance. Others have significant costs in terms of tax and civil penalties. Those taxpayers who believe they are invisible may face criminal prosecution.

INTERNATIONAL TAX INVESTIGATIONS IN THE U.K.

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Tags
Budget
C.O.P. 9
Criminal Tax
Deliberate Behavior
D.I.M.F.
F.I.G.
Fraud
Long-Term Resident
Non-dom
T.O.A.A.
U.K.

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INTRODUCTION

If you are reading this in December 2024, we in the U.K. have recently just had the first new Labour Government and Chancellor Rachel Reeves' first budget, our minds turn to the less enviable issues of the impact on tax.

It is no secret that the U.K. has a significant debt burden. A large part of that arose from the various support initiatives provided during COVID-19, but some are linked back to the financial crisis of 2008. Whatever the reason, the current public sector net debt, excluding public sector banks, as set out in the Budget speech was estimated to be equivalent to 98.5% of G.D.P. (£2.7665 trillion, per the Office for National Statistics) at the end of September, although the G.D.P. percentage figure is expected to be revised as it relies on G.D.P. estimates.

Ahead of coming into power, the Labour Party set out a number of measures they would introduce to pay for its agenda. One of those was the ending of the U.K. non-dom regime. This was confirmed in the Budget, and we are starting to see the first draft of legislation for the replacement four-year Foreign Income Gains ("F.I.G.") regime and the proposals to revise U.K. Inheritance tax from focusing on domicile to a residence-based test.

In brief, from April 2025, an individual who has been U.K. tax resident for ten or more of the previous 20 years will be a "long-term resident" and as such exposed to U.K. Inheritance Tax on worldwide assets for a number of years after U.K. residency terminates! Individuals in this category who have been U.K. resident for between ten and 13 years and then become non-U.K. tax resident will remain within the I.H.T. net for three years following their departure (the "tail"). Those who have been U.K. resident for 20 years will have an I.H.T. tail of ten years. A sliding scale will apply for those who were U.K. resident for between 13 and 20 years, with each year of U.K. residence beyond 13 adding one extra year to their I.H.T. tail. There are some transactional limitations for individuals who were not domiciled in the U.K. on October 30, 2024, and who are non-U.K. resident in tax year 2025/26.

Also, of particular interest to the writer, given the many asset managers he acts for, the Budget increased the rate of capital gains tax to 32% on carried interest from April 2025, alongside the wider proposals on C.G.T. to raise the rate to 18% and 24% from the current 10% and 20%, respectively, from October 30, 2024. A Consultation will also take place to bring carried interest gains into the Income Tax arena,(which currently has a maximum rate of 45%, possibly to sit alongside the Disguised Investment Management Fee ("D.I.M.F.") regime which was introduced in 2015.

Another measure which the Labour Party pointed to in its pre-election manifesto was the countering of tax evasion and avoidance. It stated that the government would invest £855m over five years on the U.K. tax authority, H.M.R.C., to raise £2.7 billion per annum from this investment. They went further than this in the Budget by setting out various proposals to close the tax gap that will recoup £2.7 billion each year for the five years of the current Parliament period.

Considering the Government's statements on tax avoidance and fraud, this article focuses on the U.K. approach to tax fraud, through H.M.R.C.

H.M.R.C. APPROACH OF TAX FRAUD/EVASION

One of the first things to appreciate in terms of the U.K. and H.M.R.C. in serious tax matters is their use of words like fraud, tax evasion, and deliberate behavior interchangeably. In essence, they are looking at acts where tax has been lost to the exchequer, as a result of dishonest intent. But the interchanging of some of these words can have significant tax consequences, particularly in the case of deliberate behavior.

It's worth considering the H.M.R.C. criminal investigation policy. H.M.R.C. refers to this policy in terms of fraud. The U.K. Adopts a policy of selective prosecution. This in practice means that when H.M.R.C. discovers situations where fraud is prevalent, whilst they always consider the possibility of commencing a criminal investigation, more often than not they choose to pursue a civil settlement, to include tax, interest, and penalties.

The H.M.R.C. Criminal Investigation policy sets out examples of the types of areas where H.M.R.C. will more likely commence a criminal investigation rather than a civil investigation. While not exhaustive the list is set out as follows:

- Where organized criminal gangs attack the tax system or systematic frauds where losses represent a serious threat to the tax base, including conspiracy
- Where an individual holds a position of trust or responsibility
- Where materially false statements are made, or materially false documents are provided in the course of a civil investigation
- Where, pursuing an avoidance scheme, reliance is placed on a false or altered document or such reliance or material facts are misrepresented to enhance the credibility of a scheme
- Where deliberate concealment, deception, conspiracy or corruption is suspected
- Where there is use of false or forged documents
- Where there is importation or exportation breaching prohibitions and restrictions
- Where money laundering exists with particular focus on advisors, accountants, solicitors and others acting in a professional capacity who provide the means to put tainted money out of reach of law enforcement

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- Where the perpetrator has committed previous offences or there is a repeated course of unlawful conduct or previous civil action
- Where theft, misuse, or unlawful destruction of H.M.R.C. documents occurs;
- Where there is evidence of assault on, threats to, or the impersonation of H.M.R.C. officials
- Where there is a link to suspected wider criminality, whether domestic or international, involving offences not under the administration of H.M.R.C.

A central part of representing a client in any serious tax investigation or voluntary disclosure is to determine if tax fraud or deliberate behavior is prevalent. It is therefore very important to fully understand the concept of tax fraud. The badges of tax fraud are not always easy to identify, and over the years, the writer has come across many situations where a tax matter has some features of tax fraud and yet the advisers saw the facts differently, often reflecting the complexity of taxation law. Given the use of interchangeable terms between fraud, evasion, and deliberate behavior, it is worth also understanding how it all links together.

WHAT IS FRAUD?

As well as understanding H.M.R.C.'s policy on criminal prosecution, when considering cases of suspected serious fraud, some understanding of what constitutes fraud is clearly helpful. There is an abundance of common law (both tax and non-tax related) on this subject.

H.M.R.C.'s enquiry manual (EM5106) publishes the following extract from Halsbury's Laws of England (LexisNexis), in relation to "misrepresentation and fraud."

> **Section 757 What Constitutes Fraud?**
>
> Not only is a misrepresentation fraudulent if it was known or believed by the representor to be false when made, but mere non-belief in the truth is also indicative of fraud. Thus, whenever a person makes a false statement which he does not actually and honestly believe to be true, for purposes of civil liability, that statement is as fraudulent as if he had stated that which he did not know to be true, or knew or believed to be false.* Proof of absence of actual and honest belief is all that is necessary to satisfy the requirements of the law, whether the representation has been made recklessly or deliberately; indifference or recklessness on the part of the representor as to the truth or falsity of the representation affords merely an instance of absence of such a belief. A representor will not, however, be fraudulent if he believed the statement to be true in the sense in which he understood it, provided that was a meaning which might reasonably be attached to it, even though the court later holds that the statement objectively bears another meaning, which the representor did not believe.

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[* See Derry v Peek 14 App Cas 337, p 374, per Lord Herschell: fraud is proved when it is shown that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false; the third case being but an instance of the second.]

Section 759 Irrelevancy of Representor's Motive

It follows from the meaning of fraudulent misrepresentation that, given absence of actual and honest belief by the representor in the truth of the misrepresentation, his motive in making the misrepresentation is wholly irrelevant. It may be that he intended to injure the representee without benefiting himself, or to benefit himself without injuring the representee; it may be that he did not intend to do either, but solely to benefit a third person, or even the representee himself, or otherwise to do right. Lastly, he may have acted with no intelligible or rational notice whatsoever and told a lie from mere caprice, mischievousness or stupidity. In all these cases, provided that there was an absence of actual and honest belief in the truth of his assertion, the misrepresentation is accounted fraudulent and no proof of any wicked or other intention (other than an intention to induce) on the part of the representor is required by the law; or if it is necessary to establish an intention to deceive or injure, that intention is immediately and irrebuttably presumed in law from the mere act of making the misrepresentation without such belief.

Section 760 Representation Subsequently Discovered by Representor to be False

Where a representation is a continuing one and where, between the time when it was made and the time when the representee altered his position on the faith of it, either (1) the representor discovers that his original statement which, when he made it, he honestly believed to be true, was false, or (2) supervening events render, to the knowledge of the representor, his statement no longer true, a duty to disclose the changed situation to the representee may arise. In such cases the mere fact that the statement may have been innocently made, though false, or true when made, will not, it seems, prevent the representee from establishing fraud where he can show that the representor dishonestly failed to discharge the duty of disclosing the change in the situation.'

The above demonstrates that, particularly in terms of civil liability, the term "fraud" is widely drawn. For example, it extends to the deliberate submission of understated accounts and incorrect tax returns.

The U.K. also introduced the Fraud Act in 2006. The Fraud Act 2006 defines fraud in three categories:

- Fraud by false representation
- Fraud by failing to disclose information
- Fraud by abuse of position

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The Act states in all three categories that there must be an act of dishonesty.

The tests for dishonesty for many years were linked to two tests as set out in *R v Ghosh* [1982] EWCA Crim 2b.

The *Ghosh* test provided a two-limb test, which required juries to consider the following:

- Whether the conduct complained of was dishonest by the lay objective standards of ordinary reasonable and honest people (the "objective test") and
- If yes, whether the defendant must have realized that ordinary honest people would so regard his behaviour (the "subjective test")

More recently Ghosh has been surpassed by a number of judgements, including the Court of Appeal in *Booth and another v R* [2020] EWCA Crim.

In *Booth*, the central issue was the status of the Supreme Court decision in the civil case of *Ivey v Genting Casinos (U.K.) (trading as Cockfords Club)* [2017] U.K.SC 67 regarding the test for dishonesty in criminal cases. The Court of Appeal held that it was bound to a new two-stage test:

- What was the defendant's actual state of knowledge or belief as to the facts? (subjective)
- Was the defendant's conduct dishonest by the standards of ordinary, decent people? (objective)

"A key part of the changes was to introduce new terms such as 'deliberate' and 'deliberate behavior.'"

WHAT ABOUT DELIBERATE BEHAVIOR?

In 2007, H.M.R.C. undertook a significant review of its investigatory and administrative tax powers. This resulted in huge changes to its powers to raise assessments, seek information and charge penalties, among many other things.

A key part of the changes was to introduce new terms such as "deliberate" and "deliberate behavior." This replaced the previous use of terms "fraud" and "fraudulent behavior." As someone who participated in the professional consultations at the time, it was clear that while these were new terms they were to be regarded as a cut across from the old rules. But over the years there has been case law and various interpretations, not always confirming the cut across intended.

There is some legislative assistance in (TMA 1970, s. 118(7)). It confirms that, within the meaning of "deliberate," is the following:

> In this Act references to a loss of tax or a situation brought about deliberately by a person include a loss of tax or a situation that arises as a result of a deliberate inaccuracy in a document given to H[is] Majesty's Revenue and Customs by or on behalf of that person.

But this clearly doesn't provide clarity on the meaning.

A number of cases have all looked at the common law meaning of the term "deliberate." Included are *Auxilium Project Management v H.M.R.C.* [2016] U.K.F.T.T. 249, *Cliff v H.M.R.C.* [2019] U.K.F.T.T. 564, *Leach v H.M.R.C.* [2019] U.K.F.T.T. 352 (TC), and *Tooth v H.M.R.C.* [2021].

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In *Auxilium*, the F.T.T. stated as follows:

> "* * * a deliberate inaccuracy occurs when a taxpayer knowingly provides H.M.R.C. with a document that contains an error with the intention that H.M.R.C. should rely upon it as an accurate document. This is a subjective test. The question is not whether a reasonable taxpayer might have made the same error or even whether this taxpayer failed to take all reasonable steps to ensure that the return was accurate. It is a question of the knowledge and intention of the particular taxpayer at the time.

In *Tooth*, the Supreme Court stated as follows:

> * * * for there to be a deliberate inaccuracy in a document * * * there will have to be demonstrated an intention to mislead the Revenue * * *."

Current case law therefore states there must be an intention to mislead H.M.R.C. for the submission of an incorrect document to be treated as arising from deliberate behavior or inaccuracy and the administrative matters that turn on that intent, such as extended assessing time limits and increased civil penalties.

THE U.K. CIVIL APPROACH TO TAX FRAUD

C.O.P. 9

If H.M.R.C. discover tax fraud or fraud is prevalent when an individual is considering making a voluntary disclosure it is important to be aware of the main tool available to handle cases of tax fraud within a civil investigation. This is H.M.R.C. Code of Practice 9 ("C.O.P. 9").

> Under COP 9, the recipient is given the opportunity to make a complete, accurate, open and honest disclosure of all their deliberate behaviour bringing about a loss of tax or duty (and all other irregularities in their tax affairs, including basic mistakes). In return HMRC effectively provide an undertaking not to commence a criminal investigation for the matters disclosed. COP 9 has had various iterations over its many years of existence, including at one point the requirement of a formal interview under criminal caution under the UK Police and Criminal Evidence Act (PACE) rules. However, that was dispensed with some time ago and we saw the latest iteration of COP 9 being introduced in July 2023.

C.O.P. 9 in Practice

At the beginning of a C.O.P. 9 investigation the recipient is asked to sign a contract known as the Contractual Disclosure Facility ("C.D.F."). The C.D.F. contract effectively sets an understanding of what is required under C.O.P. 9 and that the recipient will abide by those terms. A rejection of the contract (or failing to reply) will risk H.M.R.C. commencing a criminal investigation.

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Where the C.D.F. is accepted, an important next step is to submit an outline disclosure within 60 days. This should set out the basic issues around any fraudulent acts such as “what happened,” “when did it occur,” “how much was involved,” and “what entities or what people are involved.” Most importantly the outline disclosure is a statement confirming a loss of tax to H.M.R.C. from deliberate behavior. The burden of proof for deliberate behavior is on H.M.R.C., and so the up-front confirmation by the C.O.P. 9 recipient extent overcomes the point to some.

In some straight forward cases, the outline disclosure might amount to the whole disclosure. However, in larger more complex cases, it will often be necessary to work towards preparing and submitting a more detailed disclosure report further down the line. As long as H.M.R.C. accept the outline disclosure, the case can continue. The submission of the outline disclosure can be a stressful time for clients as H.M.R.C. have been known to reject outline disclosures, and this could again result in a criminal investigation. It is therefore essential to spend sufficient time and effort to ensure the Outline disclosure is not rejected.

An important aspect of C.O.P. 9 will be holding an opening meeting with H.M.R.C. where they can satisfy themselves that the recipient understands what is required, and his or her commitment to the process. It is also an opportunity for the H.M.R.C. investigator to ask questions about the outline disclosure and other questions about the recipient’s tax affairs and circumstances more broadly. Opening meetings can last several hours and be incredibly detailed, and so it is essential to spend significant time in preparing for such meetings.

At the point that the final disclosure is submitted to H.M.R.C., it must be a complete and accurate disclosure. Disclosures will often involve the submission of various H.M.R.C. certificates, including signed certificates confirming details of bank and credit card accounts held and a statement of personal assets and liabilities held at specific points in time. It goes without saying these certificates must also be comprehensive and accurate. Errors in such certificates can result in the protection of C.O.P. 9 being lost and the commencement of a criminal investigation taking place, at the time of submission, or often many years down the line where errors are discovered.

H.M.R.C. will also expect a signed Certificate of Full Disclosure, where the C.O.P. 9 recipient makes a formal statement that they have made a complete and full disclosure. Again, if at some later point H.M.R.C. become aware that the disclosure was not full and accurate this certificate again could form part of a criminal investigation.

Once the investigation phase has completed and lost tax identified and agreed upon, discussions progress to penalties. H.M.R.C. charges interest on late paid tax (9% from April 2025). This is set in legislation, and there are very limited opportunities to mount successful arguments that interest should not apply.

The calculation of penalties and the number of back years H.M.R.C. can assess is now a complex affair in the U.K. It is important to recognize that where tax fraud is in point because of deliberate behavior – the current legislative language for civil penalties linked to tax fraud – H.M.R.C. are able to assess tax back 20 years. In certain cases of Inheritance Tax there is no time limit.

The U.K. made significant changes to the civil tax penalty regime in 2007. Prior to 2007, penalties were fairly straight forward. H.M.R.C. could charge penalties of up

to 100% of lost tax in cases of negligence or fraudulent behavior. These penalties could then be mitigated up to 100% based on factors such as disclosure, cooperation, size, and gravity. The change in 2007 brought in minimum penalties and also different rates for different categories of offence, such as carelessness, deliberate behavior, and deliberate behavior with concealment.

