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INSIGHTS

2024: A YEAR IN REVIEW

A YEAR OF GUEST FEATURES

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EDITORS' NOTE

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

This year, 23 articles were written by 39 guest authors hailing from 13 countries.

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

Happy Holidays!

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Issue No. 5

Issue No. 6

SQUARE PEGS IN ROUND HOLES – YOU LIKE "TO-MAY-TO" AND I LIKE "TO-MAH-TO"[1]

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INTRODUCTION

In a post COVID19 world, anecdotal evidence suggests that sophisticated cross-border personal estate planning is back in vogue. There is increased incidence of individuals and families relocating to other jurisdictions. Equally, individuals have evidenced renewed vigor in acquiring and structuring assets across a range of jurisdictions. The reasons for this are myriad:

- A genuine desire to roam again following unprecedented travel restrictions.
- In some cases, the need for geographical diversification of assets.
- Geopolitical unrest and uncertainty of the highest degree.

People move. People invest internationally. Where individuals move around the world, or where assets are acquired in different countries, the cross-border tax and legal implications can be great but, in many cases, somewhat invisible at first sight.

This article provides a high-level overview of various issues that can arise, with a focus on cross-border tax. In real life, the analysis is inevitably highly fact-dependent as the technical outcome can vary dramatically between two similar cases with only slightly differentiated facts. But we believe that it is interesting to consider a range of points that should always be addressed in the context of a proposed change of residence, or cross-border asset acquisition, particularly with regard to real estate.

On occasion, there may be genuine opportunities to arbitrage the relevant tax systems, and achieve genuinely clean and clear tax mitigation. More often than not, however, it is more a question of avoiding the bear traps. This is due to significant differences between the tax regime in the new country and expectations based on tax residence in another country. What is common best practice planning in one country may be disastrous in the other, and vice versa.

As U.K. lawyers, we shall focus on particular U.K. issues that arise between the U.S. and the U.K., noting some key U.K. tax and succession concepts in passing. The general principles are, however, global in nature. Sometimes, tax errors can be corrected after the event – but more often than not, mistakes will have enduring consequences for clients.

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[1] "Let's Call the Whole Thing Off" (1937) George and Ira Gershwin.

GLOBAL MOBILITY AND CHANGE OF TAX RESIDENCE

An immediate point to note is that apparently familiar terms of art can have different technical meanings in different legal systems. This in itself can lead to inadvertent misanalysis of a client's position.

For the purposes of this article, we shall use the U.K. terms "tax residence" – a factual test of where an individual resides, based on a statutory multi-factor formula – and "domicile." Domicile is a notoriously complex and nuanced concept, based on a person's individual family history, as well as intentions for the future. It is a link to a particular jurisdiction, such as an individual state of the U.S., for example New York State and Florida. Within the U.K., England & Wales is a unitary jurisdiction. Scotland and Northern Ireland are separate.

Whether a person is U.K. tax resident is a key "gating" question. People who fail to recognize that they have exceeded the triggering point in a given tax year become resident in the U.K. notwithstanding any soft considerations such as intent. Nonresidents with regard to the U.K. generally are outside the scope of tax on U.K. income and capital gains, with a few limited exceptions. By contrast, U.K. residents generally are within the scope of U.K. income and capital gains taxes, and will likely need to file a tax return for the U.K. tax year, which runs from April 6th in one calendar year to April 5th in the next. Assessing a person's tax residence is essential. Residence impacts U.K. tax exposure in both the current and subsequent years. The consequences are wide-reaching, and for that reason, identifying the date a person becomes resident is key. It may be before a person is physically present in the U.K.

The starting point is that liability to income and capital gains tax is global. It can relate to a person's individual income and gains, as well as income and gains in trust and corporate structures to which they are connected. For that reason, global corporate structures need to be very carefully reviewed and understood. There are two important qualifications to global tax liability. First, being able to claim a domicile other than the U.K. Secondly, the potential impact of a double tax treaty.

Having (and, where necessary, formally claiming) nondomicile status is a powerful tool. When available, it limits the scope of tax to U.K. source income and gains, and any income or gains that are remitted to the U.K. "Remittance," here, is a broad concept that encompasses assets physically brought to the U.K. or otherwise enjoyed in the U.K. With careful planning, the use of "remittance basis taxation" can dramatically restrict a person's liability to U.K. tax. But there are points to watch.

Favorable remittance basis of taxation does not apply to certain assets such as cryptocurrencies and other cryptoassets, certain life insurance policies, and carried interest. It may also not apply to trading or employment income where any element of the trade or employment is carried on in the U.K. The source of income and the situs of assets is key, and in the U.K., the rules sometimes lead to counterintuitive results. For example, crypto assets and certain other assets such as debt instruments may be treated as U.K. situs if the owner is U.K. resident. This is H.M.R.C.'s current stated practice, but the position is controversial. The rules for debt instruments are different for purposes of capital gains tax and inheritance tax. It is not surprising that confusion can abound.

Being nondomiciled is also very significant for inheritance tax, which is the U.K.'s combined gift, estate, and trust wealth tax. A person who is not domiciled in the U.K. is within the scope of inheritance tax only on U.K. situs assets, which can include indirect interests in U.K. situs real estate. By contrast, a person who is domiciled in the U.K. is within the scope of inheritance tax on worldwide assets that are owned, potentially subject to treaty relief, as discussed further below.

Assessing a person's domicile status and monitoring that status on a year-by-year basis are essential. If a person becomes a British citizen, certain representations may conflict with the actual domicile position of the individual. Citizenship has other impacts, too, including the material scope of the U.K.-U.S. income and estate tax treaties.

In addition, a person becomes "deemed domiciled" in the U.K. once resident in 15 out of 20 tax years. This is a complicated area in itself – planning in advance of that date may be useful for some clients. After deemed domicile is established, an individual is fully in scope of all U.K. direct taxes, including worldwide inheritance tax. Even at that point, retaining a non-U.K. domicile as a matter of common law may still be important.

PARTICULAR TRAPS: TRUSTS, COMPANIES, CHARITIES, AND RELATED STRUCTURES

It is natural to focus on an immigrant's personal tax position. But a change of residence or just spending time in the U.K. can have a dramatic effect on global structures that may be owned directly or by trusts that have been established for the benefit of the immigrant and other persons.

A very clear preliminary point is that it is important for central management and control of foreign corporate (and like) structures be maintained outside the U.K. Failure to do so may result in an assertion of U.K. tax resident status for those companies, which will cause all relevant companies to become subject to U.K. corporation tax when the assertion cannot be rebutted. The risk is significant. Best practice is to carefully limit decision-making that occurs in the U.K. and to maintain substantial evidence of where decisions are made and who makes them.

Several risks arise when individuals are trustees of family trusts. A change of residence by the trustees as a body can cause a change in the residence status of the trust. A move to the U.K. by trustees can result in the establishment of U.K. tax residence. Worse, a subsequent change back to nonresident status of the trustees can result in a deemed sale of all trust assets at fair market value. Given that trusts are common tools in U.S. estate tax planning, any family trusts must be reviewed with care before a trustee move to the U.K.

Difficult questions of characterization may need to be answered.

- Is a foundation treated as a trust or a company?
- Who is properly taxed in connection with a *usufruct* arrangement?

- What is the U.K. tax characterization of (a) the rights of the holder of the bare legal title to the property and (b) the rights of the holder of the *usufruct* interest in the property?
- How might the U.K. residence of individuals affect the tax treatment of an underling group of companies?

What is a common structure in one jurisdiction may well not expressly be catered for in another. As a result, domestic concepts in the U.K. must be applied to foreign structures, which often is an exercise of fitting square pegs in round holes.

When placing those square pegs in round holes, the practice in the U.K. is to pay careful attention to the legal analysis of property rights, contractual arrangements, tax, and procedural questions in relevant foreign jurisdictions. This can be relevant for (i) characterizing corporate receipts as income or something else, (ii) determining whether a foreign entity is opaque or transparent, (iii) determining whether tax errors can be rectified, and (iv) identifying whether property transactions can be recharacterized retroactively, which the authors have seen successfully achieved in one case.

Another very real trap is that the same word may have a meaning that is different in two countries. To illustrate: just because something is a charity in the U.S. does not mean that it will be treated as charitable in the U.K. It may be exempt from taxation in one jurisdiction, but not the other. As a result, dual-registered charities must be structured with great care to ensure that exemptions are triggered in both jurisdictions. As Winston Churchill once said: the U.K. and the U.S. are separated by a common language.

In this context – and to the theme of "to-may-to / "to-mah-to" – estate planning using trusts may result in problems. Common trusts in U.S. tax planning can give rise to difficult U.K. tax and reporting obligations. An example involves the use of a revocable grantor trust. Depending on how the trust instrument is drafted, there may be an immediate tax consequence when the trustees move to the U.K. or subsequent tax consequences if the grantor dies or becomes incapacitated while in the U.K. Careful review and potential restructuring are always essential.

Care also needs to be taken in relation to U.S. L.L.C.'s holding assets that generate profits potentially within the scope of U.K. tax. H.M.R.C.'s starting point is that an L.L.C. is opaque, meaning that income is taxed at the level of the L.L.C. rather than the members. As a result, distributions are taxable as separate income of the members, with potential for double taxation and denial of treaty tax credits. This thorny issue was addressed in *Anson v. Commissioners for Her Majesty's Revenue and Customs*,[2] where the U.K.'s Supreme Court was prepared to accept that based on the particular drafting of the L.L.C. documents in that case, the L.L.C. should be regarded as transparent for U.K. tax purposes. But since H.M.R.C. does not accept this as the general position with respect to all L.L.C.'s, close attention should be paid when setting up such structures where a U.K. nexus is envisaged. It is understood that regulations issued by the I.R.S. may cause U.K. resident members of the L.L.C. to be subject to full 30% withholding tax in the U.S. on their respective shares of dividends, income, and royalties income received by the L.L.C.[3]

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2 [2015] U.K.SC 44.

3 Treas. Reg. §1.8945-1(d)(1).

TREATY RELIEF

A discussion of tax treaties covering (i) income and gains and (ii) estate taxes would require several articles to cover the rules. Sometimes treaties give rise to outcomes that are surprising, helpful, or both. But not always. This is particularly because the same economic item of income or gain may be taxed at different times by each treaty partner jurisdiction. Equally, the same item of income or gain may be assessed on one entity or person in one treaty partner jurisdiction, but on another entity or person in the other treaty partner jurisdiction. That is a particular problem because of the way the U.K. taxes settlors and beneficiaries of trusts, and owners and funders of companies. Relief will not always be available.

Regardless of whether a treaty can and should be invoked in a given case, ensuring correct filing of U.K. and U.S. accounts is essential, not least given that the tax years and filing deadlines are different, which can lead to cashflow challenges. And a change of residence may also affect internal and cross-border reporting regimes, such as F.A.T.C.A. and the common reporting standard. The U.K., itself, has recently expanded reporting in relation to trusts and companies, and is consulting on further new regimes.

"Structuring the ownership of real estate in a foreign jurisdiction is another arena in which mismatched legal and tax regimes often clash."

PLANNING FOR ASSETS

Structuring the ownership of real estate in a foreign jurisdiction is another arena in which mismatched legal and tax regimes often clash.

Classically, foreign owners of U.K. real property have utilized corporate structures, or in the case of U.S. purchasers, L.L.C.'s. Successive changes to the U.K. tax regime have generally made such structures unattractive compared to personal ownership (particularly for property intended for personal use as a second home) because of increased stamp duty land tax ("S.D.L.T.") and the annual tax on property held in corporate structures ("A.T.E.D."). And the U.K.'s recently introduced public register of foreign entities owning U.K. real property means that corporate structures no longer offer the level of confidentiality they once did.

However, for a person domiciled in the U.S., the U.K.-U.S. Estate Tax Treaty may still provide protection from inheritance tax for property held in corporations, which could justify the additional tax costs of S.D.L.T. and A.T.E.D., particularly in light of the relatively minimal tax-exempt amount for inheritance tax compared to the current amount of the Unified Tax Credit in the U.S. For U.S. families, debt structuring may also help to mitigate inheritance tax exposure. This must be assessed on a case-by-case basis.

Where trusts are involved, particular care is required to avoid difficulties arising from a mismatch between the U.K. and U.S. tax treatment of U.S. revocable grantor trusts noted earlier and succession issues that can arise in relation to U.K. real property because the U.K. does not recognize the concept of lifetime testamentary trusts.

NON-TAX CONSIDERATIONS

Life is rarely about tax, exclusively. Numerous non-tax considerations surround a change of residence and domicile. From the U.K. perspective, the following should be considered, where relevant:

- Change of status may impact where a person can be served with process in civil proceedings. The rules are complex.
- In particular, the threshold for service of divorce papers in England is relatively low.
- If a person becomes domiciled in England & Wales, then succession to worldwide estate becomes subject to English law. For some clients, this may not seriously impact their succession plans. But for others, such as those from civil law jurisdictions with forced heirship, this can be a dramatic difference. The conflict of law rules in succession planning – including renvoi – are notoriously complicated in an area where different domestic systems of law vary massively.

We are not talking about subtle distinctions, necessarily, here. Bluntly, it might be possible to disinherit an heir in one jurisdiction, but not in another. The consequences can plainly be severe.

CONCLUSION

Even if you like "to-may-to" and I like "to-mah-to," let's not "call the whole thing off." Exploring the very different approaches of legal systems to the same underlying facts is an interesting and important exercise. Not falling into traps is of course important. But every now and then, genuinely worthwhile planning opportunities may be found.

ANDORRA: A COMPREHENSIVE TAX AND LEGAL ANALYSIS

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Tags
Andorra
Co-Principality

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INTRODUCTION

Andorra is a tiny landlocked principality nestled in the Pyrenees mountains between France and Spain. It boasts a unique history and political structure originating in feudal times. Andorra is a Co-Principality that is shared by the Catholic Bishop of Urgell in the north of Catalonia and the President of the Republic of France. At the same time, it operates as an independent parliamentary democracy.

Less than a three-hour drive from Barcelona, Andorra is known for its ski resorts, mountains, long streets lined with stores, and low crime rate. Perhaps the country's biggest attraction is taxation. Hundreds of high net worth individuals, such as content creators, cyclists, YouTubers, gamers, Moto GP racers, poker players, big online marketers, traders, and crypto investors have established residence in Andorra. The country is linguistically diverse. Catalan is the official language, and Spanish, French, English, and Portuguese are widely spoken.

This article provides a brief introduction to the rich history of Andorra. It then addresses the legal and tax facets of residence.

HISTORY

Legend has it that Charlemagne founded Andorra in the year 805, though the first mention of the country appears in the Act of Consecration of the Cathedral of Santa Maria d'Urgell in the middle of the 9th century. In the 13th century, a conflict over Andorra's sovereignty arose between the religious authorities of Urgell and the counts of the region. The conflict was resolved in 1278 by an agreement between the French Count of Foix and the bishop of La Seu d'Urgell, who shared their power over the country (the "Co-Princes"). This agreement gave the small principality its territory and the current form of government, that of a Co-Principality. The Co-Princes are jointly and severally the Heads of State.