H.M.R.C. also applies different penalty rates depending whether the tax offences were voluntarily disclosed, or were identified by H.M.R.C. after having opened an enquiry. Deliberate penalties range between 20% and 70% and penalties for deliberate with concealment range between 30% and 100%. The penalty range can be mitigated to take into account disclosure, cooperation, and providing access to the relevant documents or issues. Careless behavior results in penalties of between 0% and 30%, and also the possibility of penalties being suspended.

“If the above isn’t complicated enough, the U.K. brought in numerous different penalty provisions where the underlying lost tax is linked to offshore matters.”

If the above isn’t complicated enough, the U.K. brought in numerous different penalty provisions where the underlying lost tax is linked to offshore matters. In 2011 these provisions brought in the concept of an offshore multiplier linked to the category of the jurisdiction in which the tax offence occurred. The categories are linked to the commitments of those jurisdictions to international exchange of information agreements. For example, jurisdictions fully signed up to the O.E.C.D. Common Reporting Standard (“C.R.S.”), or F.A.T.C.A. in the case of the U.S., the penalty limits stayed the same as for U.K. domestic offences. However, where countries involved lack exchange of information agreements, the penalties are double the domestic penalties, so the maximum penalty becomes 200%. In 2016, H.M.R.C. brought in penalties of 10% of the value of assets linked to the offshore noncompliance. Many other penalties and rules and categories exist, but are beyond the scope of this article.

Having agreed on tax, interest and penalties, the investigation will be concluded with a legal written contract.

Burden of Proof

In cases of fraud or deliberate behaviour the burden of proof rests with H.M.R.C.

Anti Money Laundering

One area that is highly relevant when looking at tax fraud and deliberate behavior is that of ancillary A.M.L. issues. Tax evasion is an indictable crime in the U.K. and as such falls squarely within the U.K. Anti Money Laundering Regulations and the Proceeds of Crime Act 2002, including the requirement for making Suspicious Activity Reports and in many cases seeking Consent Orders from the National Crime Agency. Consideration should always be given to A.M.L. obligations when any tax adviser discovers or seeks to act for clients with such issues.

CROSS BORDER TAX INVESTIGATIONS

For several decades the U.K. and H.M.R.C. has focused heavily on tax risk arising from cross border activities. That can include simple cases of U.K. residents holding bank accounts offshore, but it also extend to complex international tax structuring.

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Companies as Targets

As part of H.M.R.C.'s strategy to counter cross border tax avoidance and fraud, H.M.R.C. has introduced various initiatives, beginning with the offshore disclosure campaigns starting in 2007, proceeding to the Requirement to Correct offshore noncompliance in 2017, and the introduction of various new penalty regimes as mentioned above. H.M.R.C. has also focused its criminal investigation capability and significant civil investigation resources on the tax gap associated with offshore matters.

Like many other countries, the U.K. has significant tax provisions designed to protect its tax base. Following the O.E.C.D. Model Tax Convention, it has Transfer Pricing, Permanent Establishment, Controlled Foreign Company and Anti-Hybrid rules, and most of the other model articles. The U.K. signed the Base Erosion Profit Shifting (B.E.P.S.) Multilateral Instrument. The U.K. has over 100 tax treaties. it has introduced its own Digital Services Tax, and in 2015, the Diverted Profits Tax ("D.P.T.") to counter structures set to avoid taxation of permanent establishments or to meet Transfer Pricing requirements.

H.M.R.C. regularly investigates overseas companies where it believes they resident in the U.K. because they believe Management and Control takes place in the U.K. This test is broadly similar to that of effective management and control as set out in the O.E.C.D. Model Convention articles.

The U.K. also introduced additional corporate criminal offenses in the 2017 Criminal Finances Act. They apply where a U.K. company – or in some cases and overseas company doing business in the U.K. – fails to prevent the facilitation of tax evasion in the U.K. or overseas.

Private Clients as Targets

Significant provisions are also available to counter offshore avoidance and fraud linked to private clients. This includes penalties for tax advisers. H.M.R.C. carefully monitors those U.K. resident non-domicile clients claiming the remittance basis.

In recent times we have seen criminal investigations and many serious civil fraud investigations in this area. Under the current rules that will change in April 2025, non-doms who have been resident in the U.K. for more than seven out of the previous nine years must pay a remittance basis charge ("R.B.C.") in order to continue to limit their taxation to U.K. situs income. Under the current regime, they are taxed only on foreign income and gains ("F.I.G.") that are remitted to the U.K. Currently that charge is £30,000. After 12 years out of the previous 14 of residence, the R.B.C. increases to £60,000.

We have seen many investigations where the R.B.C. has not been paid, yet the non-dom files a tax return without paying tax on offshore F.I.G.. If the nonpayment of the R.B.C. is deliberate, the basic elements for H.M.R.C. to conduct a criminal investigation exist. Also, where taxable remittances are made to the U.K. or complex structures are created to mask taxable remittances to the U.K., H.M.R.C. could mount a criminal investigation under the rules discussed above.

Often in these cases, tax advisers are involved. There are significant risks for advisers, as well as the non-dom client. In addition to the risk of a criminal investigation, H.M.R.C. has many new civil powers to charge significant civil penalties on

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intermediaries linked to serious offshore noncompliance. In 2009 H.M.R.C. were also given powers by the U.K. Government to publicly name taxpayers or agents associated with serious tax noncompliance.

It is important to understand that the U.K. has powers to impute the income of offshore structures to U.K. residents by way of the Transfer of Assets Abroad ("T.O.A.A.") rules and also to tax U.K. resident participators on capital gains made by offshore companies. Both of these provisions can tax the U.K. resident, even where no benefit, income, or distribution has been received from the structure.

The T.O.A.A. rules can charge tax to a U.K. resident on income arising in an offshore structure where (i) there has been a relevant transfer of assets, and as a result, (ii) income arises to an overseas person. Note that the transferred assets need not have been in the U.K. prior to the transfer. Note also that the transferee can be an individual, trust, or company. The charge applies where the U.K. resident can benefit, so this is not restricted to amounts actually paid out currently. The rules can also tax beneficiaries but in those cases a benefit must be realized.

The T.O.A.A. rules will not apply where the offshore structure has been set up for commercial purpose or where tax avoidance was not a motive. For the exemptions to apply, they must be claimed in tax returns. In part, because of the complexity of these rules, they are hugely misunderstood, and so incorrect claims are common. Also, many situations are simply not reported to H.M.R.C.

However, where matters have been deliberately ignored or false claims made serious tax investigations can result, including criminal investigations. The T.O.A.A. rules have been viewed at times as providing an infringement to the rights of E.U. citizens Cases include *Commissioners for His Majesty's Revenue and Customs (respondent) v Fisher and another (Appellants)* [2023]U.K.SC 44. As a result, the rules were changed to try and make them more E.U. compliant. Nonetheless, with the U.K. leaving the E.U. and the sunset of E.U. retained law on December 31, 2023, U.K. citizens no longer can benefit from such protections. Whether E.U. citizens resident in the U.K. can continue to rely on the infringement arguments is beyond the scope of this article.

Non-doms claiming the remittance basis often have been sheltered from these rules. With the ending of the remittance basis in April 2025, former non-doms will face significant liabilities unless they qualify for the new four-year F.I.G. protections. Given the Government's Budget commitments to increase the number of investigations undertaken, this group will most definitely see more investigations.

The U.K. also has provisions to tax U.K. resident participators on gains in nonresident companies where they hold on their own or with associates 25% of the shareholdings of the nonresident company. Again, there are more recent exemptions linked to motive and again non-doms claiming the remittance basis may have been historically shielded, but just as for T.O.A.A., the rules are often overlooked leading to significant tax noncompliance, some undertaken deliberately.

Fund Managers

London and the U.K., as a major world financial center has resulted in H.M.R.C. opening investigations into asset managers, hedge funds, and private equity businesses for offshore noncompliance and fraud. The U.K. also introduced significant tax provisions specifically to tax disguised management fees and treat them as U.K.

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source to limit treaty protections. This has included criminal investigations linked to fraudulent transfer pricing positions taken. Again, it is important to appreciate that if transfer pricing adjustments are made without real foundation, and those adjustments were made deliberately, the elements of tax fraud would be present.

Often fund structures will be located in low or zero taxation jurisdictions, in part to reduce tax leakage for investors. Asset managers can share in the profits of the funds by way of tax structuring often using a mixture of opaque and transparent tax structures, mostly in the form of partnerships. Where asset managers are U.K. resident, they should always undertake a detailed review of the whole structure in case there are exposures to T.O.A.A.

The U.K. also introduced Profit Fragmentation rules in 2019. These rules apply where the following fact pattern exists:

- There has been a transfer of value from the U.K. trader to an offshore entity – this could take the form of a diversion of income to the offshore entity or payment of expenses to the offshore entity.
- The effect of the arrangement is that a significantly lower level of tax is paid on the profits than would be the case if they were correctly taxed in the U.K. in accordance with the current law.
- The proprietor of the business, whether a sole trader or partner in an unincorporated business, or as director or shareholder of a company, is able to enjoy the profits that have been diverted.
- The U.K. person must have arranged for the profits to be diverted to the offshore entity.
- The diversion or payments mentioned in the first bullet above are not commensurate with the work undertaken by the offshore entity.

Where these conditions are present, the arrangement can be counteracted by bringing the profits back into U.K. tax by attributing the correct amount of profits to the U.K. taxable source.

EXCHANGE OF INFORMATION

A significant part of H.M.R.C.'s armory when it comes to countering tax fraud and avoidance both domestically and internationally is the huge amounts of data it receives. When introducing the self-assessment system in 1997, the U.K. invested heavily in technology and continues to do so. Currently, H.M.R.C. is seeking to hugely digitize the tax system.

H.M.R.C. plays a significant role within the O.E.C.D. and was an early adopter of the O.E.C.D. Common Reporting System in 2016. As an early member of the E.U., the U.K. fully participated in the exchange of information mechanisms via the E.U. Directive of Administrative Cooperation ("D.A.C."). Since Brexit, the U.K. has continued to participate hugely in international exchange mechanisms by way of its membership in the O.E.C.D., through the Mutual Assistance in Taxation Convention ("M.A.C."), through its many treaties, and through multilateral and bilateral exchange of information agreements.

The U.K. is also a significant contributor to the O.E.C.D. Tax Inspectors Without Borders initiative. Tax payers should be cautious as the O.E.C.D. plans to use its Tax Inspectors Without Borders initiative to assist new O.E.C.D. members investigating Pillar II rules.

We see many information notices issued to tax residents in the U.K. by H.M.R.C., as a result of requests made by tax authorities overseas. Advisers should also review these requests carefully to ensure they meet their own countries domestic information powers but also that they meet the U.K.'s own domestic rules. The U.K. has many of its own safeguards and limitations on information notices and any request from an overseas authority must comply with the U.K.'s own rules.

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THE EVOLUTION OF TAX ENFORCEMENT IN SWITZERLAND

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INTRODUCTION

In this article we describe the most recent developments in the Swiss tax enforcement arena:

- Attacks by Swiss federal and cantonal tax authorities on the use of offshore structures utilized by Swiss tax residents.
- Increased scrutiny, questioning, and tax audits directed at Swiss taxpayers.
- The active exchange of information program by which Switzerland provides and receives administrative assistance within the framework of the more than 100 double tax treaties.

ATTACKS ON OFFSHORE COMPANIES USED BY SWISS TAXPAYERS

Basis for Challenge

Based on established jurisprudence, there are three ways by which offshore structures are attacked by the Swiss tax authorities:

- The offshore company is considered effectively managed in Switzerland.
- The offshore company is deemed to act on behalf of a Swiss resident by means of an agency mandate, and as a result, the income is attributed to the Swiss principal.
- The offshore company is not recognized because it is a sham that is utilized for tax avoidance purposes.

Effect of Successful Challenge

If the Swiss tax authorities are successful in their attack on the offshore structure, the following Swiss tax consequences may arise:

- Swiss corporate income tax could be due on all income derived by the offshore structure. No special tax regime or ruling would be applicable. Consequently, the full corporate income tax rates would apply, which in most cantons, fall within the range of 12% to 15%.
- Swiss dividend withholding tax could be due on all distributions made or deemed made by the offshore company. This triggers a 35% Swiss dividend

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withholding tax. The tax is grossed up to about 54%[1] if the offshore company fails to collect the tax from the person considered to have benefited from the dividend. In practice, it is difficult to apply reduced treaty rates as the recipient is generally not able to benefit from an income tax treaty.

- 8.1% Swiss V.A.T. may be due on services invoiced to the offshore company by Swiss service providers or even on any service the offshore company imported from abroad. In practice it will be difficult to obtain a refund because of factual and formalistic requirements under Swiss V.A.T. law.
- 1% Swiss stamp duty on the capital contribution would likely not become due, because the stamp duty law is rather formalistic in nature and generally requires a company to be (i) incorporated or domiciled in Switzerland or (ii) registered in the Swiss trade register. In cases of capital contribution tax avoidance, a risk would continue to exist.
- Swiss securities transfer tax of 0.15% or 0.30% on an actual or deemed transfer of Swiss or foreign securities if the company can be considered a Swiss securities dealer under the Swiss stamp duty law. This can be a real risk for a fund investing in equities and debt instruments.

Attack Based on Effective Management

In practice, the attack directed to an offshore company by Swiss tax authorities is based on the concept of effective management in Switzerland. In Switzerland, the concept of effective management is not based on formalisms. In recent jurisprudence, the key element is where the day-to-day management of the business takes place. The location of board meetings, annual shareholder, place of strategic decisions, or the location of the books and records, by themselves, no longer carry much weight when Swiss tax authorities assert that effective management is in Switzerland.

To reduce the risk of a successful attack by the Swiss tax authorities on an offshore company related to a Swiss tax resident, the following recommendations need to be considered:

- The statutory and actual purpose of the offshore company should be defined precisely, and the object clause should not be cluttered by irrelevant filler purposes.
- The day-to-day business of the offshore company, as defined, must actually take place in the offshore jurisdiction where the company employs qualified personnel who work at adequately equipped office space.
- No part of the day-to-day business should take place in Switzerland.
- To eliminate inconsistencies that weaken a taxpayer's position, board meetings and annual general meetings should be held in the offshore jurisdiction. While holding those meetings in the offshore jurisdiction is not controlling, the failure to hold those meeting in the offshore jurisdiction weakens the position of the Swiss company as to the substance of the offshore company.

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[1] The gross up formula is as follows: 35% * 100/65 = 53.85%.

- Preferably, no Swiss residents should serve on the board of the company or carry on other important functions as an employee, agent, or representative. If this cannot be avoided, the Swiss resident could be appointed as an agent or representative with limited authority that is precisely drafted and impeccably followed.

- Preferably, the books and records of the company should be kept at its place of domicile, never in Switzerland. Regarding electronically accessible systems, preferably no access should be allowed from Switzerland.

- The bank accounts of the offshore company should be in the jurisdiction of domicile. Bank relations maintained by the offshore company should not be the same as the bank relations of Swiss resident individuals related to the Swiss shareholder.

- Swiss residents should not have signing authority on the bank accounts of offshore companies, and they should also not have indirect access, *e.g.* by way of electronic banking systems or credit cards etc.

Attack Based on Mandate Concept

Even if an offshore company is not effectively managed in Switzerland but is clearly acting on behalf of a Swiss principal, and is heavily financed by the Swiss principal, the Swiss tax authorities may assert that the offshore company is an agent acting on the basis of a mandate for the risk and account of the Swiss principal. Under this approach, the offshore company would be entitled to a service fee, but the bulk of the profits would be attributed to the Swiss principal. At least one Swiss Federal Court decision has adopted this view, although it is criticized by commentators.

Attack Based on Nonrecognition and Tax Avoidance

In cases of tax avoidance, the Swiss tax authorities will not recognize the existence of the offshore company. This theory has been successfully applied by the authorities with respect to direct corporate income taxes and for dividend withholding tax.

Based on established Swiss jurisprudence, the following conditions must be met for a finding of tax avoidance:

- The form or structure chosen by the taxpayer is unusual, inappropriate, or strange, and is not adequate for achieving any economic objective.

- The form or structure was set up for the sole purpose of avoiding the payment of taxes that would otherwise be payable.

- If accepted by the tax authorities, the form or structure chosen by the taxpayer would have led to significant tax savings.

The following steps should be considered by a taxpayer concerned about a potential challenge based on tax avoidance. All involve hiring staff in the foreign country to carry on the business with only moderate direction from Switzerland:

- The offshore company should have sufficient staff with sufficient experience to demonstrate that it has sufficient substance to carry on the activities of its business.

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- Closely aligned with the foregoing step is the need to ensure that local staff members carry on the activity that is required to run the business in the country where resident; in other words, effective day-to-day management of the business takes place abroad.
- The performance of economic modeling in advance of adopting the structure demonstrating the pre-tax economic benefits that are anticipated through the adoption of an offshore structure; the elimination of Swiss taxes should not be the principal economic benefit.
- Closely aligned with the foregoing step is the need to demonstrate that the same opportunity for economic benefit is not available if operations were carried on in Switzerland.

INCREASE OF DOMESTIC TAX AUDITS

In the past, the Swiss federal and cantonal tax authorities carried out tax audits mainly for simple and obvious cases where the profits that should accrue to a Swiss company were shifted to empty shell companies located in low-tax jurisdictions. Customary targets were Swiss residents forming companies in Panama or comparable jurisdictions that posted high annual profits without an operational infrastructure, staff, or premises.[2]

Today, Swiss tax audits have evolved towards more complex cases involving intragroup transfer pricing issues. Swiss tax authorities now look at the details of operational activity, examining the prices charged for intragroup transactions, such as interest,[3] royalties,[4] management fees and commissions. The emphasis is on analyzing the substance of the operation and ensuring compliance with the arm's length principle for intercompany transactions.

From 2009, Switzerland gradually extended and intensified exchanges of information with foreign countries, in line with international standards of tax transparency. In some instances, Switzerland transmits information to foreign tax authorities, and in others, it receives information for use in its own internal tax audits. This includes information on foreign bank accounts, country-by-country ("C-b-C") reporting by multinationals, and administrative assistance on request. As a result, the effectiveness of Swiss tax audits measured in terms of lost tax recovery is now significant.

Exchange of C-b-C Reports

Exchange of C-b-C reports[5] enables tax authorities to gain a better understanding of the profit distribution and economic activity of multinational groups with sales in excess of €750 million.

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2 In particular cases 2C_1073/2018 and 2C_508/2014.

3 "Ikea a Caché Des Millions Au FISC Suisse: Deux Personnes Inculpées." Gotham City, November 30, 2022; Decision of the Criminal Court of Appeal of the Canton of Vaud of August 24, 2023 - Jug/2023/432.

4 Federal Court ruling of October 12, 2022 (2C_824/2021).

5 Swiss Law on the Exchange of CBC Reports ("C-b-C Act").

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Automatic Exchange of Foreign Bank Account Information

Under the Federal Act on the Automatic Exchange of Information in Tax Matters, ("A.E.O.I."), Swiss tax authorities automatically receive information on the foreign bank accounts of Swiss tax residents. As a result of A.E.O.I. rules now in force, Swiss taxpayers with foreign accounts can no longer take advantage of nonpunishable voluntary disclosure concerning undeclared foreign accounts.[6] It is not surprising that information furnished to Swiss tax authorities resulted in an increase in the number of audit procedures initiated against individual taxpayers resident in Switzerland.

Nonetheless, banking secrecy remains in force for Swiss residents. This means that, barring certain legal exceptions, Swiss banks are not authorized to disclose information on Swiss residents' bank accounts to the Swiss tax authorities.

Spontaneous Automatic Exchange of Rulings

Agreements concluded between a company and the tax authorities, notably on intra-group transfer pricing, are automatically communicated without prior request.[7]

Exchange of Information on Request

Switzerland generally responds to requests from foreign tax authorities in accordance with Swiss law.[8] In Switzerland, the taxpayer that is the subject of the request has the right to participate in the procedure, thus guaranteeing a degree of transparency and the possibility of asserting.

"Nonetheless, banking secrecy remains in force for Swiss residents."

However, practice shows that Switzerland transmits various items of data, including financial statements, tax returns, tax rulings and other relevant documents relating to the target taxpayer, regardless of the taxpayer's participation.

Switzerland does not currently participate in multinational tax audits coordinated among several countries, as recommended by the O.E.C.D.[9] and applied by the European Union.[10] However, it has become known that a working group within the Federal Tax Administration is studying the possibility of future participation in coordinated audits. This could mark an evolution in the way Switzerland collaborates in international tax matters and would strengthen its alignment with international practices in terms of transparency and tax cooperation.

Despite the movement toward information exchanges and tax audits, Switzerland remains an attractive jurisdiction for companies and individuals. Advance tax rulings are available in matters related to transfer pricing, restructuring, and taxation according to expenditure for those individuals benefitting from a *forfeit* arrangement. These advance agreements, negotiated between the taxpayer and the Swiss tax

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6 Art. 175 para. 3 LIFD.

7 Swiss Ordinance on Administrative Assistance in Tax Matters ("T.A.A.O.").

8 Swiss Law on International Administrative Assistance in Tax Matters ("T.A.A.A.").

9 O.E.C.D., Recommendation of the Council Concerning an O.E.C.D. Model Agreement For Simultaneous Tax Audits, O.E.C.D./LEGAL/0269.

10 Council Directive (EU) 2021/514 of March 22, 2021, amending Council Directive 2011/16/EU on Administrative Cooperation in the Field of Taxation.

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authorities, offer legal certainty. They enable taxpayers to better anticipate their tax burden and reduce the risk of discrepancies or unpleasant surprises during Swiss tax audits, thus reinforcing a climate of trust.

THE LONG, STEADY SHIFT TO TRANSPARENCY

Switzerland, long known for its commitment to banking secrecy, has historically resisted international demands for transparency and tax information exchange. This principle came under increasing challenges following the 2008 financial crisis. Under sustained international pressure, Switzerland adopted the O.E.C.D. standards on tax assistance in 2009, initiating a significant transformation of its legal framework.

Expanding the Scope of A.E.O.I.

Implemented in Switzerland on January 1, 2016, the A.E.O.I. framework stems from the Federal Act on the International Automatic Exchange of Information in Tax Matters (the "A.E.O.I. Act"), which incorporates the Multilateral Competent Authority Agreement ("M.C.A.A.") into domestic law.

The Swiss Federal Tax Administration (the "F.T.A.") operates with no discretionary authority regarding the transmission of data under A.E.O.I., except in cases where such actions could infringe fundamental rights, such as human rights violations or significant procedural breaches. By October 2024, the F.T.A. exchanged information on approximately 3.7 million financial accounts with 108 jurisdictions,[11] underscoring A.E.O.I.'s role as a central pillar of international tax cooperation.

While initially focused on financial accounts, the A.E.O.I. framework is expanding to include new areas such as crypto assets and salary data, reflecting Switzerland's ongoing legislative developments announced this year.

Incorporating Crypto Assets into A.E.O.I. via C.A.R.F.

Switzerland is actively preparing to integrate crypto assets into the A.E.O.I. framework by adopting the O.E.C.D.'s Crypto Asset Reporting Framework ("C.A.R.F."). Scheduled to take effect in 2026, the draft bill complements the existing Common Reporting Standard ("C.R.S.") by imposing targeted obligations on Reporting Crypto Asset Service Providers ("R.C.A.S.P.'s") operating in Switzerland. Under the proposed legislation, R.C.A.S.P.'s which fall under the C.R.S. are obligated to comply with the C.A.R.F. requirements. While this dual compliance approach broadens the regulatory scope, it also presents significant administrative challenges for such businesses.

Crypto services are defined as a business if the provider qualifies as a financial intermediary under Article 2, Paragraph 2 of the Swiss Anti-Money Laundering Act, or if it offers crypto services as specified in Articles 7 to 10 of the Swiss Anti-Money Laundering Ordinance, meeting any of the following thresholds:

- Annual gross revenue exceeding CHF 50,000
- Managing over 20 client relationships per calendar year

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11 "Echange de Renseignements Avec 108 États Sur Environ 3,7 Millions de Comptes Financiers." Confédération Suisse, Départment fédéral des finances, October 10, 2024.

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- Discretionary authority over assets from third parties exceeding CHF 5 million
- Execution of transactions exceeding a total volume of CHF 2 million per calendar year

R.C.A.S.P.'s will also be required to collect and report user information, mirroring C.R.S. processes. However, practical questions remain, particularly regarding nexus criteria for specific cross-border entities such as trusts.

Switzerland's adoption of C.A.R.F. underscores its leadership in aligning international standards with the growing significance of digital assets.

Integrating Salary Data into A.E.O.I. for Cross-Border Workers

Switzerland's newest double tax treaties with Italy and France establish specific rules for taxing cross-border workers. These new agreements rely on the automatic exchange of salary data to ensure accurate taxation in the worker's country of residence.

To implement these agreements, Switzerland proposed new federal legislation governing the exchange of salary data with partner jurisdictions. This law, which may also serve as a legal framework for future agreements with other states, sets the terms for data transmission between cantonal tax authorities and the F.T.A. The procedures for the exchange of information between the F.T.A. and foreign authorities are governed by the relevant tax treaty.

The legislation, expected to take effect in 2026, aims to cover income earned during the 2025 fiscal year. Employers will be required to electronically submit detailed data on employees, including identity, gross income, residency, and remote working percentages. Employers must also inform employees of this exchange, enabling them to exercise their data protection rights.

These legislative developments reflect Switzerland's growing commitment to combating tax evasion through increased transparency. However, they also raise questions about the balance between Switzerland's tradition of confidentiality and international demands for greater openness. While these reforms enhance fiscal transparency, they impose additional administrative burdens on businesses and raise concerns about data protection. Furthermore, the expansion of A.E.O.I. to new domains could very well set a precedent for including other sensitive areas, such as real estate or precious metals.

Handling Information Requests: A Swiss Balanced Approach

Switzerland's international tax cooperation is governed by double tax treaties incorporating Article 26 of the O.E.C.D. Model and Tax Information Exchange Agreements ("T.I.E.A.'s"). Domestically, it is regulated by the T.A.A.A., which is the Federal Act on International Administrative Assistance in Tax Matters mentioned at n. 8, above, and its ordinance, in force since 2012. These laws have been revised to include the Convention on Mutual Administrative Assistance in Tax Matters ("M.A.C."), ratified by Switzerland in 2015.

The F.T.A.'s Exchange of Information Service, acting as the central authority, evaluates all information requests for legal compliance before obtaining the requested data from third parties, such as banks or companies. The process is underpinned

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by the principle of foreseeable relevance, established in Article 26 of the O.E.C.D. Model, which limits the exchange to targeted and justified requests. Fishing expeditions, requests based on illegally obtained information, or those violating the principle of good faith are systematically rejected.

Requests must include sufficient details to identify the taxpayer or group concerned. For group requests, the Swiss Federal Supreme Court has ruled that the requesting state must describe the group in detail and demonstrate why the taxpayers may be noncompliant.[12]

Additionally, the principle of subsidiarity requires that the requesting state exhaust all domestic avenues for obtaining information before seeking international assistance.[13] The principle of proportionality ensures that data transmission is limited to what is strictly necessary, without excessively infringing taxpayer rights.

Procedural safeguards are integral to Switzerland's framework. Under Article 14 of the T.A.A.A., affected individuals must be notified of requests and given the opportunity to respond before their data is transmitted. This right to be heard, enshrined in Article 29 of the Swiss Constitution, is fundamental. Its violation can render a procedure invalid, as confirmed by the Swiss Federal Supreme Court.[14]

The exchanged information must be used by the requesting state exclusively for the fiscal purposes outlined in the request and can include

- banking documents,
- corporate tax data, or
- personal information, such as tax declarations or residency details.

In cases involving specific regimes, such as lump-sum taxation, the relevance of the information depends on the context and purpose of the request, as determined by Swiss courts.[15]

The introduction of A.E.O.I. and spontaneous data exchanges has significantly increased the volume of information requests. In 2023, Switzerland received 853 requests for assistance while issuing only 75 requests.[16] Most inquiries pertain to transfer pricing audits or intra-group profit adjustments involving Swiss banks or companies.

Despite its robust framework, Switzerland maintains limits on its cooperation. It refrains from assisting with the recovery of foreign tax claims and prohibits foreign partners from conducting notifications on its territory. These restrictions, aimed at preserving the integrity of Switzerland's fiscal system, are increasingly questioned, notably by the European Union, which seeks to extend agreements to include tax claim recovery.

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[12] 2C_1174/2014 24.09.2015.

[13] 2C_703/2019 16.11.2020.

[14] 2C_653/2017 13.05.2019.

[15] 2C_1053/2018 22.07.2019.

[16] "Chiffre Indicatifs Assistance Administrative Internationale." Administration fédérale des contributions AFC, October 28, 2024.

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CONCLUSION

The balance between Switzerland's adherence to international cooperation standards and its protection of national fiscal sovereignty remains a pivotal issue. As the global push for transparency continues, Switzerland's ability to navigate these challenges will define its role in the evolving international tax landscape.

"As the global push for transparency continues, Switzerland's ability to navigate these challenges will define its role in the evolving international tax landscape."

TRUSTS IN ITALY: THE VIEW OF ITALIAN TAX AUTHORITIES & RECENT DEVELOPMENTS

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Opaque Trust
Transparent Trust

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INTRODUCTION[1]

The legal construct of a trust is a common law arrangement having features that make it suitable for a wide range of uses, including asset protection, family and child protection, special needs, generation-skipping of family businesses, charitable, corporate governance issues, and management of inheritance needs. Notwithstanding its flexibility and its recognition worldwide, it remains relatively unfamiliar in civil law jurisdictions, such as Italy.

Unlike common law countries with established trust regulations, Italy lacks a specific legal framework for trusts, which limits its use in a purely Italian set of circumstances. Nevertheless, Italy ratified the Hague Convention on the Law Applicable to Trusts and on their Recognition (1985) (the "Convention"), and in so doing, introduced a degree of recognition of trusts governed by foreign law. Consequently, Italy acknowledges and enforces the validity of trusts regulated by foreign law, as long as they adhere to the minimum standards outlined in the Convention.

Over the years, trusts have become increasingly common in Italy, even in cases where the only foreign element in the structure is the governing law, as the settlor, trustee, beneficiaries, and assets are all Italian. This trend reflects a growing reliance on trusts for estate planning, asset protection, and general planning purposes within Italy. At the same time, it is increasingly common for foreign individuals moving to Italy have previously implemented wealth planning structures involving the use of foreign trusts.

The absence of a specific civil law framework for trusts, combined with Italy's fragmented and evolving tax law regarding the treatment of trust structures has led to significant interpretative uncertainty. Both direct and indirect tax implications for trusts in Italy are subject to varied interpretations, leading to an inconsistent approach that has complicated the use of trusts.

This interpretative ambiguity, coupled with the general unfamiliarity of the Italian legal system with trust structures, has prompted the *Agenzia Delle Entrate*, the Italian tax authorities ("I.T.A."), to adopt a frequently skeptical and aggressive stance toward trust arrangements. In particular, the I.T.A. has identified various situations in which it views the trust as a mere "screen" interposed between the actual asset holder (either the settlor or a beneficiary) and the assets themselves, with the purpose of circumventing tax liabilities or regulatory requirements. In other words,

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[1] The authors acknowledge the contribution to this article made by Maria Pia Giovinazzo, an associate in the Rome office of Gianni & Origoni.

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in cases where a trust retains control over assets ostensibly separated from the settlor's estate, the trust may be classified as fictitiously interposed, meaning it will be disregarded for tax purposes.

The purpose of this article is to provide an updated overview of the tax treatment of trusts in Italy, examining both direct and indirect tax implications. Special attention will be given to recent legislative developments in indirect taxation, as well as to the I.T.A.'s evolving approach toward the assertion of fictitious interpositions in trust structures. This analysis aims to offer a clear framework for understanding the legal and tax landscape for trusts in Italy, highlighting areas where taxpayers and practitioners should exercise caution to ensure compliance with interpretations Italian regulations by I.T.A., especially for individuals relocating to Italy.

ITALY'S TAX FRAMEWORK FOR TRUSTS

Direct Taxation

According to the Italian law, trusts are subject to the Italian corporate income tax ("I.R.E.S."). For I.R.E.S. purposes, trusts are treated in one of three ways:

- They are commercial entities where their principal activity is a business activity.
- They are treated as noncommercial entities where their main activity is not a business activity.
- They are treated foreign entities where their tax residence is maintained abroad.