On January 14, 1982, Andorra's first government took office, separating the legislative power from the executive for the first time. In the early 1990's, Andorra signed an agreement with the European Economic Community and a new penal code was adopted, while the population continued to grow rapidly. On March 14, 1993, the second written constitution in its history was approved by referendum, dismantling the last feudal remnants of Andorra's government by declaring the Andorran people as the sole sovereign of the state. The power of the Co-Princes was reduced and a modern parliamentary system of government was created. On July 28, 1993, Andorra became a full member of the United Nations.

The Euro is the official currency of Andorra by virtue of the monetary agreement signed with the European Union.

In 2022, Andorra's G.D.P. reached €3.188 billion, with a per capita G.D.P. of €39,068, placing it in a prominent position internationally.

TAXATION

Andorra as a Tax-Approved Jurisdiction

Andorra has been included for decades in international lists of tax havens due to its bank secrecy and its refusal to exchange tax information with other jurisdictions. Despite that history, Andorra has worked diligently to enhance transparency and to promote international cooperation.

Currently, most O.E.C.D. members and all E.U. Member States recognize Andorra as a tax-approved jurisdiction for the following reasons:

- Its commitment to transparency and international cooperation
- The existence of bilateral agreements on exchange of tax information upon request
- Its participation in the O.E.C.D.'s automatic exchange of information agreement known as the Common Reporting Standard ("C.R.S.")
- Its removal from the O.E.C.D. list of non-cooperative tax havens May 2009, and its removal from the ECOFIN list in 2018 after its participation in the B.E.P.S. Inclusive Framework
- The ongoing negotiations regarding the execution of an association agreement with the E.U., which will result in a closer relationship with the 27 Member States of the E.U., even though taxation is excluded from the negotiations

In sum, Andorra is widely considered to be a jurisdiction that complies with the requirements of minimum taxation, tax fairness, and tax transparency. It is also a country with a stable and reliable legal and tax system. All of this makes it attractive for foreign investors.

Transition to Openness

Andorra's Modern Tax System

Andorra's tax system has evolved in accordance with the activity and economic structure of the country, and the tax base has been broadened in order to distribute the weight of the tax burden in a more optimal manner, moving from reliance mostly on indirect taxes to a modern system of direct taxation.

In 2013, the current General Indirect Tax was adopted, replacing most existing indirect taxes on consumption. This move created a more neutral and efficient framework for businesses and a fairer system for citizens. The general rate of the indirect tax is 4.5% for most items and 1% for goods and services related to health, education, culture, food, and rentals. The rate is much lower than rates in France (20%) and Spain (21%), its neighboring countries.

State direct taxation commenced in 2006, with the implementation of the tax on capital gains in real estate transactions. In 2010, the Company Income Tax law and the

Nonresident Tax Law were passed. Finally, in 2014, Personal Income Tax was introduced, completing the configuration of the Andorran tax framework, and introducing a tax comparable in concept to those in other European and O.E.C.D. countries.

Double Taxation Agreements

In 2013 Andorra signed its first bilateral Double Taxation Agreement ("D.T.A.") with France, which entered into force on July 1, 2015. Andorra's D.T.A. with Spain was signed in early 2015 and entered into force on February 26, 2016. Today, D.T.A.'s exist with (i) France, (ii) Spain, (iii) Luxembourg, (iv) Liechtenstein, (v) Portugal, (vi) the United Arab Emirates, (vii) Malta, (viii) Cyprus, (ix) the Republic of Saint Marino, and (x) Hungary. D.T.A.'s with Germany and the Netherlands are currently under negotiation.

CURRENT TAX SITUATION

No wealth tax, inheritance and gift taxes, or exit tax exist in Andorra. Therefore, the two main direct taxes applicable are Personal Income Tax and Corporate Income Tax.

Personal Income Tax ("P.I.T.")

Taxpayers Subject to This Tax Are Individuals with Tax Residency in Andorra

"No wealth tax, inheritance and gift taxes, or exit tax exist in Andorra."

The income of individuals considered to be tax resident in Andorra is taxed on a worldwide basis.

Individuals are considered to be tax residents in Andorra in either of the following circumstances:

- The individual resides in the Andorran territory for more than 183 days during the calendar year. For this purpose, sporadic absences are disregarded, unless the taxpayer can prove tax residency in another country.
- The individual's center of vital interests or base of activities or economic interests is located directly or indirectly in Andorran territory. If an individual's spouse and minor children are resident in Andorra, the individual is presumed to be tax resident in Andorra unless legally separated from the spouse.

Transactions Exempt from P.I.T.

Several exempt or zero-rated transactions make Andorra attractive for resident investors:

- Dividends and other income derived from participation in net assets are exempt, when paid by tax-resident entities in Andorra or by Andorran collective investment undertakings subject to the Andorran Corporate Tax.
- Capital gains[1] resulting from the transfer or redemption of shares or stakes in collective investment organization are exempt.

[1] It follows that if a transaction is of a type for which capital gains are not taxed, capital losses incurred from that type of transaction are not deductible.

- Capital gains resulting from the transfer of shares are exempt when the transferor and certain related parties collectively own less than 25% of the capital during the twelve months preceding the transfer.
- Where the transferor and related parties collectively own more than 25% of the capital of the issuing company, capital gains resulting from the transfer of shares are exempt when those shares have been held for ten years or more.
- Capital gains from the transfer of real estate located outside the Andorran territory when the taxpayer has owned these properties for at least ten years prior to the transfer.

Main Reductions to P.I.T.

Taxpayers have the right to apply several reductions, the most relevant ones being the minimum personal reduction, the reduction on contributions made to pension plans, and the €3,000 exemption for financial income realized.

- The minimum personal reduction amounts to €24,000. The reduction is increased to €40,000 where the spouse or life partner living with the taxpayer receives no income.
- The reduction for contributions made to pension plans is based on the actual contributions made. The reduction is capped. It cannot exceed the lower of (i) 30% of the net income from employment and economic activities and (ii) €5,000 per year.

Tax Rate

The tax payable is determined by applying a flat 10% tax rate to the tax base of the individual. In computing the tax base, the reductions discussed above are taken into account as well as deductions to eliminate domestic and international double taxation within certain limitations.

The following example illustrates the computation of the tax base. In the facts presented below, an individual with a total income of €270,000 would only end up paying a total of €11,300, which represents an effective average tax rate of 4.18%.

Example

Personal Circumstances

- Male
- Married (the spouse does not earn any income)
- Two children under 25 years

Income

- Salary: €100,000
- Capital gains: €10,000 for the sale of shares of a company (<25% of shares during 2 years)
- Interests from Andorran bank accounts: €10,000

- Dividends from Andorran company: €100,000
- Dividends from non-Andorran company: €50,000

Sources of Income Analysis

Source of Income	Amount (€)	Taxable/Exempt
Salary	100,000	Taxable
Capital gains	10,000	Exempt
Interests from bank accounts	10,000	3,000 exempt
Dividends from an Andorran company	100,000	Exempt
Dividends from a non-Andorran company	50,000	Taxable

Applicable Reductions

Reductions	Amount (€)
Other deductible costs (3% salary, max. €2,500)	2,500
Personal minimum reduction	24,000
Personal minimum spouse reduction	16,000
Descendants (2 sons) reduction	1,500
Total	**44,000**

Calculations

Total Income	270,000
Less	
Exempt Income	113,000
Taxable income	**157,000**
Less	
Applicable Reductions	44,000
Tax base	**113,000**
× Tax Rate	10.00%
Tax payable amount	**11,300**
Effective tax rate	**4.18%**
After Tax Net Income	**258,700**

Corporate Income Tax

In principle, corporate income tax is not applied on a territorial basis. Consequently, corporate income tax applies to the income of a resident Andorran legal entity no matter where generated. An entity is considered to be tax resident in Andorra in three fact patterns.