The tax treatment of trusts is largely determined by their classification as either opaque or transparent. This classification directly impacts income attribution and the tax obligations of the trust and its beneficiaries.

Transparent Trust

A trust is considered transparent when its beneficiaries are identified. According to the I.T.A., beneficiaries must be timely identified and have the right to claim from the trustee the allocation of that part of the income that is imputed to them by reason of transparency.[2] This implies that beneficiaries (i) must be specifically named and (ii) must hold an enforceable right to a portion of the trust's income as it arises.

For tax purposes, any income generated by a transparent trust is attributed directly to the identified beneficiaries. They must report the income and pay taxes on the income at the time generated, even if no amount is distributed. This means that the income flows through to the beneficiaries and is taxed in their hands as if it were earned directly. For individual beneficiaries, this income qualifies as capital income ("*reddito di capitale*") and is subject to I.R.P.E.F., Italy's progressive personal income tax, with rates reaching up to 43%. When the income is eventually distributed to the beneficiaries, no additional tax is due.

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[2] See circular letter No. 48/E of 2007 issued by I.T.A.. The material in the text is an unofficial translation.

Opaque Trust

A trust is considered opaque when its beneficiaries are not timely identified and do not have enforceable rights to distributions of income when and as realized by the trust. Stated somewhat differently, in an opaque trust:

- beneficiaries may be partially identified but lack specific enforceable rights to claim a portion of the trust's income as it arises, or
- beneficiaries may be only broadly defined without immediate entitlements.

This classification applies when the trustee retains discretion over the distribution of income and capital or are contingent on certain future events, or when beneficiaries are not named.

For tax purposes, any income generated by an opaque trust is not allocated to beneficiaries but instead is subject to I.R.E.S. in the hands of the trust itself at the standard rate of 24%. The taxable base for I.R.E.S. purposes depends on whether the trust is involved in commercial activities. If so, taxable income is calculated in a manner that is similar to a corporate entity. If not, taxable income is calculated according to specific rules for noncommercial entities.

As with transparent trusts, an actual distribution of income by a noncommercial opaque trust does not trigger additional income tax for the beneficiaries. However, an actual distribution of income by a commercial trusts is treated as income for the recipient beneficiary and is subject to income tax or to 26% withholding tax based on the status of the recipient.

Without prejudice to the above distinction, the I.T.A. maintains the view that it is possible for a trust to be both opaque and transparent.[3] This may occur when the deed of trust specifies that a part of the income generated by the trust is to be retained in order to increase the trust's capital, while another part is attributed directly to beneficiaries. In that set of circumstances, the trust is referred to as a mixed trust for tax purposes. Consequently, the retained income is taxed at the trust level, while the income allocated to beneficiaries is taxed under concepts of transparency.

Trusts Resident in Blacklisted Jurisdictions

In contrast to the above rules, Italy applies specific anti-avoidance measures to trusts resident in blacklisted jurisdictions. Under these rules, distributions from a nonresident trust based in a blacklisted country are treated as taxable capital income in the hands of the Italian resident beneficiaries, even if the trust qualifies as opaque. This means that beneficiaries are subject to taxation on all distributions received regardless of the trust's classification and its tax treatment in its jurisdiction of residence. This measure is intended to prevent Italian residents from using offshore trusts to shield income from Italian taxation. Tax is imposed when funds are repatriated to resident beneficiaries. In principle, only income distributions by trusts that are resident in blacklisted jurisdictions are subject to income tax. Capital distributions remain nontaxable upon receipt. However, the burden of proof is on the beneficiary to clearly demonstrate the capital nature of the distribution. Otherwise, the distribution is presumed to be an income distribution that is fully taxable.

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[3] See circular letter No. 48/E of 2007 issued by I.T.A.

Inheritance and Gift Taxation

Italian inheritance and gift tax ("I.G.T.") applies to transfers of valuable assets as a result of death, gifts, or donations. In broad terms, I.G.T. applies to transfers of assets located both in Italy and abroad if the donor is, or the decedent was, resident in Italy. It also applies to transfers of assets located in Italy, if the donor is, or the decedent was, resident abroad.

Rates vary depending on the relationship between the donor and the relevant beneficiary. Exemption thresholds apply.

Relationship with Donor or Decedent	Tax Rate	Exemption Threshold
Spouse of direct descendant	4%	€1 million
Sibling	6%	€100,000
Other relatives up to 4th degree of consanguinity	6%	N.A.
Other individuals	8%	N.A.

I.G.T. and Gifts to Trust

According to Italian law, trusts may be relevant for the application of I.G.T. Until recently, the absence of specific legislation on trusts for civil law purposes, combined with tax regulations that are fragmented, fostered a climate of significant uncertainty, debate, and tax disputes regarding how and when I.G.T. should apply with reference to the transfer of assets to trusts. Recently, the situation has been clarified through legislation that is intended to provide a definitive framework for I.G.T.

Historically, the I.T.A. maintained a stringent approach to I.G.T. in connection with transfers to trusts. Specifically, tax was imposed at the moment assets were transferred to a trust. It did not matter that beneficiaries may not have been identified at this stage. Nor did it matter that actual transfers by the trust to the beneficiaries would first take place at a later stage. This interpretation was set out initially in Circular Letter No. 48/E of 2007, which was based on the assumption that transferring assets into a trust constituted a complete disposition of the transferred assets, thereby triggering I.G.T.

This appraoch sparked significant debate within the legal community. Some scholars pointed out that the position leads to taxation prior to the time of actual receipt by beneficiaries. Others pointed out that the system in place benefited beneficiaries because any subsequent growth in the value of the transferred assets owned by the trust is not relevant for I.G.T. purposes. Under this view, taxpayers could effectively shield the trust's accumulated gains from a potentially higher I.G.T. burden down the line by frontloading the tax obligation.

Over time, Italian case law on this issue evolved. Early decisions of the Italian Supreme Court supported the approach of the I.T.A., treating the initial transfer of assets as a taxable event. However, in more recent decisions, the Italian Supreme Court endorsed the position of commentators who argued in favor of deferring I.G.T. until the time assets are distributed by a trust. Under this approach, the sole taxable event for I.G.T. purposes is the final transfer of assets to beneficiaries. The decisions of the Supreme Court led the I.T.A. to review its earlier position.

Legislative Decree No. 139

Finally, Legislative Decree No. 139 of September 18, 2024, clarified the rule in the following way. First, it declares that that for transfers to trusts by Italian residents, the triggering event for I.G.T. is the transfer by the trust of assets and rights to the beneficiaries. Second, it allows an Italian resident settlor to opt for the application of I.G.T. at the time of contribution of assets to the trust. Should the option be exercised, subsequent distributions to the beneficiaries are irrelevant for I.G.T. purposes. In this bifurcated way, wealthy clients and their advisers have an opportunity to evaluate the approach that best aligns with specific tax planning objectives.

"The increasing use of trusts in Italy – often used in foreign legal systems for estate planning and wealth management – has led the I.T.A. to scrutinize these structures closely."

FICTITIOUS INTERPOSITION: VIEW OF THE I.T.A.

Background

The increasing use of trusts in Italy – often used in foreign legal systems for estate planning and wealth management – has led the I.T.A. to scrutinize these structures closely. Given the unique challenges that trusts present within Italy's civil and tax law framework, the I.T.A. has expressed particular concern over cases where trusts may be used as instruments to shield assets from taxation. In line with broader anti-avoidance principles, the I.T.A. has developed an approach to identify and address cases of fictitious interposition in trust structures, examining whether a trust functions primarily as an artificial barrier that conceals the real economic ownership of assets, thereby circumventing, reducing or deferring tax liabilities.

In this section, we explore the I.T.A.'s evolving stance on fictitious interposition, including the criteria it employs to identify interposed trusts and the tax implications for direct taxes and I.G.T. This analysis underscores the importance of carefully structuring trust arrangements and evaluating trust structures already in place in case of relocation to Italy, as the classification of a trust as a fictitiously interposed device has significant consequences for both settlors and beneficiaries under Italian tax law.

Criteria Adopted by the I.T.A.

In the absence of specific legislation directly governing the issue, the I.T.A. developed an approach to identify those situations in which a trust might be deemed to have been fictitiously interposed. Relying on foundational principles used to define trust structures, the I.T.A. gradually developed criteria that allow it to scrutinize trusts and assess their substance as well as form. The approach involves examining whether a trust serves as a genuine vehicle for asset management or merely as a formal layer without substance to shield assets from Italian tax obligations.

The central pillars in this interpretative journey are Circular Letters No. 43/E of 2009 and No. 61/E of 2010, which laid the groundwork by offering a comprehensive set of

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indicators that are used to evaluate a trust's independence and true economic function. The mentioned circular letters provided guidance on characteristics that may suggest the fictitious interposition of trusts, such as the direct or indirect retention of control by the settlor, or the lack genuine autonomy given to the trustee in managing the assets of the trust.

A fundamental element in I.T.A.'s approach is the genuine authority of the trustee to manage and dispose of the assets contributed to the trust by the settlor. The settlor must not retain any power or control over the trust assets that would impede the trustee from fully and autonomously exercising its activity. Consequently, if the settlor retains, in whole or in part, the power to manage and dispose of the trust's assets – whether it explicitly emerges from the trust deed or implicitly from factual circumstances – a true divestment has not occurred, and the trust should be considered fictitiously interposed for tax purposes.

To operationalize this general principle, and to provide guidance for local offices in conducting tax assessment activities, the I.T.A. has outlined a set of specific indicators that, if present, suggest that a trust is fictitiously interposed. The indicators include the following:

- The settlor or beneficiary can terminate the trust at any time, typically for his or her own benefit or the benefit of third parties.
- The settlor has the power to designate himself or herself as the beneficiary at any time.
- The settlor or beneficiary holds powers under the trust deed, requiring the trustee to obtain his or her consent before exercising discretionary powers in the management and administration of the trust.
- The settlor can terminate the trust early, designating himself or herself or others as beneficiaries to receive termination distributions, an arrangement known as "term trusts."
- The beneficiary is entitled to receive assets from the trustee.
- The trustee must follow the settlor's instructions regarding the management of the trust's assets and income.
- The settlor can remove and appoint beneficiaries during the life of the trust.
- The settlor has the power to assign income or assets from the trust or to have the trust grant loans to chosen individuals.
- Any other case in which the trustee's management and decision-making powers, as defined by the trust deed or law, are limited or conditioned by the will of the settlor and/or beneficiaries.

Tax Implications of Fictitious Interposition

Should a trust be classified as having been fictitiously interposed, it loses its independent status for tax purposes. Its income and assets are treated as if they are directly owned by the settlor or the beneficiary, as the case may be. This reclassification has substantial consequences, affecting direct taxes and I.G.T.

Direct Tax Implications

When a trust is deemed interposed, the I.T.A. view is that it must be treated as if it does not exist for tax purposes, with the consequence that any income generated by the trust is taxed directly, as if it were generated by the settlor or the beneficiary, as appropriate in the facts. This interposition negates the application of standard tax rules that would otherwise apply to either opaque or transparent trusts, described above.[4] If I.T.A. challenges the trust's structure, it may allege that the settlor or beneficiary committed tax violations due to failure to file the required tax return or due to inaccuracies in a submitted return, where relevant income was omitted. Such violations can lead to administrative penalties, and if the amount of unreported tax exceeds certain thresholds, criminal penalties may also apply.

I.G.T. Implications

The reclassification of a trust as fictitiously interposed can significantly impact the application of I.G.T. The position of the I.T.A. is that, depending on the terms, the settlor or beneficiary of a fictitiously interposed trust passes away, I.G.T. will apply as if the assets held by the trust were directly owned by the deceased at the time of death. This view is premised on the absence of a true transfer to the trust, trust assets should be included in the deceased's estate and therefore subject to I.G.T.[5]

The approach of the I.T.A. has drawn substantial criticism from commentators.[6] Critics argue that the I.T.A.'s position overlooks the foundational civil law principles underpinning the existence and operations of a trust. Under civil law, the assets transferred into a trust should be segregated from the settlor's personal estate, reflecting a fundamental characteristic of trusts recognized internationally and by the Convention. Consequently, the I.T.A.'s interpretation of fictitious interposition effectively disregards the trust's civil law validity and asset segregation, which should be recognized in Italy as long as the trust is structured and administered in accordance with applicable foreign law and the Convention.

Additionally, in the absence of a judicial declaration voiding the trust, the I.T.A.'s unilateral reclassification of the trust's assets as part of the settlor's estate stretches the limits of tax authority, blending tax administration with determinations typically reserved for civil courts. The lack of a judicial ruling challenging the trust's validity leaves the trust intact for civil law purposes. This raises questions concerning the I.T.A.'s authority to disregard this status purely for tax reasons.

Another criticism concerns the timing and legal basis for imposing inheritance tax. If the I.T.A.'s position were consistently applied, inheritance tax could be levied on trust assets as part of the settlor's estate upon their death. This timing ignores the typical trust function and could impose tax liabilities on individuals who may not have control or even knowledge of the trust assets. In practice, heirs and beneficiaries could face challenges in reporting these assets in the inheritance tax return,

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[4] Circular Letter No. 34/E of 2022.

[5] Circular Letter No. 34/E of 2022 and Ruling No. 176 of 2023.

[6] C. Culiersi - G. Zoppis, "*Trust "interposto": quali impatti ai fini dell'imposta sulle successioni?*" in il Fisco No. 12/2023; S. Loconte, "*Deroghe nella tassazione dei trust opachi e trasparenti: trust interposto e autodichiarato*," in il Fisco No. 11/2023; S. Loconte - G. Floriddia, "*Criticità e anomalie della ritenuta rilevanza dell'interposizione del trust ai fini del tributo successorio*," in il fisco No. 1/2024.

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particularly if they are not the trust beneficiaries and therefore lack access to details about the trust assets.

Court Cases and I.T.A. Rulings

Ruling No. 267 of 2023 – Extension of Guardian's Powers

The case concerned a trust established in 2018 which was used by the settlor for generational wealth transfer, specifically transferring an amount equal to 93.86% of his shares in a family holding company to the trust, with his descendants designated as beneficiaries.

Based on a draft trust deed submitted to it in 2015, the I.T.A. indicated that the trust could be considered to be fictitiously interposed due to the settlor's ability to substantially influence the trustee's conduct indirectly through the guardian. Subsequently, the trust deed was modified to address the concern, including the introduction of (i) restrictions on the settlor's ability to remove or appoint the guardian and (ii) limitations on the trustee's obligations to follow the settlor's directives.

Despite these adjustments, Ruling No. 267 concluded that the trust was fictitiously interposed, based on the ongoing influence of the guardian, whose binding consent was required for numerous critical trustee actions. These included the guardian's powers over the appointment of beneficiaries, major amendments to the trust deed, and transfers of significant holdings. In addition, the guardian could be removed without cause by the settlor with the agreement of one of the beneficiaries, which was viewed by the I.T.A. to be an indirect link between the settlor's will and the trustee's authority that undermined the trust's independence. Consequently, the trust was deemed to be nonexistent for income tax purposes. All income generated by the trust remained taxable at the level of the settlor.

"Ruling No. 267 is important because it addresses the role of the guardian rather than focusing solely on the role of the settlor."

Ruling No. 267 is important because it addresses the role of the guardian rather than focusing solely on the role of the settlor. The position of the I.T.A. appears to be particularly strict and somewhat unclear in defining the boundaries of permissible influence that naturally accompanies the guardian's role. In international trust practice, it is common to require a guardian's approval for specific trust matters, a provision that does not automatically signal control by the settlor. Nonetheless, the ruling underscores the delicate balance between these common practices and the requirement that the settlor relinquish influence over the trust and its assets.

Ruling No. 267 is important also because it illustrates the I.T.A.'s view that even formal provisions typical of standard trust arrangements may trigger reclassification if they permit indirect influence over trustee actions. This scrutiny is particularly significant when the trust instrument fails to provide objective criteria for appointing and removing the guardian or trustee. In sum, it is not the role of the guardian that is problematic. Rather it is the retained power of the settlor to remove the guardian and to appoint a successes. The existence of the guardian's authorization powers should not automatically result in the interposition of the trust, even in cases where the guardian can be appointed or removed by the settlor.[7]

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[7] E. Vial, "*Interposto il trust con il guardiano nominato o revocato dal disponente?"* in il fisco No. 19/2023.

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Ruling No. 796 of 2021 – Power of Beneficiaries Over the Trust

In ruling No. 796 of 2021, the I.T.A. examined a trust established in Italy, ultimately concluding it was fictitiously interposed due to the significant influence over trust management that was given to the beneficiaries, exerted indirectly through a guardian. The case involved a trust created for generational wealth transfer purposes. It held the majority participation in a partnership held by the settlor. The beneficiaries were the settlor's descendants. The trustee was an Italian company, and the guardian was a trusted family advisor.

The I.T.A. concluded that the trust lacked independent tax status, classifying it as having been fictitiously interposed by the settlor. The I.T.A. based its conclusion on several factors:

- The trustee's ability to manage assets in the trust was constrained because guardian consent was required for specific actions.
- The beneficiaries held the right to terminate the trust early.
- The beneficiaries retained the power to dismiss the guardian.

The I.T.A.'s conclusion relied on the argument that the guardian's powers were held in substance by the beneficiaries who jointly held the power to appoint and remove the guardian. The grant of that power undermined the trustee's independence, rendering the trust to be fictitiously interposed, and accordingly, nonexistent for tax purposes. Although the tainted power was held by the beneficiaries, the I.T.A. classified the settlor as the ultimate owner of the assets, leading to the attribution of taxable income to the settlor. Commentators have questioned the logic that links the powers of the beneficiaries to the retained ownership by the settlor.[8] Some believe it may be based on the conclusion reached in Circular Letter No. 61/E of 2010, which stated that trust income should be attributed to the settlor in all cases where the transfer of control is incomplete. This approach appears misplaced here, where the I.T.A. concluded that control was exercised by the beneficiaries.

CONCLUSIONS

In conclusion, this article has explored Italy's fragmented regulatory landscape regarding trusts, highlighting the uncertainty that has long surrounded their use in Italy due to the lack of a clear domestic framework. The absence of comprehensive legislation tailored to trusts has historically led both Italian taxpayers and practitioners to operate in a climate of ambiguity, facing challenges particularly in matters of tax compliance and reporting. Nevertheless, a growing trend toward legislative clarification is emerging, as seen in the recently introduced I.G.T. regulations. This legislative shift, which creates specific tax provisions rather than merely adapting existing Italian rules to an institution of foreign origin, reflects a deeper understanding by lawmakers of the unique nature of trusts.

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8 E. Vial, "*Clausole dell'atto di trust che portano all'interposizione: la prassi dell'Agenzia delle entrate*," in il fisco, No. 12/2022; G. Zoppis, "*Trust inesistenti e poteri di guardiano e beneficiari: un accertamento non sempre agevole,*" in il fisco, No. 3/2022; E. Vial, "*Un recente caso di interposizione del trust,*" in Commercialista telematico of December 10, 2021; S. Bettiol, "*I beneficiari invasivi rendono il trust interposto nei confronti del disponente,*" in Cesi Multimedia of December 9, 2021.

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For professionals advising clients relocating to Italy with pre-existing wealth structures, it is essential to understand this nuanced landscape. Trust powers must be structured thoughtfully in order to avoid potential challenges from the I.T.A. based on the concept of fictitious interposition.

Advisers based outside of Italy should be aware of the interaction between common international trust provisions and Italian concepts of excessive influence by the settlor or beneficiaries. Although some cases clearly exhibit undue influence, others involve standard clauses commonly accepted in international practice. Navigating this fine line is crucial, particularly in distinguishing the natural supervisory role of the guardian from a settlor's direct or indirect retention of predominant influence over trust assets.

By recognizing potential risk areas, high net worth individuals contemplating a move to Italy and their advisers abroad must carefully tailor the powers within a trust in order to avoid tax problems arising from Italian expectations that are designed to safeguard the trust's integrity for direct and indirect tax purposes.

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FOCUS ON H.N.W.I.'S AND OFFSHORE STRUCTURES – AN INDIAN PERSPECTIVE

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INTRODUCTION

The topic of offshore assets held by high-net-worth individuals ("H.N.W.I.'s") based in India is a topic of substantial interest for various governmental authorities in India. It is not just the Indian Tax Authority that is interested in offshore accounts. Substantial exchange control regulations are in place in India and other regulatory authorities keep a close track of the offshore interests of Indian residents.

Over the years, Indian names appeared in data leaks of offshore structures and bank accounts, triggering significant administrative focus and amendments to the law. In 2015, the Black Money Act[1] was introduced in India, with the stated intent of enacting provisions to deal with the problem of undisclosed foreign income and assets and to impose tax on undisclosed foreign income and assets.

DATA LEAKS

Information leaks and action on that account by the regulators have been the focus of global political campaigns for several years. There have been multiple data leaks, of which the most prominent are the Swiss Bank data leaks, Portcullis leaks, Panama Papers leaks, and the Paradise Papers leaks, which invited the attention of the legislators and regulatory authorities in various parts of the world. In India, these leaks created huge political interest, so much so, that recovering black money stashed abroad was one of the most prominent agenda on the Bhartiya Janta Party's manifesto[2] during its successful 2014 election campaign.

In comparison to the general perception regarding leaked names, not all named individuals and entities appearing in these leaks are tainted. It is possible that the leaked structures are fully compliant with the regulatory framework in India that is applicable for setting up external holding companies and business related structures.

INDIA'S REACTION

Several legislative and administrative changes were introduced in Indian tax laws as a direct result of the data leaks.

- In 2011, the Supreme Court of India directed the creation of a special investigation team to monitor the offshore assets investigations undertaken by various authorities.

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[1] The Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015.

[2] The Bhartiya Janta Party is the ruling party in India.

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- In 2012, significant reporting requirements were introduced in Indian income tax forms, specifically requiring submission of data concerning offshore assets and interests held by resident Indians.
- Also in 2012, the legislature increased the maximum look-back period for imposing tax on undeclared income from six years to sixteen years for cases involving offshore assets.
- Various measures were taken to strengthen income tax treaty provisions dealing with exchange of information with various jurisdictions, most prominently Switzerland. In addition, a number of Tax Information Exchange Agreements ("T.I.E.A.'s") were entered into to obtain information relevant to taxation of Indian residents and companies owned abroad.
- •In 2015, the Black Money Act was introduced to specifically deal with the issue of money stashed abroad. The Black Money Act provides for the imposition of a 30% tax and a penalty of 90% on the amount of undisclosed income and assets discovered by the tax authorities. Prior to the introduction of the Black Money Act, the law provided for a one-time opportunity for eligible declarants to (i) make a voluntary disclosure, (ii) pay a 30% tax and a 30% penalty on undisclosed offshore incomes and assets, and (iii) obtain immunity from the application of various Indian laws that would otherwise punish an Indian resident holding hidden accounts abroad.

UTILIZATION OF LEAKED DATA

Investigations were initiated, notices issued, and searches conducted on the premises of entities and individuals named in the data leaks, all with the purported goal of gathering information for purposes of confrontation with the named party. Information requests were made to the authorities of various jurisdictions, such as Switzerland, Singapore, and the British Virgin Islands. Ultimately, adverse orders were issued against individuals named in such leaked data.

In the case of the Swiss Bank data leaks, the Indian authorities received certain summaries referred by them as "base notes." Typically, the base notes provided the name of the individual, basic identification data, names of related entities or trusts linked to the individual, peak balances held in bank or investment accounts, and information concerning assets and investments held in such structures. Based on the information received, the Indian authorities issued tax assessment orders and penalty orders against named individuals.

In many cases, the peak balances mentioned in the base notes related to bank accounts held by a holding company that was owned by a trust having multiple beneficiaries. Indian tax authorities simply disregarded the structures and possible beneficiaries and treated the peak balances as belonging to the Indian resident named in the base notes. The path chosen by the Indian authorities seemed to be inconsistent with settled case law.

The leading case regarding the taxation of discretionary beneficiaries of trusts is *CWT v Estate of Late HMM Vikram Sinhji of Gondal*, [2015] 5 SCC 666, 672. There, the Indian Supreme Court, which is the highest court of law in India, observed that the mere status of a person as a beneficiary in a discretionary trust does not mean that the income of the trust belongs to that discretionary beneficiary when and as

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realized by the trust. Rather, a beneficiary has only a hope of receiving a distribution until such time as the trustee exercises discretion to make a distribution to that beneficiary.

It is normal for H.N.W.I.'s in India to set up trusts for wealth planning, asset protection, and inheritance purposes. Similarly, it is not uncommon for an H.N.W.I that is of Indian origin but is resident in an offshore jurisdiction to settle an offshore trust in a third jurisdiction for the benefit of his family members and relatives. The class of beneficiaries may include one or more Indian residents. As part of the onboarding process followed by the financial institutions and service providers, the names of all beneficiaries of the trust will wind up in the K.Y.C. records of the financial institution holding the assets of the trust. Even though no current benefit may have been realized by an Indian discretionary beneficiary, the beneficiary's name may appear in the base note. In many instances, the Indian resident individual does not know that he or she is a discretionary beneficiary.

Nonetheless, the unwavering position of the Indian tax authorities is to adopt a "look through" approach and to impose tax and penalties on all Indian residents named in the base notes. It is believed that hundreds of requests for information have been made to Switzerland by the Indian tax authorities as a result of the base notes. Much litigation has taken place to challenge the actions of the Indian tax authorities. More is expected in the future.

"Nonetheless, the unwavering position of the Indian tax authorities is to adopt a 'look through' approach and to impose tax and penalties on all Indian residents named in the base notes."

INFORMATION EXCHANGE

When the tax authorities in India made their initial requests to tax authorities in Switzerland in accordance with Article 26 (Exchange of Information) of the India-Switzerland Income Tax Treaty, the Swiss authorities denied the requests. The basis for denial was grounded on public policy, a legitimate exception in the treaty. Stolen data could not be exchanged because it arose from stolen property. This is often referred to as "fruit of a poisonous tree."

That position was reversed in 2018, when the Swiss Federal Court adopted a narrow approach to the poisonous tree doctrine. It ruled that while the information was stolen, the theft was made by an independent actor, not the tax authorities, and the information was gratuitously transferred to the Indian tax authorities by tax authorities of another country. As India did not steal the documents, its hands were clean. Accordingly, information could be exchanged.

Based on that view, hundreds of previously denied information requests were revived and information exchanges took place. From 2019 onwards, various decisions have been rendered by Swiss courts allowing sharing of banking and other financial information sought by India.

While Swiss local laws provide stakeholders with a mechanism to challenge exchanges of information, challenges by stakeholders is not the norm in many other countries. When a request for information is received, a prompt sharing is made. Information is shared without any opportunity to challenge the exchange by the requisite stakeholders.

STAKEHOLDER CHALLENGES

Several concepts are universally enshrined in exchange of information articles of income tax treaties and T.I.E.A.'s.:

- The requested information must have foreseeable relevance to a tax obligation in the requesting country. Treaties and T.I.E.A.'s cannot be used as part of a fishing expedition.
- The request for information must be made in good faith.
- The exchange of information must not violate public policy in the country receiving the request. Requests should be denied if they (i) relate to secretive local laws, (ii) are made with the intent to further political vendetta, or (iii) will allow for the retroactive application of criminal sanctions against the taxpayers.
- The requesting country must have in place adequate data protection laws.
- The requesting country must have end-user restrictions so that the shared information should be used principally the proper administration of tax laws.

These concepts have been dealt with at length in a number of court rulings concerning requests made by the Indian tax authorities to counterparts in Switzerland, the U.S., and Singapore. Challenges to contemplated exchanges generally have been unsuccessful. Courts reason that arguments such as those listed above are more properly made before judicial panels of the country making the request. Stated somewhat differently, courts shy away from having to rule on the good faith of a treaty partner jurisdiction.

SHARED DATA

Broad contours of data sharing generally appear in the exchange of information provisions in income tax treaties, the operative provisions of T.I.E.A.'s, and multilateral agreements. Information requests tend to relate to the following items:

- Information regarding bank accounts, including account balances, bank statements, bank advice, and the identity of account holders
- K.Y.C. documents and account opening forms. This may also include company incorporation documents, trust deeds, and similar documents that were collected by financial institutions and corporate service providers at the time of onboarding
- Beneficial ownership details of bank accounts, investments, and properties
- Portfolio statements
- Internal email correspondence, communications with the bank, meeting notes and client instructions recorded by bank employees

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AVENUES FOR INFORMATION GATHERING

E.O.I on Request

A country may make an exchange of information request under the relevant treaty or agreement for the purposes of implementation of the tax treaty or for administration or enforcement of domestic tax laws.

Income Tax Treaties

Income tax treaties are bilateral agreements that focus on sharing taxation rights between participating countries. In very broad terms, taxing rights and administrative obligations are undertaken by both treaty partner countries. The tax authority in each country is entitled to seek information regarding its residents from the tax authority of the other country. In turn the tax authority in the other country is obligated to obtain the sought after information and to forward it the tax authority making the request.

Tax Information Exchange Agreements

In comparison to income tax treaties, T.I.E.A.'s refer to agreements under which each partner country undertakes to provide information to the other country regarding the residents of the other jurisdiction. Certain information is provided spontaneously, other information is provided on request.

Multilateral Convention on Mutual Administrative Assistance in Tax Matters

The Convention provides for administrative cooperation between signatory countries in the assessment and collection of taxes. Cooperation ranges from automatic exchanges of information, to exchanges on request, and finally to the recovery of foreign tax claims.

Mutual Legal Assistance Treaties ("M.L.A.T.")

M.L.A.T.'s enable law enforcement authorities and prosecutors to obtain evidence, information, and testimony abroad in a form that is admissible in the courts of the requesting state.

Common Reporting Standards ("C.R.S.")

The C.R.S. is a global standard for the automatic exchange of financial account information between governments to combat cross-border tax evasion. India has adopted the C.R.S. and has signed up to share financial information with other countries. Under C.R.S., there is a systematic and periodic collection and transmission of bulk taxpayer information by the source country to the country of residence of the taxpayer, without the latter having to make a request for the same.

PATH FORWARD FOR H.N.W.I.'S IN INDIA

There is a continuous uptick in modes and procedures of cooperation among nations regarding exchanges of information and assistance in recovering taxes. This

trend has enabled Indian law enforcement agencies administering exchange control and anti-money laundering laws to provisionally attach offshore bank accounts and assets linked to residents of India.

Indian H.N.W.I.'s owning offshore assets must be careful when it comes to reporting foreign income and assets in Indian tax filings and in filings before the exchange control authorities of the Reserve Bank of India. In spite of the fast globalization of the Indian economy, offshore assets, trusts settled under foreign law, and related structures formed under foreign law continue to be perceived negatively by administrative authorities. Hence, caution is imperative when responding to official questions and follow-up inquiries. Compliance deficiencies may result in heavy penalties and criminal sanctions under Indian tax law and the Black Money law.

Robust documentation in support of all offshore transactions must be maintained and provided to Indian authorities upon request. Professional support to oversee compliance throughout the year is extremely helpful when it comes to dealing with offshore interests.

"H.N.W.I.'s should also maintain proper documents in support of their residential status."

H.N.W.I.'s should also maintain proper documents in support of their residential status. These include passport copies with in-and-out travel stamps where available, visa copies, Tax Residency Certificates ("T.R.C.") for periods of stay outside of India. It may be difficult to obtain past copies of T.R.C.'s after a certain amount of time passes. Hence, one may consider to apply regularly for T.R.C.'s and to keep them handy for future submissions. Also helpful are copies of accommodation receipts, rent agreements, and utility bills in order to prove residential status if required. Also helpful is the use of geographical tracking applications on mobile devices, allowing an individual to demonstrate his or her location for every day during the year simply by walking around with the device.

Notices and questionnaires received from a regulatory agency or a law enforcement authority should be taken seriously, reviewed by competent counsel, and then responded to promptly. Indian tax returns require robust information concerning offshore assets and should be taken seriously.

H.N.W.I.'s relocating to India or moving out of India should seek professional advice from local advisers prior to the transfer of assets and investments to entities formed outside of India.

CONCLUSION

While Indian H.N.W.I.'s are expanding their businesses, activities and footprint on a global basis, they need to keep abreast of the changing laws and regulatory framework in tax and exchange control laws.

Maintaining robust documentation and ensuring accurate and complete disclosure in all statutory filings in India are key to avoid litigation or criminal prosecution stemming from the failure to file a complete report.