- It is established under Andorran law.
- It has a registered office or maintains co-working space in Andorra.
- Its place of effective management of a business is located in Andorra.

General Corporate Tax Regime

The rate of Corporate Income Tax is 10% of net profits. Collective investment companies enjoy a 0% tax rate under certain circumstances. However, an Andorran company that is part of a multinational group with consolidated revenues of at least €750 million is subject to a 15% tax on profits. This adjustment aligns Andorran tax law with the new global minimum top-up tax under B.E.P.S. 2.0.

Reductions in Tax

The general tax rate is reduced for companies engaged in the international exploitation of intangible property, provided the company maintains a minimum level of economic substance. The bar for meeting the substance requirement is relatively low. It is met if the company has an employee working at least 4 hours per day and an office consisting of twenty square meters.

Dividends or capital gains obtained by Andorran companies from certain local or foreign companies are exempt in order to avoid double taxation when the following three conditions are met:

1. Holds directly or indirectly owns at minimum 5% of the share capital of the foreign company;
2. The shares must be held for more than one year; and
3. If it is a foreign company, has to be subject to income tax imposed at rates analogous to Andorran corporate tax rates. This requirement is considered fulfilled when the invested entity is a nonresident subject, without the possibility of exemption, at a nominal rate equivalent to at least 40%. This condition is considered satisfied when the invested entity is a resident in a country with which Andorra has entered into an agreement to avoid double taxation.

The tax benefit is cut back with effect as of January 1, 2024. A minimum tax of 3% is imposed on the corporate income for all companies generating profits, irrespective of existing deductions and offsets.

Withholding Tax on Outbound Dividends and Certain Gains

No withholding is made on dividends paid to nonresidents.

In comparison, a 10% tax is imposed on capital gains derived by nonresidents from the transfer of shares of an Andorran company. The 10% tax is also imposed on the payment of liquidation distributions to nonresidents at the time an Andorran company is wound-up.

Special Tax Regime for Holding Companies

A special tax regime applies to dividends and gains derived by an Andorran holding company. No tax is levied in Andorra on a holding company that receives dividends from, or realizes capital gains related to, a foreign company. The exemption is subject to the following condition: the foreign company must be resident in a country in which corporate tax rate is at least 4% or be resident in a country with which Andorra has signed a D.T.A. (Double Taxation Agreement). An Andorran holding company need not maintain a minimum percentage of the share capital of the foreign corporation in order to benefit from the regime. Similarly, no minimum holding period is required.

"A special tax regime applies to dividends and gains derived by an Andorran holding company."

Dividends paid from the holding company to Andorran companies or private individuals who are tax resident in Andorra are also exempt.

Nonresidents Income Tax ("N.R.I.T.")

Several exempt or zero-rated transactions make Andorra attractive for foreign investors (individuals or companies):

- Dividends and other income derived from participation in net assets are exempt, when paid by tax-resident entities in Andorra or by Andorran collective investment undertakings subject to the Andorran Corporate Tax.
- Capital gains[2] resulting from the transfer or redemption of shares or stakes in collective investment organization are exempt.
- Capital gains resulting from the transfer of shares are exempt when the transferor and certain related parties collectively own not more than 25% of the capital during the twelve months preceding the transfer.

TRUSTS IN ANDORRA: A LEGAL OVERVIEW

Trusts play a pivotal role in wealth management and succession planning. Originating from English common law, trusts are recognized in various legal systems, particularly in Anglo-Saxon countries. Notably, Andorra lacks an equivalent instrument to the trust and has not signed The Hague Convention of 1985.

A technical announcement of November 25, 2015, explains the treatment of foreign trusts in Andorra. The trust is not recognized in Andorra. Consequently, the settlor is considered to be the owner of the trust's assets when control has not been transferred to the beneficiary. Therefore, the settlor will be subject to P.I.T. on the income generated by the assets, due to transparency of the trust. However, where the trust is irrevocable, both control and possession are viewed to shift to the beneficiary, resulting in the recognition of a capital gain by the settlor. Given the absence of taxes for the beneficiary on donations and inheritance, the transfer of assets from settlor to beneficiary is not subject inheritance tax or gift tax.

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[2] It follows that if a transaction is of a type for which capital gains are not taxed, capital losses incurred from that type of transaction are not deductible.

In the event that an Andorran company is part of a foreign trust, the ultimate beneficiary must be officially disclosed to the Andorran government through an official declaration. This ensures compliance with regulatory requirements and fosters transparency in financial dealings involving trusts within the jurisdiction.

LEGAL RESIDENCE IN ANDORRA

Understanding the criteria for legal residence in Andorra is crucial for those considering a relocation. There are various ways to obtain legal residence in Andorra.

- **Employment Visa.** This visa requires an employment contract calling for permanent residence in Andorra. More than 183 days annually must be spent in the country. Police oversight ensures compliance with required days of presence. The renewal of residence hinges on meeting both requirements. An initial deposit of €15,000 must be paid. The deposit is refundable upon permanent departure from the country. Persons who carry on certain professions are exempt from the deposit requirement.

- **Self-Employment Visa.** This visa requires the formation of a company in Andorra. More than 183 days annually must be spent in the country. A deposit of €50,000 must be made with the Andorran Financial Regulator ("A.F.A."). The individuals obtaining the visa must serve as the company administrator and own more than 34% of the shares of the company.

- **Investment Visa.** This visa requires a €600,000 investment in Andorran real estate, shares of an Andorran company, or listed financial products in Andorra. Additionally, a deposit of €47,500 must be made with the A.F.A. for the investor and an extra €9,500 must be made for each dependent. An investment visa requires presence in Andorra for a period of only 90 days. This visa is suitable for individuals already retired, managing assets from Andorra, and benefiting from its tax advantages. It is comparable to "golden visa" programs in other European countries.

- **Scientific, Cultural, and Sports Visa.** This visa is equivalent to an O-1 visa in the U.S. applicable to individuals with extraordinary ability or achievement. It is open to any foreign individual with international recognition for talent in science, culture, or sports. It requires a stay in Andorra of a minimum period of 90 days each year. In addition, it requires the acquisition or lease of personal use residential property in Andorra. At least 85% of the individual's talent related services must be performed outside of Andorra. A deposit of €47,500 must be made to the A.F.A. for the individual and an additional deposit of €9,500 must be made for each dependent individual.

- **Professionals with International Operations.** This visa is available for a professional or sole trader establishing a headquarters for operations. At least 85% of the services of the professional or businessperson must be performed outside of Andorra. The visa holder can employ only one person on a regular basis.

Rights of Mobility to Spain and France for Andorran Residents

While maintaining its autonomy and not being a part of the European Union or the Schengen area, Andorra provides residents with unique mobility rights in Spain and

France under a Mobility Agreement approved in 2020. The practical implications are that individuals arriving from any European state need not undergo any special procedures. A simple passport or ID card is sufficient for entry or exit from Andorra.