Comparable attention to documentation is important for expats moving into India as their global assets, investments, and income will be reportable in India once they become tax residents of India.

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The following key aspects apply to expats moving to India:

- Maintain day count in and out of India; apps are available for tracking days automatically on a mobile device.
- Redesignate nonresident ordinary and nonresident external accounts to Indian Rupee and savings accounts.
- All leveraged and sophisticated financial instruments owned prior to arrival which may be problematic from an exchange control viewpoint should be identified; regulatory approvals will be required under Indian exchange control regulations once an expat becomes a resident of India and planning is required prior to immigration.
- Foreign directorships and operational control over offshore entities from India should be discouraged, as each may have adverse tax implications in India for the offshore entity.
- Careful fiscal planning on wealth retained abroad should precede arrival in India.

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RECENT DEVELOPMENTS TO COMBAT TAX AVOIDANCE IN GERMANY

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Tags
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StUmgBG

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INTRODUCTION

"Paper is patient." This is a common German saying, typically used to highlight the sluggishness of processes and plans of all kinds. However, paper can also catch up with you or even take you by surprise in a way that may be embarrassing or worse. Examples include the following:

- The Luxembourg Leaks (2014)
- The Panama Papers (2016)
- The Bahamas List (2016)
- The Paradise Papers (2016)
- The Pandora Papers (2021)

All brought tax and tax-related criminal issues to the forefront, as they described purportedly abusive arrangements entered into for the purpose of tax avoidance. The public was titillated. Tax and law enforcement authorities were motivated. For over a decade, tax and law enforcement authorities worldwide have focused on abusive international investment and holding structures. As a result, the density of regulations and the complexity of national and international legal systems have increased year by year.

Jurisdictions with preferential tax regimes are under the scrutiny of tax and investigative authorities. This affects multinational corporations, family offices, entrepreneurial families, and wealthy private individuals who invest their assets internationally in a diversified and international manner. Cross border corporate structures are commonplace. The primary considerations are economic, reflecting investment volume, return on investment expectations, global trends, and developments. Legally permissible tax optimization of the investment is also considered as taxes represent costs when looked at from an economic perspective. The goal remains to achieve high net returns, which are usually reinvested, often for the benefit of the next generation or the public via charitable foundations.

Often, private and institutional investors are not sufficiently aware of the increased compliance effort associated with global investment forms and the resulting tax and tax criminal risks. European and German legislation have enacted numerous regulations, sometimes vaguely formulated. Tax administration officials use these regulations against taxpayers, especially wealthy private individuals. Emotions should not be underestimated here when unequal wealth distribution is perceived as unjust. Additionally, tax administrations are increasingly relying on A.I.-powered risk detection tools to uncover tax irregularities.

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Wealthy individuals frequently become the focal point of emotionally charged debates on tax justice, redistribution, and anti-tax evasion measures. Calls for reinstating a wealth tax and higher taxation of the "super-rich" are growing, aimed at achieving perceived fairness.

This article aims to provide (i) an overview of the latest measures of the European Union and the Federal Republic of Germany to combat tax avoidance and (ii) insight into current advisory practice. It draws from experience and advisory practice to illustrate concrete challenges and potential solutions for wealthy private individuals and family offices. It concludes with a cautious projection of future developments.

One thing is certain. Investors and their advisers must pay ever more attention to tax compliance and the economic and tax aspects on a forward-looking basis when an international investment is made. In comparison, tax examiners will first review the tax consequence of an international investment several years down the road. At that time, tax examiners will benefit from having 20/20 hindsight. Tax issues that were difficult to identify at the time an investment is made become easy to spot several years later when a tax examination is carried on. Without careful front-end planning by the taxpayer, the advantage is held by the tax examiner.

E.U. AND GERMAN MEASURES TO COMBAT TAX AVOIDANCE

The E.U. and the O.E.C.D. are committed to the principles of the market economy and democracy—and increasingly to the idea of tax justice. This is evident in the B.E.P.S. Action Plan, the initiation of global tax reforms like Pillar I and II, and the enactment of the European A.T.A.D. Directives.

B.E.P.S. Action Plan

The B.E.P.S. Action Plan was adopted by the O.E.C.D. in 2013. It aims to facilitate information sharing by tax administrations across borders and to link the location of taxation more closely to the actual economic substance of the income source. Additionally, it seeks to increase the coherence of individual national tax systems and curb unfair tax competition.

Legally, the B.E.P.S. Action Plan is considered "soft law," meaning it consists of recommendations without binding legal force. However, its principles were implemented through E.U. directives (*e.g.*, the A.T.A.D. directives) and national laws, giving the measures binding effect. Consequently, E.U. member states are obligated to implement specific anti-abuse measures, including provisions on (i) exit taxation and (ii) combating tax havens and corresponding investment structures.

A.T.A.D. Directives I and II

The E.U. Directives A.T.A.D. I and A.T.A.D. II are regulations designed to combat tax avoidance practices within the E.U. Examples include a provision limiting interest expense deductions and regulations to attack hybrid structures. The 2016 Directive A.T.A.D. I[1] obligated E.U. member states to implement measures to combat tax avoidance by the end of 2018, promoting an insofar uniform tax law across the E.U. It addresses core areas like the limited deductibility of interest expenses,

[1] Directive (E.U.) 2016/1164.

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the adoption of controlled foreign company (C.F.C.) rules, and adoption of certain standards for arm's length transfer pricing rules including the need for specific documentation.

In 2017, the supplementary Directive A.T.A.D. II[2] was adopted with an implementation deadline of December 31, 2019. It contains further regulations, particularly to combat hybrid structures that can lead to double deductions of operating expenses and hybrid mismatch rules.

Pillar I and II

Pillar I, a global tax reform initiated by the O.E.C.D. in 2021, aims primarily at reallocating taxation rights between states. The focus is on multinational companies with revenue of at least €20 billion and a profit margin of greater than 10%. Profits of multinational companies principally in the digital sector are to be allocated to market states where revenues are generated rather than the place of residence of the company.

Pillar II, also published by the O.E.C.D. in 2021, proposes the adoption of a global minimum level of taxation for multinational enterprise groups. Central to this is the introduction of a global minimum tax of 15% for multinational companies with consolidated revenues exceeding €750 million. It led to E.U. Directive 2022/2523.

Recent Tax Legislation in Germany

Tax Avoidance Prevention Act (StUmgBG)

The Tax Avoidance Prevention Act (*StUmgBG*) was passed on June 23, 2017. It was enacted in response to the publication of the Panama Papers in 2016, illustrating tax avoidance through the widespread use of shell companies and letterbox companies. The act aims to combat tax avoidance more effectively and encompasses several key measures:

- **Increased Transparency:** Financial institutions are obligated to collect and provide comprehensive information about account holders, beneficial owners, and authorized persons. Controlling business relationships of domestic taxpayers with partnerships, corporations, associations, or assets located or managed in states or territories that are not members of the E.U. or the European Free Trade Association (the "E.T.A.") are to be made transparent.
- **Extended Cooperation Obligations:** Both taxpayers and third parties, such as banks, must actively contribute to clarifying tax matters such as by disclosing comprehensive documents.
- **Investigation Powers for Tax Authorities:** The authorities are given extended capabilities for investigating and uncovering tax avoidance. The associated discovery and prosecution risk is intended to have a deterrent effect.
- **Adjustments to the Fiscal Code:** Limitation periods for tax assessments are extended, and specific regulations are introduced regarding information and reporting obligations for international matters, in particular regarding relationships with third countries.

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[2] Directive (E.U.) 2017/952.

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Tax Haven Defense Act (StAbwG)

In 2021, the Act to Combat Tax Avoidance and Unfair Tax Competition (so-called Tax Haven Defense Act (*StAbwG*)) replaced the Tax Avoidance Prevention Act. It was embellished by an application letter from the Federal Ministry of Finance dated June 14, 2024. An official, nonbinding English translation of the Act is available on the website of the Federal Ministry of Finance. This demonstrates that the tax administration is serious and shows its willingness to enforce regulations concerning structures involving tax havens in the service of tax justice.

The aim of this Act is to make business relationships or shareholdings of taxpayers with noncooperative states – an administrative euphemism for the old school term "tax havens" – economically unattractive, regardless of the taxpayer's motive. Noncooperative states are particularly those that are nontransparent in tax matters, engage in unfair tax competition, or do not meet the E.U.'s B.E.P.S. minimum standards.

The Act also covers contractual relationships and processes based on cooperation arrangements, even if the parties are not related. Moreover, the *StAbwG* does not provide the possibility of an exemption. This gains even more importance when a country is on the E.U. blacklist. Specific measures apply to curb tax avoidance practices in the context of those countries. The E.U. blacklist is updated twice each year. In December 2023, the Russian Federation was added to the E.U. blacklist. The next revision is planned for February 2025.

This step is intended to create legal certainty in the form of a uniform approach by the tax administration to tax havens and to prevent the tax administration from establishing differing definitions of the term "tax haven" in the course of practice.

Measures adopted in the Act include the following:

- Disallowance of Business Expense Deductions[3]
- Enhanced C.F.C. Rules, especially concerning intermediate companies domiciled in tax havens[4]
- Withholding Tax Measures concerning certain types of income (refer to the E.U. Code of Conduct from 2019) by extending limited tax liability and the obligation to withhold taxes[5]
- Measures on Profit Distributions and Share Disposals, such as denying exemption provisions under national law and tax treaties and corresponding sanction norms for individuals[6]
- Increased Cooperation Obligations in business relationships with tax havens[7]

The application of the *StAbwG* is not restricted by income tax treaties. The law specifically overrides treaty obligations to ensure that national measures take

[3] Sec. 8 *StAbwG*.

[4] Sec. 9 *StAbwG*.

[5] Sec. 10 *StAbwG*.

[6] Sec. 11 *StAbwG*.

[7] Sec. 12 *StAbwG*.

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precedence. Thus, German taxation rights are not altered by income tax treaties with noncooperative tax jurisdictions. Allocation rules of taxation rights are overridden so that the tax credit of foreign taxes against German tax follows general German principles, with the consequence that the taxpayer faces the risk of double taxation.

The inclusion of the Russian Federation in the *StAbwG*, which is effective as of 2024, increases the practical relevance of these regulations. When only national law applies, economic double taxation cannot be avoided through a primary adjustment under Paragraph 2 of Article 9 of the O.E.C.D. Multilateral Agreement or through a mutual agreement procedure under Art. 25 of the O.E.C.D. Multilateral Agreement.

Moreover, national law on the crediting of foreign income taxes does not provide a remedy, either. Avoiding double taxation can be achieved, if at all, only through equitable measures by the tax administration. In practice, such measures will not likely provide relief due to the purpose of the *StAbwG*, which is to discourage transaction with noncooperative countries.

Particularly, the regulations on enhanced C.F.C. taxation pose significant challenges for taxpayers in add-back cases involving complex foreign corporate structures. In the context of an acquisition of a foreign corporation according to the German legal type comparison rules, the due diligence team must take into account the effect of the *StAbwG* during the examination of the foreign target that itself and/or its lower-tier subsidiaries could be based in noncooperative jurisdictions.

"Avoiding double taxation can be achieved, if at all, only through equitable measures by the tax administration."

Anti-Treaty Shopping Regulation[8]

This highly controversial anti-abuse provision (the "Anti-Treaty Shopping Regulation") is intended to combat the abuse of income tax treaties and E.U. directives through targeted arrangements. It has been the subject of preliminary ruling procedures before the European Court of Justice (the "E.C.J.") multiple times and was found to be contrary to E.U. law on two separate occasions. The law was adjusted each time to address the identified violation in a minimalist way. The regulation establishes a steep hurdle that must be overcome when claiming treaty benefits in an arrangement that uses intermediate foreign holding companies. The intent is to ensure that the use of the intermediary company does not constitute a purely artificial arrangement to "unjustifiably" obtain a tax advantage. Consequently, taxpayers planning to make an investment through one or more foreign holding companies must take the regulation into account. While it is highly controversial in terms of E.U. law, it remains valid and applicable under German law.

Controlled Foreign Company Taxation and Exit Taxation

The Foreign Tax Act ("*AStG*") addresses exit taxation[9] and C.F.C. taxation.[10] It has existed since 1972 and was last revised following the A.T.A.D. Directives. Its aim is to secure the German tax base. It is intended to prevent a German tax resident subject to German tax on worldwide income from (i) shifting tax residence abroad or (ii) shifting income into foreign companies with lower tax rates. In the former event, emigration from Germany is treated as a taxable event. In the latter case, the passive income of a C.F.C. is attributed to German resident shareholders.

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8 Sec. 50d III Income Tax Act ("I.T.A.")

9 Sec. 6 *AStG*.

10 Sec. 7 *et seq. AStG.*

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For the exit tax to apply, the emigrating German resident must own at least 1% in a domestic or foreign corporation or cooperative that is held in a private capacity. In addition, the emigrating German resident must have been subject to tax on worldwide income in Germany for at least seven years within the most recent 12-year period.

The termination of tax residence is equivalent to the gratuitous transfer of shareholdings in all corporations to a recipient that is not subject to worldwide tax in Germany. In addition, exit tax applies if Germany's right to tax gains from share disposals is excluded or limited in any other way. Overall, the exit tax is intended to ensure that built-in reserves in corporate shareholdings that have arisen during the period of tax residence in Germany are actually taxed prior to the time the taxpayer or the assets leave the country.

In the past 12-months two developments have taken place. First, the Federal Ministry of Finance published an extensive circular with the intent of achieving a uniform application of the law. The second is a legislative proposal to extend the exit tax to shareholdings in certain investment funds.

SELECTED PRACTICAL EXPERIENCE

Recent experience regarding German domestic and international tax issues in the examination of a family business, a family office, or a wealthy private individual is that in many instances material issues arising in a tax examination did not exist or were not known or not spotted at the time the investment was made. Additionally, points of contention seem to multiply and intensify as the tax audit proceeds. Taxpayers and their advisors must demonstrate high expertise, sound judgment, and effective communication. In an advisory practice, situations often arise that require an administrative appeal, legal action, and in some cases, a readiness to defend against criminal charges.

More Aggressive Tax Examinations

Certain tax examiners adopt an overly aggressive approach. They can be described as following a path that calls for "shooting first and asking questions later." Unfortunately, we increasingly observe in daily advisory practice that the tone in complex tax audits is becoming harsher. For example, high additional assessments are often proposed in the area of transfer pricing and C.F.C. taxation with little justification other than vague assertions of economic substance. Legal appeals and lawsuits to address the assertions can be quite lengthy and uncertain, and pose considerable risks.

The problem is compounded when criminal tax proceedings are threatened or actually initiated in circumstances that previously amounted to differences of opinion as to the law or facts. In part, the tax examiner who conducts the examination is also the responsible person to assess whether objective indications of criminal tax behavior exists. Often, the tax examiner is not trained in criminal law and is also not responsible for the criminal assessment of facts. The easy way out for the tax examiner is to make a report to the criminal matters unit. The criminal matters unit, in turn, is hampered by having to assess complex facts in a very short period of time and may have limited tax expertise. The easiest path forward is to assume criminal intent and move forward with the prosecution. Aggravating this onward movement to

a criminal prosecution is the fact that taxpayers sometimes do not get an opportunity to comment, often based on a reluctance by the tax examiner or the criminal matters unit to "tip his hand." In case of doubt, the criminal matters unit will initiate criminal proceedings, if only to generate a case file.

In such cases, effective professional advice is essential, as tax criminal charges can have significant repercussions. The advisor should maintain regular contact with the tax authority's contact person. If the advisor encounters a breakdown in communication with the tax examiner, it may mean that the tax examiner is already speaking with the criminal matters unit. If such critical points are reached and the criminal matters unit or even the tax investigation department is involved, the taxpayer has no choice but to obtain legal support in criminal tax matters. A professional defense by tax and criminal law experts can defuse the conflict and lead to a constructive solution. Not infrequently, a criminal aftermath can be avoided. In other circumstances, the path to court is unavoidable. Due to (i) various tightening of substantive tax law and criminal law, (ii) the push to criminalize reasonable differences of opinion, (iii) related administrative instructions for tax authorities regarding stricter sentencing, (iv) extension of the statute of limitations, (v) notifications to other authorities, and (vi) triggering of non-tax consequences, experienced advisors should be brought on board.