CONCLUSION

Andorra stands out as an exceptionally attractive European destination for living, seamlessly blending natural beauty, a high quality of life, and distinctive advantages. Its strategic proximity to major European cities positions it as an ideal choice for those seeking a quiet lifestyle while still maintaining accessibility to larger urban centers. It is an alternative to more well-known locations due to its favorable tax system, while providing mobility to the rest of Europe.

MAURITIUS – GATEWAY TO AFRICA

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Tags
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C.I.G.A.
Collective Investment Scheme
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V.A.I.T.O.S.
Virtual Assets

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INTRODUCTION

Rightly called the Pearl of the Indian Ocean, Mauritius is much more than a popular tourist destination. With an area of 2,040 square kilometers and a population of just over 1.3 million, the tiny island is situated off the southeast coast of Africa next to Madagascar. It pulls more than its weight when it comes to financial services. Mauritius positioned itself for cross-border activities in the early 1990's, and since then, it has been recognized as a reputable International Financial Center ("I.F.C.'') and the preferred gateway for investments into (and out of) Africa and Asia (mainly India).

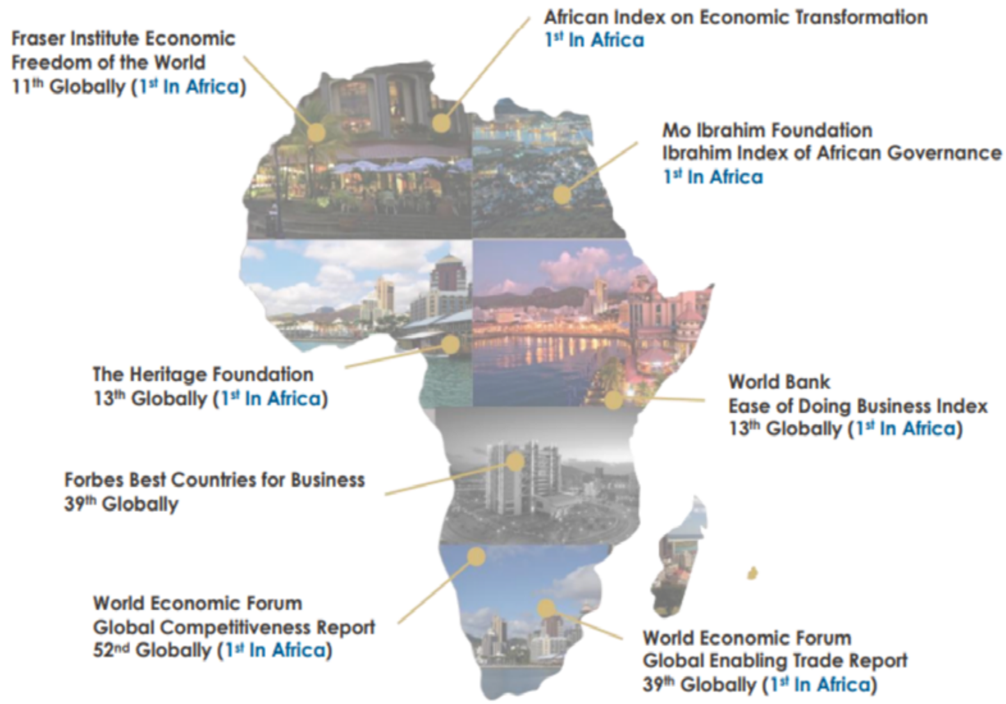
MAURITIUS AT A GLANCE

The 2022 World Bank statistics placed Mauritius as the country with the second highest per capita G.D.P. in Africa, ahead of its better-known neighbor, South Africa. The country offers a high standard of living in a stable social, political, and economic environment.

Mauritius is a multicultural and multiethnic hotchpot with a diverse population of Indian, African, Chinese, and European origins. The country has long served as a cultural bridge between Asia and Africa. This cultural connectivity can be advantageous for businesses looking to understand and navigate the nuances of different markets. Although the official language is English, French remains widely used, and both languages are used for business purposes.

The country is a multiparty parliamentary democracy with a well-regulated financial services sector and an effective, independent legal system having the Judicial Committee of the Privy Council in the U.K. as its highest court of appeal. One attractive characteristic of the legal system is that it remains a hybrid system with features of both the English Common Law and the French Napoleonic Code Civil.

Over the years, Mauritius has won a number of international accolades reinforcing its reputation as an I.F.C.



WHY MAURITIUS?

Mauritius offers all the advantages of an established I.F.C.

- Mauritius is one of the most stable and attractive environments for doing business in Africa thanks to its political and economic regime, tax rules, robust legal and judicial framework, and foreign currency availability with free capital flows.

- Mauritius has a highly literate, comparatively low-cost, and multilingual workforce. The country has a skilled workforce of around 15,000 professionals servicing the I.F.C. including accountants, fund administrators, lawyers, and bankers to deal with modern international clients' exigencies. The level of service is high and the culture is hard working, fast, and efficient.

- The island offers excellent infrastructure. Mauritius actively encourages foreign talent, know-how, and investment into the country. The infrastructure in Mauritius is on par with international standards.

- The banking system in Mauritius comprises of 19 banks with over $43 billion of assets on a cumulative basis. The banking industry is at the cutting edge of innovations and international regulatory developments.

- Favorable regulatory environment. Mauritius has developed an internationally compliant regulatory framework that encourages foreign investment.

- Foreign companies enjoy free repatriation of profits, which positions Mauritius as a welcoming and investor-friendly jurisdiction.
- Strategic time zone (G.M.T. +4), which enables trading and business to be conducted with Africa, Europe, Asia, and the U.S. on the same business day.

THE MAURITIUS I.F.C.

Mauritius, as an I.F.C., offers a range of products and structures which have helped develop a conducive ecosystem for promoting cross-border investment and solutions to high net worth individuals in positioning private wealth.

The Global Business Company ("G.B.C.") is the vehicle of choice for holding foreign assets. About 15,000 G.B.C.'s are in existence as of the date of this article. In addition, over 900 global funds are based in Mauritius. The legal framework for trusts and foundations also makes Mauritius a favored jurisdiction for succession, wealth planning, and philanthropic solutions for individuals and families.

The I.F.C. sector represents more than 13% of G.D.P., arising from

- the export of goods and services;
- cross-border investment and corporate banking;
- recent emphasis on tapping into renewable energy and E.S.G. projects built around U.N. Sustainable Development Goals by African countries;
- private banking and wealth management;
- business and financial rules that promote capital raises and public offerings;

- frameworks for FinTech, Virtual Assets, and Initial Token Offering Services;
- emerging products, such as peer-to-peer lending, crowdfunding, and artificial intelligence-enabled services;
- mediation and arbitration rules for non-judicial settlement of legal disputes; and
- global headquarters administration.

NEW DEVELOPMENTS

The recent legislation around virtual assets and initial token offerings ("V.A.I.T.O.S.") makes Mauritius one of the first countries in Africa to provide a regulatory framework for Virtual Assets Service Providers ("V.A.S.P."), removing the lack of transparency and certainty around these activities. The regulatory framework also paves the way for V.A.S.P. to access formal banking services enabling growth and expansion for those operators.