The Search for Tax Residency

There is a noticeable trend that tax administrations are increasingly searching for tax points of contact that could establish Germany's taxation right, especially when it comes to taxpayers resident abroad with income sources related to Germany or assets located in Germany, particularly real estate.

A tax residency or an habitual abode in Germany can lead to the assertion of German tax on worldwide income, or in inheritance and gift cases, the assertion of German inheritance and gift taxes on the entire estate or the entire gift.

From the perspective of the German tax administration, a taxpayer can have multiple residencies at home and abroad, and the requirements for a tax residency in Germany are relatively low. Therefore, in the case of stays in Germany that go beyond mere business trips or short leisure stays with hotel accommodations, special caution is advised.

Taxpayers who were once resident, but who have moved away from Germany often believe they no longer are tax resident in Germany. Especially in seemingly clear cases, where only a holiday apartment or an otherwise vacant inherited property exists in Germany, the tax situation often looks different from the view of German tax authorities. The tax authorities can now rely on various instruments for fact finding, such as observing and searching properties, obtaining witness statements, evaluating bank statements, searching the internet including social media platforms, and including entries from registration authorities and the Federal Financial Supervisory Authority.

Additionally, inheritance and gift tax laws provide that an inheritance tax residency can be maintained even after moving away for German nationals who give up their residence in Germany but have not yet stayed permanently abroad for more than five years, or for those living in the USA, ten years. Regulations in the *AStG* extend such five-year period of subsequent extended limited tax liability under certain

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circumstances to up to ten years. If taxpayers receive wages from a domestic public fund (such as embassy staff, civil servants, etc.), this can result in an inheritance tax residency that includes family members with German citizenship living in the same household.

Germany currently has agreements to avoid double taxation in inheritance and gift taxes with only six countries. They are Denmark, France, Greece, Sweden, Switzerland, and the USA.

Under German law, inheritance or gift tax does not become statute-barred before the tax administration becomes aware of the taxable event. This complicates the possibility of a voluntary self-disclosure to avoid punishment.

Exit Tax on Shares in Corporations

Wealthy private individuals are regularly affected by exit taxation in emigration plans or plans on restructuring measures and asset transfers. Frequently, directly or indirectly held shares in (i) domestic or foreign corporations or (ii) cooperatives with high built-in reserves are part of the investment portfolio. Consequently, the German tax administration places a special focus on exit scenarios, as this is the last opportunity for the German state to tax the hidden reserves before the taxpayer or the assets leave the country.

Participations in asset-managing partnerships that do not hold shares in corporations are currently not covered by the exit taxation provisions. The same applies to assets such as real estate, bank accounts, or objects of art. However, for real estate located in Germany, a limited tax liability will continue to exist in Germany in most cases.

"Germany currently has agreements to avoid double taxation in inheritance and gift taxes with only six countries."

As the taxable sale of shares in an exit tax event is hypothetical, taxpayers face significant tax burdens without a commensurate inflow of cash from an actual sale. In a sense, the deemed sale represents "dry income," the opposite of a "liquidity event." For large assets, this can easily lead to financial bottlenecks and necessitate unplanned asset sales to obtain liquidity to settle taxes due. Even if double taxation agreements exist between the relevant states in exit cases, they usually do not mitigate the effects of German exit taxation. If significant uncertainties or risks remain when analyzing the planned circumstances, consideration should be given to applying for a binding ruling from the tax administration prior to implementation. This can provide increased security, although not in short-term projects, as an application for a binding ruling involves additional preparation effort and typically a long processing time by the chronically overloaded tax offices, often six months or longer.

While the burden of exit taxation can be mitigated by returning to Germany within seven years after ending worldwide tax liability or by applying for deferral of the tax due with installment payments against security, these exceptions are subject to strict conditions, restrictions, and ongoing cooperation and notification obligations. If, for example, deferral of the exit tax is utilized, share transfers or profit distributions may no longer be possible or only possible in a very limited way without violating the deferral regulations. Violations may result in the acceleration of the tax payment due date potentially with interest on the deferred payment, so a planned approach is advisable.

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Beyond planned restructuring and transfer processes or relocations of residence abroad, the issue of exit taxation can suddenly and unexpectedly arise in unforeseeable deaths of family members, for example, when a beneficiary living abroad inherits shares in one or more corporations. Share transfers through gifts and in the context of business successions should also be analyzed concerning exit taxation prior to implementation. Since inheritance situations can arise suddenly to younger people as well as older people, prudence suggests that estate, corporate, and tax law precautions should be taken not only in the context of exit taxation in cross-border fact patterns, but also in purely domestic cases.

Exit Tax on Membership Interests in Certain Partnerships

Under German tax law, asset-managing or commercially active partnerships are generally considered fiscally transparent for tax purposes, unless the option to be taxed as a corporation has been chosen. In addition, asset-managing partnerships are deemed to be commercially active for tax purposes under certain conditions. Partnership income is attributed to the partners for income tax purposes. The partnership itself owes the tax for trade tax purposes, *i.e.*, in cases where the partnership operates commercially or is deemed to be commercially active.

Against this background, the relocation of a wealthy private individual who is involved in a family limited partnership to another country can cause his or her share of the assets to be viewed as if they also moved abroad. In case of an asset-managing partnership, an Exit tax could apply if the partnership holds shares in a corporation (see last chapter above). In case of a commercially active or deemed commercially active partnership, the hidden reserves in the assets that migrate abroad might be subject to trade tax (economically burdening all limited partners), resulting in shifts between the partners. Additionally, there is an income tax burden regarding the share of the emigrating partner, which can be considerable.

The tax administration is often reluctant to secure the position of the emigrating partner within the framework of a so-called binding ruling during the planning of an exit. The binding ruling serves in German tax law to coordinate the tax effect of not yet realized situations in advance. In recent years, the willingness of the tax administration to provide such security has significantly decreased, and the emigrating partner is often exposed to considerable tax risks. Moreover, during tax audits of partnerships, data on partners who have moved abroad are explicitly requested, and discussions about unpaid tax liabilities are initiated, which can, in the worst case, lead to criminal proceedings.

Inbound/Outbound Taxation of Corporations – Arrival/Departure of a Managing Director

Often, wealthy private individuals residing outside Germany hold positions as managing directors of corporations. The arrival of a managing director to Germany can result in a relocation of the place of effective management of a non-German entity. This can lead to a foreign corporation or an L.L.C., which is often treated as a corporation, becoming tax resident in Germany from a German perspective. This entails declarations and tax obligations regarding the worldwide income of the company. Since these cases are often only discovered after their realization, they lead to an after-the-fact self-disclosure made by professional advisors in order for the managing director to avoid criminal consequences. This is often quite elaborate, as tax offices insist on evaluating the bookkeeping from a German income and tax

perspective, and the period covered by the disclosure can extend back for up to 13 years. Therefore, the self-disclosure must be prepared very carefully and conscientiously by advisors specializing in this area.

Conversely, the departure of a managing director can lead to a corresponding tax residency abroad for a German corporation, resulting in dual tax residency. Since it is usually unclear which state has which taxation rights, situations of double taxation are frequent. In this context, some corporations immediately consider seeking resolution under an Income tax treaty. Regrettably, we often observe that the German tax administration is aware that a Mutual Agreement Procedure under an income tax treaty is expensive and lengthy, and many taxpayers ultimately avoid these procedures. Consequently, the German tax administration rarely moves away from double taxation.

C.F.C. Taxation

C.F.C. taxation under the provisions of the *AStG* poses a significant challenge for many internationally active wealthy private individuals for various reasons. The scope of C.F.C. taxation is not always known to the personal tax advisor. The effect of C.F.C. taxation can be immense and completely incomprehensible to a taxpayer. We often see cases of cross-border investments in which the C.F.C. taxation could be applicable. However, the investor often does not receive sufficient information about the investment vehicles from the provider of the investment, even though he is subject to increased obligations to cooperate and provide evidence under German tax law. The result is that the attribution of income under German C.F.C. rules to a German resident individual first becomes visible after many years have passed. Moreover, the requirements to prove that a foreign company pursues a significant economic activity in its state of residence using adequate *substance*, *i.e.*, material and personnel resources, and thus is not an intermediate company in the sense of C.F.C. taxation are significant and the process is complex. In practice, a careful analysis of the participation structures and income sources of foreign companies from the perspective of C.F.C. taxation is essential. Regardless, it should be noted that in some structures, the necessary information cannot be provided because many investors do not have the same requirements for information provision.

Crypto Assets in Focus

Recently, digital assets, especially cryptocurrencies, have come into the focus of tax authorities. Blockchain transactions can constitute taxable private sales transactions since cryptocurrencies are considered other assets. This is based on a letter from the Federal Ministry of Finance issued in 2022, which assumes the taxability of such transactions, despite the fact that there has been a structural enforcement deficit and constitutional concerns for some time. It remains questionable whether a blockchain entry would have to convey specific, economically relevant rights or claims to qualify as an asset, as a blockchain entry often consists only of a combination of numbers and letters without real equivalent value. It is also doubtful to what extent cryptocurrencies represent property or contractual positions, as they lack physical substance and often lack a contractual basis. The absence of clear and specific legal frameworks leaves many questions about cryptocurrencies unresolved. The tax treatment of cryptocurrencies is based on a legal interpretation that predate the introduction of Bitcoin.

Regarding the tax administrative procedure, taxpayers are obliged to fulfill their duty to cooperate by fully and truthfully disclosing crypto transactions. For tax documentation, taxpayers are often dependent on transaction histories from trading platforms or tracking programs. This can raise practical difficulties in fulfilling the extended cooperation obligations, especially when using foreign trading platforms regarding contact persons or data accessibility. Investments in the cryptocurrency sector should be made with the understanding of the difficulty that may be encountered in providing information at a level that is satisfactory for tax purposes. In practice, the tax administration often resorts to estimates that are favorable to it.

Intensified Examination of Conduit Companies and Meander Structures

Against the backdrop that the German government has twice adjusted the anti-abuse provision of Sec. 50d Paragraph 3 ITA of Anti-Treaty/Directive Shopping Regulation) after it was twice declared contrary to E.U. law by the E.C.J., the future direction is clear. The government aim is to continue to proceed against tax-driven behavior that involves setting up purely artificial constructions devoid of any economic reality for the purpose of unjustly obtaining a tax advantage. While taxpayers have opportunities to provide counter-evidence, namely that the foreign intermediate company itself is economically active and not merely a conduit company for passing on income, the provision continues to presume abuse, and the hurdles for counter-evidence remain high.

Applications for Refund of Withholding Tax by Foreign Recipients

When foreign residents apply for refunds of withholding tax, two hurdles must be overcome before refunds are issued. The first hurdle is substantive: The individual must be entitled to a refund under national law and treaty law, if the case may be. The second is the lengthy processing times for such refund applications by the Federal Central Tax Office ("*BZSt*"). For several years, the processing time for refund applications has been over 20 months, with little prospect of improvement. Filers of tax refund claims should consider short-term and long-term liquidity planning, as a quick refund of excessively withheld withholding tax cannot be expected.

Cross-Border Group Financing

A topic that the tax administration has been addressing more systematically recently is cross-border financing relationships, especially group financing. Tax audits often result in a limited allowable interest deduction for cross-border loans. This does not only concern loan relationships with lenders from tax havens. To illustrate, assume the acquisition of German real estate by a real estate company that aims to hold and profitably manage the properties. It is financed by a foreign parent or sister company with loans. Almost universally, the tax administration will contend that the interest rate on the loans exceeds an arm's length rate of interest. The intent is to create a negotiating position against the taxpayer. Additionally, discussions will revolve around prohibiting the deduction of interest expenses based on arguments related to the interest barrier rule, taxation inconsistencies, and lack of substance.

Here, it's essential to point out the risks to the taxpayer when setting up the financing structure and to refute allegations of violating the arm's length principle. Arguments range from recent case law of the Federal Fiscal Court on group financing, to examples of market situations, to economic influencing factors, and to reasoned transfer pricing studies.

CONCLUDING REMARKS

The increasing regulatory density in tax law through national and international anti-abuse provisions like the *StUmgBG* or the *AStG* make continuous monitoring of these regulations an indispensable routine in analyzing investment decisions and corporate transactions having a German nexus.

Existing legal uncertainty reinforces the need to focus on tax compliance and adjustment prevention in strategic planning. Wealthy private individuals and their advisors should analyze relevant regulations early to minimize tax risks while creating viable contractual structures. Even if residual risks cannot be completely avoided, this often aligns with the government's intention to deter aggressive tax planning models through these uncertainties.

Especially in international matters, early involvement of specialized legal and tax advisors is essential. Advisers should be chosen based on expertise and experience in practical dealings with tax authorities and criminal matters units. Professional advice is crucial to avoid errors in fundamental provisions on tax residency or the application of special legal regulations.

Failure to correctly apply tax provisions entails significant risks, both civil and criminal. Systematic examination by tax authorities conducting external audits and assessment procedures in the context of international investment and holding structures should be anticipated.

A forward-looking, strategically sound approach combined with advice from seasoned professionals will be a key to successfully mastering the challenges of the modern tax landscape.

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THE B.V.I., CAYMAN ISLANDS, AND BERMUDA – CURRENT PRACTICE, ENFORCEMENT, AND EMERGING TRENDS

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Beneficial Ownership
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C.I.G.A.
Economic Substance
T.I.E.A.

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INTRODUCTION

This article surveys selected recent developments in regulatory and tax-related law and practice in the British Virgin Islands ("B.V.I."), Cayman Islands and Bermuda that are relevant to end-clients, advisors and intermediaries.

OVERVIEW

The three leading Caribbean international financial centers – namely, Bermuda and the B.V.I. and Cayman Islands (together, the "I.F.C.'s") – are members of the Caribbean Financial Action Task Force (C.F.T.F.) and have consistently implemented O.E.C.D. initiatives and similar E.U. requirements. As such, these I.F.C.'s participate in C.F.T.F. and O.E.C.D. peer review and monitoring and continue to develop their legal systems and enforcement mechanisms to reflect international best practices.

As mentioned in the introductory remarks to this edition of *Insights*, the past decade has seen significant changes in law and regulatory enforcement across the I.F.C.'s. The implementation and periodic review timetables are largely set by the international standards setters. The pace of change does not show any signs of slowing.

The main emphasis is on information exchange and transparency. Prior to the adoption of Bermuda's domestic minimum tax from 2025 onwards on certain constituent entities in large M.N.E. groups (broadly, groups with annual consolidated revenues of €750 million or more) in response to O.E.C.D. Pillar 2, which is beyond the scope of this article, these I.F.C.'s were largely "tax neutral" and did not impose any corporate income or similar taxes on companies. This article also does not consider O.E.C.D. Country-by-Country Reporting ("C-b-C Reporting"), as that is again limited to large M.N.E. groups, which do not account for a very significant proportion of the corporate registry in the I.F.C.'s, when measured by number.

None of the regimes discussed below are taxing regimes, as such. Rather, they are concerned with information exchange and increased transparency or, in the case of the economic substance requirements, a *sui generis* compliance and reporting regime for no-tax or nominal-tax jurisdictions" ("N.T.J.'s"). The goal is to ensure a level playing field regarding tax competition, as perceived by the E.U. or O.E.C.D., in order to avoid tax results that are harmful to the interest of member states.

For the ultimate client, its advisors, and intermediaries, keeping abreast of regulatory changes is essential to ensure that entities remain compliant and prepared for regulatory inspection. Although many of the compliance regimes are not new, revisiting them is important as we are seeing or anticipating increased investigation

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and enforcement action in these areas. It is not uncommon to find that entities have misunderstood their classification, or the level of compliance and reporting requirements, only to discover this when an inquiry or notice is received from the regulator.

This article surveys some common themes and key developments across the I.F.C.'s, particularly regarding

- beneficial ownership transparency initiatives,
- C.R.S./F.A.T.C.A. and the Crypto Asset Reporting Framework ("C.A.R.F."),
- economic substance requirements,
- tax information requests, and
- general trends in investigation and enforcement action in relation to these areas.

As well as current market trends and future regulatory trajectories, we will consider some key practical points to consider for advisors or other persons responsible for ensuring ongoing compliance.

This is a high-level survey rather than a detailed comparison. There are important differences between the laws of the three jurisdictions. For simplicity, this article deals in general terms, and except where otherwise stated, focuses on companies limited by shares, since that is the most popular form of corporate entity in each I.F.C. jurisdiction. Readers considering their specific obligations should seek appropriate advice from competent legal counsel.