The V.A.I.T.O.S. Act provides for several subcategories of licenses:

- Licenses allowing Virtual Asset Broker-Dealers to carry out activities such as exchanges between virtual assets ("V.A.'s") and fiat currencies or exchange between one or more forms of V.A.'s
- Virtual Asset Wallet Services licenses pertain to the transfer of V.A.'s
- Virtual Asset Custodian licensees are responsible for the safekeeping of V.A.'s or instruments enabling control over V.A.'s, administration of V.A.'s or instruments enabling control over V.A.'s
- Virtual Asset Advisory Services licenses covering the participation in, and provision of, financial services related to an issuer's offer or sale of V.A.'s
- Virtual Asset Market Place licenses that allow for the setting up of a Virtual Asset Exchange as a centralized or decentralized virtual platform, whether in Mauritius or in another jurisdiction, thereby facilitating the exchange of V.A.'s for fiat currency or other V.A.'s on behalf of third parties for a fee, a commission, a spread, or other financial benefit

This new legislation coupled with the regulatory sandbox regime available in Mauritius has created a conducive environment for V.A.S.P. and other new technology providers to collaborate and develop innovative solutions. This is proving especially useful for Africa where V.A.S.P. are playing a critical role across all sectors of the continent's economies.

GATEWAY TO AFRICA

Mauritius is the jurisdiction of choice for firms wanting to expand their business into Africa. Mauritius has long-standing relationships with key African and international bodies, including the Southern African Development Community ("S.A.D.C.") and the Common Market for Eastern and Southern Africa ("C.O.M.E.S.A."), the World Trade Organization, and the Commonwealth of Nations. It has also established a network of agreements, comprising 24 signed Investment Promotion and Protection Agreement (“I.P.P.A.’s”) and 21 signed Double Taxation Avoidance Agreements (“D.T.A.A.’s”) with African states, which means that global investors, traders, and private equity companies gain preferential access to a number of key African markets and hundreds of millions of customers.

The African Continental Free Trade Agreement (“Af.C.F.T.A.”), established in January 2021, covers preferential trade for both goods and services between all 55 African countries. Mauritius is a signatory. With 55 African countries, a market of 1.3 billon people, and an economy of $2.6 trillion, the opportunity for member states is huge. The agreement has the potential to drive inclusive growth in Africa.

“Over the last few years, Mauritius has undertaken a complete overhaul of its tax system eliminating all laws deemed as harmful tax practices by the O.E.C.D.”

THE MAURITIUS TAX REGIME

The tax regime of Mauritius remains one of the points of attraction for the country. Mauritius has a low income tax rate. In addition, Mauritius offers a range of incentives that reduces the tax rate in order to boost the competitiveness of the island in terms of facilitating business in the country. For instance, dividends paid by a Mauritius resident company and gains derived from the sale of units, securities, or debt obligations are exempt from income tax in Mauritius. There is no withholding tax on dividends paid by a Mauritian resident company. There are no capital gains tax and no inheritance tax in Mauritius.

Over the last few years, Mauritius has undertaken a complete overhaul of its tax system eliminating all laws deemed as harmful tax practices by the O.E.C.D. Significant changes were implemented to the tax system for the country to shed its image of a tax haven. As a result,, Mauritius has moved away from being a traditional tax haven to a tax-efficient jurisdiction of substance.

In 2019, the headline tax rate was harmonized at 15% for both the domestic and offshore sectors providing a transparent system and level playing field for all businesses. This regime has successfully generated substantive economic activities across all sectors of the Mauritian economy.

Previously, Mauritian tax law provided for a foreign deemed tax credit for companies operating in the global business sector. No matter what taxes were paid abroad, a tax credit of 80% could be claimed on foreign income which essentially meant that such income was effectively taxed at 3%. As a result of international pressures, the deemed foreign tax credit of 80% was abolished in 2019 and replaced by a system whereby a partial exemption of 80% was applied to certain types of income subject to meeting the substance requirements in Mauritius. Under the 80% partial exemption regime, 80% of the relevant income would be treated as exempt from tax in Mauritius.

Income from the following activities are eligible for the partial exemption:

- Foreign dividends derived by the company
- Interest derived by a company other than banks, money changers, insurance companies, and leasing companies
- Income derived from ship or aircraft leasing

- Income attributable to a permanent establishment
- Income from reinsurance and reinsurance brokering activities
- Income from leasing & provision of international fiber capacity
- Income from the sale, financing, arrangement, or asset management related to aircraft, including spare parts and aviation advisory services
- Interest income derived by a person from money lent through a peer-to-peer lending platform

The partial exemption regime is only applicable to companies which have substance in Mauritius, which is defined in the following way:

- The core income generating activities ("C.I.G.A") of the company must be located in Mauritius.
- The company should be managed and controlled from Mauritius.
- The company should be administered by a Management Company.

In order for a company to be managed and controlled from Mauritius, it should meet the following conditions:

- Its principal bank account should be maintained in Mauritius at all times.
- Its accounting records are maintained at its registered office in Mauritius.
- It prepares its statutory financial statements in Mauritius.
- Meetings of directors must include at least two directors from Mauritius.

In addition to the 80% partial exemption regime, Mauritius offers numerous tax incentives to boost competitiveness. To illustrate, all profits from the export of goods are taxed at 3% and profits from a Collective Investment Scheme ("C.I.S."), Closed-End Fund ("C.E.F."), C.I.S. Manager, C.I.S. Administrator. C.I.S. Adviser, or C.I.S. Asset Manager benefit from a 95% tax exemption.

A number of regimes offering tax holidays for a certain period are also available. With a strong finance sector and business environment, Mauritius has become a popular location for global corporations to maintain regional headquarters. The Mauritian legislation is designed to promote the establishment of companies offering Global Headquarters Administration ("G.H.A.") and Global Treasury Activities ("G.T.A.") activities from a base in Mauritius.

An eight-year tax holiday on corporate income is applicable to companies holding a G.H.A. license and a tax holiday of five years is available to companies holding a G.T.A. license.

The G.H.A. licenses are issued to companies which provide any three of the following services to related corporations within a multinational grouping:

- Administration and general management
- Business planning, development, and coordination

- Economic or investment research and analysis
- Services related to international corporate headquarters in Mauritius

Companies holding a G.T.A. License are expected to provide at least three treasury services to related companies from the following list:

- Arrangement for credit facilities, including credit facilities with funds obtained from financial institutions in Mauritius or from surplus of related companies
- Arrangement for derivatives
- Corporate finance advisory
- Credit administration and control
- Factoring and re-invoicing activities
- Guarantees, performance bonds, standby letters of credit, and services relating to remittances
- Management of funds for designated investments

Despite the overhaul of its tax system, Mauritius has retained certain key attractive tax features which make it a tax-efficient jurisdiction while still being approved by international regulators.

Mauritius has proven itself to be a collaborative and responsible international financial center that has taken significant steps to adhere to international best practices. To enhance its transparency and collaboration framework, Mauritius signed the O.E.C.D. Multilateral Convention on Mutual Administrative Assistance in Tax Matters in June 2015. Mauritius is also a member of the Early Adopters Group committed to the early implementation of the Common Reporting Standard ("C.R.S.") on the automatic exchange of financial account information.