BENEFICIAL OWNERSHIP TRANSPARENCY INITIATIVES

As readers will be familiar from similar developments in the E.U. (now under the 6th Anti-Money Laundering Directive) and U.S. (under the Corporate Transparency Act), there has been sustained focus by governments and international organizations on beneficial ownership ("B.O.") information on a global basis and what are loosely described as public beneficial ownership registers ("P.B.O.R.'s").

All three I.F.C.'s already has in place robust regulatory regimes requiring covered entities to keep records of their B.O.'s and provide information confidentially under their respective domestic anti-money laundering or B.O. reporting regimes. An example is the Beneficial Ownership Secure Search ("B.O.S.S") database in the B.V.I., which has been widely praised by regulatory officials working in financial investigation units.

Very broadly, the I.F.C.'s previously committed only to the introduction of P.B.O.R.'s once adopted as the international standard. That commitment was made in response to evolving standards and the I.F.C.'s' relationship with the U.K. In particular, it responded to a draft Order in Council published by the U.K. Secretary of State to comply with a requirement under the U.K.'s Sanctions and Anti-Money Laundering Act 2018. On November 22, 2022, the European Court of Justice issued a key

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judgment declaring that public access to B.O. information in Luxembourg (and other E.U. member states) was a disproportionate interference with the rights guaranteed by the E.U. Charter of Fundamental Rights. Given that judgment and data protection concerns, it is expected that the I.F.C.'s and other U.K. Crown Dependencies will allow access to B.O. information only to competent law enforcement authorities and to those members of the public who can demonstrate a legitimate interest in the information. The I.F.C.'s have subsequently undertaken various formal and informal consultations and discussions regarding P.B.O.R.'s, including with the U.K.

At the time of writing, which was just around the time of the U.K. Overseas Territories Joint Ministerial Conference ("J.M.C.") in November 2024, this area remains in flux, particularly with regard to (i) the right of access to members of the public having a legitimate interest and (ii) the scope of appropriate protections for B.O.'s or at-risk persons. In the B.V.I., a framework regime has been introduced via amendments to the B.V.I. Business Companies Act to require companies to keep and maintain prescribed B.O. information and report it to the B.V.I. Registrar of Companies. It is expected that the detail of the regime – and any provisions dealing with P.B.O.R.'s – will be published in regulations.

"This is a fast-moving and technical area. It would be prudent taking advice early in 2025, after the law is settled and further guidance and regulations have been published."

Similar changes were adopted in the Cayman Islands in July 2024 via the Beneficial Ownership Transparency Act and related regulations and followed up by public consultation in October 2024. Bermuda has only recently launched a consultation process and has not yet implemented its precise framework, but responsibility for central B.O. registers will shift to the Registrar of Companies. A timeline for implementation is expected before the end of 2024. Further updates and public statements may be expected following the J.M.C.

This is a fast-moving and technical area. It would be prudent taking advice early in 2025, after the law is settled and further guidance and regulations have been published. It is expected that there will be transitional periods for pre-existing companies and that there will be mechanisms for B.O.'s to object to or restrict access rights in circumstances where there is a disproportionate risk of harm in the event of public access.

It would be prudent to ensure that ultimate beneficial owners of relevant entities are aware of the requirements. On a global basis, authorities have begun conducting more frequent audits of B.O. data to ensure compliance and accuracy. In practice, we find that market participants are now accustomed to B.O. identification and reporting requirements, although privacy and safety concerns remain a critical issue for a limited number of B.O.'s.

ECONOMIC SUBSTANCE ("E.S.")

The B.V.I.'s E.S. requirements implementing Action 5 of the B.E.P.S. action and equivalent E.U. criteria were introduced in the author's previous article for *Insights*.[1] Similar requirements were also introduced in 2019 in Bermuda, the Cayman Islands, and the other nine N.T.J.'s.

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[1] "British Virgin Islands Economic Substance Requirements," Volume 10 No 5 *Insights* p. 11.

Scope of E.S. Rules

Broadly, the E.S. laws apply to legal entities that are registered in the relevant I.F.C., including foreign registered entities, carrying on any of nine relevant activities or passively receiving relevant income or gains. Compliance is assessed over defined financial periods.

There is no requirement that such entities be tax resident, or deemed tax resident, in the relevant I.F.C. to be in scope, since none of the I.F.C.'s generally impose corporate income or other taxes on companies. However, there are exemptions from the E.S. requirements for entities qualifying as deemed nonresident. Broadly this is (i) an entity resident abroad, (ii) an entity that qualifies as tax "transparent" or (iii) an entity that is otherwise liable to corporate income tax on the relevant income, provided that the jurisdiction in which the status is claimed is not on Annex I of the E.U. list of non-cooperative jurisdiction for tax purposes.

There are broad exemptions for investment funds. The exemption does not extend to an entity engaged in fund management business, which is a relevant activity. There is also a simplified E.S. compliance requirement for pure equity holding entities ("P.E.H.E.'s"). A P.E.H.E. is an entity that only holds equity participations in other entities and only earns dividends and gains from those participations. This is a very narrow category of entity. Entities falling outside the narrow definition should consider the other eight relevant activity definitions, and whether they fall within any of them.

Requirements

Entities subject to E.S. requirements must meet the following requirements in order to be compliant:

- Direction and management must take place in the I.F.C.
- Core income generating activity ("C.I.G.A.") must be undertaken in the I.F.C.
- Adequate employees, operating expenditures and physical premises must be situated or be incurred in the I.F.C.
- Limitations on outsourcing of C.I.G.A., which importantly cannot be performed by another entity outside the I.F.C. must be followed

There is a further extremely onerous regime applicable to companies engaged in an intellectual property business. In particular, any special equipment used in the business must be physically located within the I.F.C. Certain legal presumptions of noncompliance exist, and enhanced penalties may be imposed for noncompliance where an entity fails to carry on qualifying C.I.G.A. within the I.F.C. or is a high risk intellectual property legal entity.

Effect of E.S. Rules

As a result, the I.F.C.'s have seen a discernible trend of intellectual property rights ("I.P.R.") being repatriated. In some instances, the I.P.R. has been moved to jurisdictions with a favorable regime for I.P.R. In other instances, activities that are dependent on personnel or premises outside the I.F.C. have been restructured, except

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where the entity is able to claim the nonresident exemption. This trend has been amplified by international tax changes aimed at traditional I.P.R. holding structures and the digital economy.

On the other hand, the practical impact has generally been more manageable for traditional private wealth structures such as (i) personal investment companies, (ii) trust and estate planning structures, (iii) transactional special purpose vehicles used in mergers and acquisitions or capital markets work, and (iv) investment funds. There has also been a significant growth of businesses providing professional outsourcing solutions to assist with E.S. requirements, although these should be carefully tailored to each relevant activity. A one-size-fits-all approach is discouraged.

Even if entities do not carry on any relevant activity, an E.S. notification or report is required. Note, there are some important technical differences between the I.F.C.'s in the format and manner of reporting. In the early years, limited guidance existed, and inevitably, some variations existed in the interpretation of certain defined terms. That was not surprising as no precedent existed under domestic law or common law. Each I.F.C. has published and updated detailed guidance notes to assist with understanding the compliance obligations. Changes to guidance notes should be monitored. It is expected that improvements and modifications to the B.V.I.'s E.S. reporting system will take place during 2025.

We have also seen a significant increase in the number of investigations and enforcement actions by the competent authorities in each I.F.C. in relation to E.S. Typically, this may take the form of a formal information request followed by further enforcement action in cases where the authority determines non-compliance.

Path Forward

In practical terms, we recommend that entities maintain proper records and take steps to ensure they remain on top of any compliance obligations and the reporting deadlines. The impact of any proposed changes to the entity's financial position or tax status should be assessed in advance, as compliance obligations may change considerably partway through a financial period.

Individuals completing reports should ensure they fully understand the regime and the civil and criminal penalties that may arise for insufficient information or late filing. Management must understand that spontaneous information exchanges may occur with overseas tax authorities under the E.S. regime. It may be prudent to revisit historic classifications or reports if there is any uncertainty whether the position taken initially was correct or whether facts may have changed.

Penalties for breaches or regulatory enforcement may also have a knock-on impact on commercial arrangements, such as contractual representations, which may not be governed by the law of the I.F.C. To illustrate, if a company is not compliant for E.S. purposes because it is not directed and managed in the I.F.C., that information may be exchanged with tax authorities of the country where a B.O. resides. In turn, this could trigger tax issues for the B.O. in its country of residence.

Entities should also ensure that the position presented in their E.S. reporting is consistent with other data reported, such as annual returns. The B.V.I. introduced annual return requirement for most B.V.I. companies commencing with 2023 onward.

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Looking ahead, the proper interaction between E.S. and Pillar 2 may present some interesting questions for multinational groups with revenues at or above the €750 million threshold. This is a topic for discussion between the standards setters. Under the current rules, any responses require analysis that is extremely fact-specific and technical. Coordination between specialist E.S. and tax advisors in each relevant jurisdiction is imperative.

"Looking ahead, the proper interaction between E.S. and Pillar 2 may present some interesting questions for multinational groups with revenues at or above the €750 million threshold."

F.A.T.C.A., C.R.S. AND THE C.A.R.F.

F.A.T.C.A. and C.R.S. Reporting

All three I.F.C.'s have established frameworks to require domestic financial institutions to comply with U.S. F.A.T.C.A. and the similar O.E.C.D. C.R.S. requirements. In addition to the legislative requirements, the competent authorities in each jurisdiction have published and updated extensive domestic guidance notes that must be considered along with the Treasury Regulations under F.A.T.C.A. or the O.E.C.D. guidance and implementation handbook for C.R.S.

Again, we are seeing increased investigation and enforcement actions in relation C.R.S. and F.A.T.C.A. Local authorities have strengthened their enforcement actions and compliance checks pursuant to data audits. There is an increased focus on risk-based reviews, particularly targeting sectors with increased potential for non-compliance or shortfalls in reporting. In practice, it is the investment entity category that raised most queries, many going beyond the usual technical questions regarding financial account identification and due diligence ("D.D.") procedures.

We are seeing reporting financial institutions ("R.F.I.'s") increasingly turn to specialized compliance services providers to ensure timely and accurate reporting. Outsourcing does not allow R.F.I.'s to shift their compliance obligations or potential liability for breach, so providers should be carefully selected. R.F.I.'s are also adopting data security technologies to meet reporting requirements and ensure safe transmission of sensitive information in compliance with data protection laws. As the C.R.S. and F.A.T.C.A. regimes have now been in place for nearly a decade, and with the recent growth of artificial intelligence tools, digital technology solutions will likely be used universally. Equally, the O.E.C.D. and other global tax authorities have enhanced the quality of data sharing in order to streamline cross-jurisdictional investigation and enforcement.

The C.A.R.F.

Continuing with the theme of new technologies, the C.R.S. was updated in March 2022 to cover digital assets, such as certain cryptocurrencies and related financial products. The updates brought certain providers within the scope of C.R.S., requiring them to conduct D.D. and report on financial accounts.

As a related development, the C.A.R.F. was proposed by the O.E.C.D. in October 2022. The C.A.R.F. outlines the scope of covered crypto assets, entities, and individuals subject to reporting and data collection requirements, transaction reporting criteria, D.D. procedures and relevant tax jurisdictions for exchange of information and reporting. Much like C.R.S., the C.A.R.F. will facilitate automatic exchanges of tax-related information among tax authorities in a manner aligned with the O.E.C.D. tax information exchange standards. The C.A.R.F. will focus on decentralized crypto

assets, including stablecoins, certain non-fungible tokens, derivatives and digital representations of value that rely on a secured distributed ledger technology.

The Cayman Islands has actively joined the group of 47 jurisdictions committed to implement the C.A.R.F. by 2027. The C.A.R.F. provides for the automatic exchange of tax-relevant information on crypto-assets between tax authorities and is part of the automatic tax information exchange standards developed by the O.E.C.D. under a G-20 mandate. Bermuda and B.V.I. have shown support for the C.A.R.F. but were not among the early adopters.

It is expected that any legislative adoption would likely follow a phased approach, as was the case with C.R.S. and F.A.T.C.A. Market participants, especially in fintech, may need to seek specialized guidance and services to navigate their C.A.R.F. compliance obligations in future. The I.F.C.'s' regulatory regimes for virtual asset service providers implementing the recommendations of the Financial Action Task Force ("F.A.T.F.") are beyond the scope of this article but should be considered in parallel.

In practical terms, entities and persons operating in the crypto-assets and virtual-assets space should continue to monitor regulatory developments and ensure that they are aware of any existing obligations under C.R.S. or F.A.T.C.A.

TAX INFORMATION EXCHANGE AND INFORMATION REQUESTS BY OVERSEAS AUTHORITIES

This article has largely focused on domestic compliance and reporting obligations. However, all three I.F.C.'s participate in numerous bilateral tax information exchange agreements ("T.I.E.A.'s") and participate (via extension from the U.K.) in the O.E.C.D.'s Multilateral Convention on Mutual Administrative Assistance in Tax Matters (the "Multilateral Convention"), facilitating exchanges of tax information on request. There are nearly 150 jurisdictions participating in the Multilateral Convention.

Whereas the regimes summarized above require reporting of data that, in practice, may be of limited interest to anyone, the two on-request regimes under the Multilateral Convention or T.I.E.A.'s usually relate to in-depth investigations into the affairs of specific taxpayers and their offshore holding entities. This may occur where there is a data leak involving the I.F.C. It may also occur in situations where there is a contentious tax controversy or investigation taking place in an onshore jurisdiction.

Authorities globally are reporting an uptick in information requests under T.I.E.A.'s, especially concerning high-net-worth individuals and complex cross-border structures or transactions reported under disclosure regimes. As global regulatory and tax enforcement strengthens, this is expected to increase. The increase in cross-border investigations underscores the need to ensure that entities have robust records and are prepared for any enquiries.

In practice, entities or persons receiving an information request should ensure that they understand their legal obligations. In most cases, it will be advisable to retain a competent attorney who can advise under the attorney-client privilege. The assignment is to check that the request is valid and complies with legislative and procedural requirements and to consider any other relevant obligations, such as director responsibilities or other fiduciary duties that are subject to confidentiality obligations.

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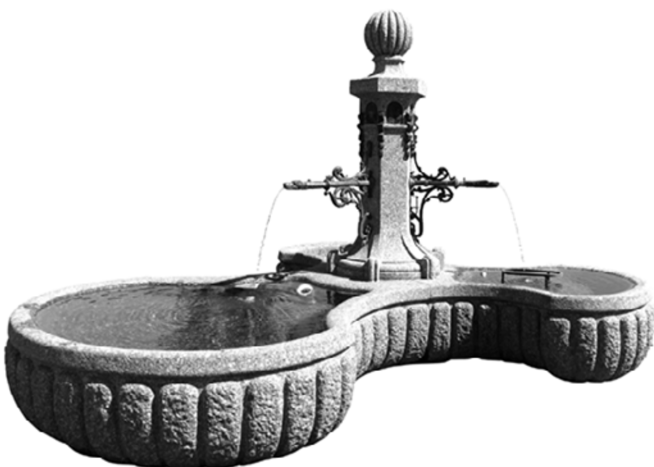
Many requirements are not set out in the E.S. legislation itself but instead apply under common law principles of procedural propriety. It is vital to consider the recipient's legal obligations. Failure to comply with those obligations, or divulging the existence or contents of a request can result in significant criminal liability. However, common law rules of fairness and due process do exist to guard against fishing expeditions and to ensure that the recipient of a request is able to determine the basis on which it has been issued and whether it is valid and in conformity with the legislative requirements.

CONCLUSION

The three leading Caribbean I.F.C.'s (B.V.I. and the Cayman Islands, and Bermuda) continue to attract international business and high-net-worth individuals due to their corporate advantages, including (i) flexible and modern company laws, (ii) efficiency of doing business, (ii) sophisticated financial services industries, (iv) robust court and other legal systems rooted in English and common law principles, and (v) generally "tax neutral" environments for cross-border inbound and outbound investment.

In line with international standards and trends, there has been a significant increase in regulatory and tax-related information exchange and transparency initiatives in the past decade or so. As domestic and overseas authorities continue to increase these requirements and exercise their investigative powers, it is important to ensure that structures remain compliant, fit-for-purpose and adequately prepared for any audits or investigations.



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