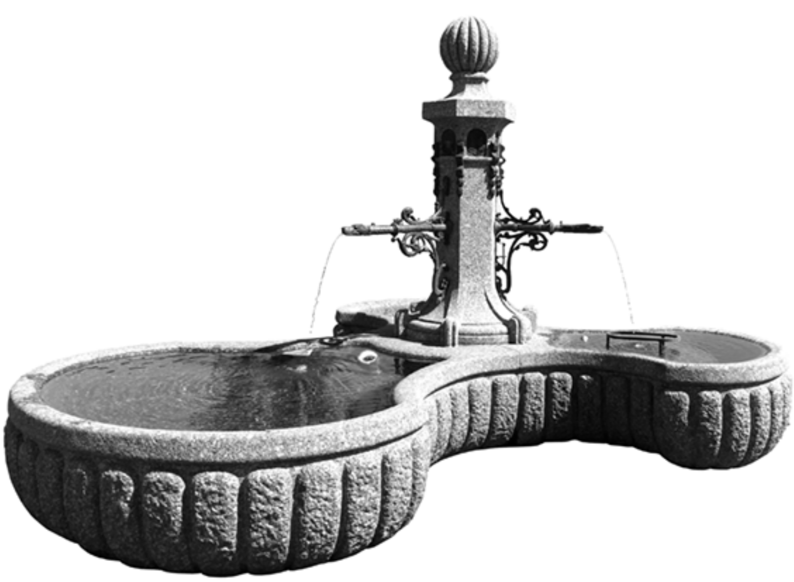
The O.E.C.D. Global Forum has rated Mauritius as a "Largely Compliant" jurisdiction – a rating which equals that obtained by developed economies such as the U.S., the U.K., and Germany. It was the first African country to sign up to an Intergovernmental Agreement with the U.S. for the implementation of the Foreign Accounts Tax Compliance Act ("F.A.T.C.A.") and has joined the O.E.C.D.'s Inclusive Framework to implement the Base Erosion and Profit Shifting ("B.E.P.S.") recommendations and the new initiative on exchange of beneficial ownership information.Why Africa, why now?

Given its youthful, rapidly urbanizing population, it is no surprise that Africa remains at the top of investment agendas for businesses. Africa is currently going through a structural change and recent trends show that investors' interest has shifted from extractive activities to consumer-oriented activities, comprising new sectors such as technology, media and telecommunications, financial services, consumer product, retail & real estate, hospitality, and construction, and next-generation industries such as business services, tech, automotive, and life sciences.

The rewards promise to be substantial. The McKinsey Global Institute projects that by 2025, African household consumption and business-to-business ("B2B") spending could reach $5.6 trillion. That is equivalent to nearly a third of the current U.S.

gross domestic product. To get there, the continent has enormous infrastructure gaps to fill. Those gaps themselves represent enormous opportunities.

Mauritius provides the right launching pad and ecosystem for structuring investments into Africa with appropriate structuring vehicles, an investor-friendly jurisdiction, a dynamic and flexible debt market, and investment protection mechanisms and tools.



U.K. BUDGET PROCLAIMS DEATH KNELL FOR REMITTANCE BASIS TAXATION

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Tags
Arising Basis
Foreign Income and Gains
Foreign Trusts
F.I.G.
Inheritance Tax
Non-Dom
Remittance Basis

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INTRODUCTION

As was widely tipped, the Chancellor used his budget speech on March 6th to announce the termination of the U.K.'s non-domicile regime and remittance basis of taxation. This seems to be a complete steal from the Labour Party, which pledged to abolish the "non-dom loophole" if and when it would come into power.

The full details are yet to be known. Some of the changes to inheritance tax are to be the subject of a consultation. Based on the H.M.R.C. technical note published shortly after the chancellor's speech ended, this article addresses the highlights of the proposal.

OVERVIEW OF BUDGET PROPOSAL

The current remittance basis of taxation will end on April 5, 2025. The remittance basis of taxation as it currently operates will no longer be available after that date. The following changes will then take effect from April 6, 2025.

- A new foreign income and gains ("F.I.G.") regime will be available for individuals who become U.K. tax resident after a period of 10 tax years of non-resident status with regard to the U.K. During the first four tax years of U.K. tax residence, individuals who qualify for the new regime will be able to bring F.I.G. to the U.K. free from any U.K. tax charges. Tax will also not be payable on distributions received from nonresident trusts. During this period, U.K. income and gains will be subject to U.K. tax in the normal way.
- If, on April 6, 2025, individuals have been nonresident for 10 years and U.K. resident for less than four years they will be able to use the new regime for any tax year of U.K. residence until the fourth year of residence is completed.
- Overseas Workday Relief ("O.W.R.") will remain available for the first three tax years of U.K. residence but will be based on an employee's residence and whether he or she opts to use the new four-year F.I.G. regime from April 6, 2025.
- The protection from taxation on income and gains arising within trust structures will be removed for all current nondomiciled and deemed-domiciled individuals who do not qualify for the new four-year F.I.G. regime. Any F.I.G. arising in a nonresident trust structure from April 6, 2025, will be taxed on the arising basis when the settlor or transferor has been resident in the U.K. for more than four tax years. This mirrors the way trust income and gains are presently taxed when the settlor or transferor is domiciled in the U.K. Any F.I.G. that arose within a trust or trust structure before April 6, 2025, will

be taxed on settlors or beneficiaries if they are matched to worldwide trust distributions.

- Any individual who is currently taxed on the remittance basis and not eligible for the new four-year F.I.G. regime will pay tax on 50% of foreign income for the U.K. tax year ending April 5, 2026. This reduction applies to foreign income only. It does not apply to foreign chargeable gains. Beginning with the U.K. tax year commencing on April 6, 2026, no reduced tax rate will apply to foreign income which will then be taxed in full on the arising basis.
- For foreign capital gains, an individual who does not fall within the four-year F.I.G. regime will be taxed when and as they arise after April 6, 2025. Transitional relief will be available for individuals who have claimed remittance basis taxation in the past. They will be allowed to rebase any asset disposed of to its value at April 6, 2019, if the asset was held at that date.
- Where an individual was previously taxed on the remittance basis, an election is available to pay tax at a reduced rate of 12% on remittances of pre-April 6, 2025, F.I.G. This benefit is temporary. It will apply for two years from April 6, 2025. The benefit will not be available for F.I.G. within trusts and trust structures.
- Subject to a consultation, it is intended that inheritance tax will be based on residence from April 6, 2025. The proposal is for U.K. inheritance tax to be charged on worldwide assets if an individual has been resident in the U.K. for a period of 10 years. Once the 10-year period has been exceeded, it will be necessary to remain resident outside the U.K. for a period of at least 10 years to escape U.K. inheritance tax.
- For assets held within trust structures, the inheritance tax position will follow the residence of the settlor. However, trusts funded before April 6, 2025 will remain outside the scope of U.K. inheritance tax provided trust assets are not brought into the charge to U.K. inheritance tax under existing rules.

PATH FORWARD FOR NON-DOM INDIVIDUALS REPORTING INCOME ON THE REMITTANCE BASIS

In light of the revisions discussed above, individuals currently claiming benefit under the remittance basis taxation rules will be affected in the following ways:

- Those persons already resident in the U.K. for four or more years will be entitled to claim a 50% reduction in foreign income subject to tax in the tax year beginning April 6, 2025.
- Individuals will be able to rebase foreign assets to the value on April 6, 2019, for disposals after April 6, 2025.
- Any unremitted F.I.G. remaining abroad on April 5, 2025, can be remitted after that date at a special rate of 12%. The relief exists only for a 2-year period. The relief is intended to incentivize repatriation of F.I.G. and investment in the U.K. The benefit appears to be available to anyone with unremitted

F.I.G., including those who are now deemed domiciled. It will not be available for remittances from trust structures. Consequently, trust beneficiaries who report income under the remittance basis should alert trustees of the benefit of making trust distributions before April 6, 2025.

- Trust structures will continue to be effective until April 5, 2025. After that date, any F.I.G. within a trust structure will be taxed on the settlor when and as it arises if the settlor, a spouse, or certain other individuals are beneficiaries or can receive a benefit from the trust. If such individuals are excluded from benefitting under the trust structure, it would appear the trust will continue to provide protection for beneficiaries resident in the U.K.
- An offshore trust structure set up before April 6, 2025 will continue to be effective for inheritance tax purposes.
- An existing offshore trust structure set up before April 6, 2025 will continue to be effective for F.I.G., provided the settlor, spouse, or certain other persons are excluded from benefitting under the trust before April 6, 2025.
- Where an offshore trust is created before April 6, 2025, and the settlor of the trust, spouse, or certain other persons are able to benefit from the trust, any F.I.G. realized within the trust structure will be taxed on the settlor on an arising basis.

CONCLUSION

On June 23, 2016, the U.K. held a referendum on its membership of the E.U. The question facing voters was whether the U.K. should remain a member of the E.U. A reported 51.89% of voters voted to leave the E.U., and the U.K. left the E.U. on January 31, 2020. On March 6, 2025, the Chancellor announced the demise of remittance basis taxation for non-dom individuals. The proposal has been explained above, as has a path forward for those currently reporting income on the remittance basis. The ultimate question is the extent to which non-dom individuals will remain or will "vote with their feet."

"The ultimate question is the extent to which non-dom individuals will remain or will '"ote with their feet.'"

THE MOST IMPORTANT 15 QUESTIONS TO ASK ABOUT THE *FORFAIT* IN SWITZERLAND

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Tags
Employment
Forfait
Inheritance Tax
Minimum Income
Social Security Tax
Switzerland
Tax Treaty Benefits

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INTRODUCTION

For many decades, the *forfait* taxation regime has been in effect in Switzerland, essentially allowing foreign nationals relocating to Switzerland to pay tax based on their worldwide living expenses.

The *forfait* regime is often mentioned alongside the soon-to-be former U.K. and non-dom regime and the Italian regime available to new residents. By comparison, the *forfait* regime, coupled with other advantages of the Swiss tax system, is more beneficial on many counts, such as legal certainty and inheritance tax.

Although the *forfait* regime was abolished locally in a number of cantons, a national vote was held in November 2014 with close to 60% of the voters voting in favor. It is fair to say that in most of Switzerland, the *forfait* is here to stay.

In light of the Budget Day announcement in the U.K., heralding the demise of non-dom taxation, wealthy non-domiciled individuals in the U.S. are likely to explore new countries in which to live under a favorable tax regime. For those contemplating Switzerland, this article answers the most important 15 questions that should be asked when considering a move to Switzerland

THE MOST IMPORTANT 15 QUESTIONS

1. **I am a not a Swiss national and I intend to relocate to Switzerland. Do I qualify for the benefits of the *forfait* regime?**

The *forfait* regime is available to foreign nationals taking up tax residence in Switzerland for the first time or after an absence of at least 10 years. Although the regime was originally aimed at wealthy foreigners coming to spend their autumn years in Switzerland, there has never been a minimum age nor a maximum age for *forfait* applicants.

2. **If I qualify for the *forfait* regime, am I allowed to work in Switzerland?**

To be eligible for the *forfait* regime an individual cannot exercise paid employment in Switzerland or be self-employed. Gainful activity abroad is permissible, however.

3. **If my spouse is a Swiss national does that affect my qualification for the *forfait* regime?**

Marriage to a Swiss spouse adversely affects an individual's qualification of the *forfait* regime. Beginning in 2016 neither the applicant nor the spouse can be a Swiss national.

4. If I am a dual national, and one of my nationalities is Swiss, does that affect my qualification for the *forfait* regime?

Individuals who are dual nationals do not qualify for the *forfait* regime when one of the nationalities is Swiss.

5. How is my income calculated when I qualify for the *forfait* regime?

Under the *Forfait* regime, income is deemed to be the highest of the following four amounts:

- An amount based on the taxpayer's worldwide living expenses. Living expenses include costs for accommodation, general living, cars, aircraft, yachts, housekeeping, and personnel for all family members financially supported by the taxpayer. Put simply, the tax base corresponds to what it takes to keep the family going, whereby cantons have substantial leeway in determining the practical aspects.

- An amount based on the rent multiple. The multiple is seven times the annual rent for the person's living accommodations.

- An amount determined under the so-called control calculation. The tax payable under the *forfait* regime must be equal at least to the income and wealth tax payable at ordinary rates on (i) Swiss real estate and related income, (ii) movable assets located in Switzerland and related income, (iii) Swiss securities and related income, (iv) Swiss intellectual property and related income, (v) Swiss source pensions, and (vi) income for which treaty benefits are claimed in a country that has in effect an income tax treaty with Switzerland.

    - Swiss securities include Swiss shares and dividends or interest from Swiss sources. A portfolio of non-Swiss shares held and managed by a Swiss bank should not give rise to any issues. In comparison, interest on a Swiss cash account may be problematic.

    - Treaty-protected income will typically include non-Swiss dividends or royalties subject to a withholding tax in the source country. Such income must be included in the control calculation if a reduction of source tax is claimed under an applicable treaty. See the answer to Question 8 for claiming treaty benefits after a *forfait* is obtained.

- A minimum amount. The minimum base for Federal tax purposes is CHF 429,100.

6. Under the *forfait* regime, how much tax will likely be paid?

Tax payable is calculated by application of the ordinary progressive tax rates to the agreed tax base. By way of example, a taxpayer with a monthly rent of CHF 5,500 will have a minimum Federal tax base of CHF 462,000 (5,500 × 12 × 7). With a monthly rent of CHF 3,500 his tax base will be CHF 429,100 (rent multiple of 3,500 × 12 × 7 = 294,000). Because the amount of CHF 294'000 is below the minimum of CHF 429,100, the minimum amount will be deemed to be the tax base.

In addition, the tax base for computing tax under the *forfait* regime Swiss source income such as dividends or interest on Swiss securities, royalties, and rental income, assets located in Switzerland, and non-Swiss income for which treaty benefits are claimed in the treaty partner jurisdiction must be taken into account. will be subject to a so-called “control calculation” The sum of that addition, if exceeding the minimum amount of CHF 429,100 or the rent multiple, will be the income tax base.

To illustrate, a married taxpayer with two children and a deemed income of CHF 429,100 would pay tax in the following cantons of residence in the following amounts:

Canton of Residence	*Approx. Tax Payable*
Zug	CHF 130,000
Gstaad	CHF 165,000
Klosters	CHF 149,000
Geneva	CHF 160,000
Lausanne	CHF 172,000

Given the wide range of applicable tax rates in Switzerland at both the cantonal and communal level, there is considerable scope for geographical tax planning.

7. <u>What is meant by the term “geographical tax planning?”</u>

Despite its relatively modest size, Switzerland has 26 cantons each of which is subdivided into more than 2,000 local communes. Tax is levied at the federal, cantonal, and communal levels. A *forfait* is negotiated with the cantonal authority to arrive at the tax base to which ordinary tax rates apply. Although a statute exists calling for the harmonization of taxes between cantons, considerable differences exist in how the cantonal authorities apply the law in practice. In addition, cantons and communes have strongly differing tax rates.

In other words, if your main concern is to pay as little tax as possible you will look first at the communes with the lowest rates and most attractive local practice. Income tax, wealth tax, and inheritance tax must be taken into account when choosing a jurisdiction. As a rule of thumb, remote cantons are generally viewed as having the most attractive tax rates.

Usually, a client will have an idea of where he or she would like to live. The first cut is based on language preference, (German/French/Italian-speaking cantons). Then, the cut is preference for cities, mountains, or somewhere in between. Taking these preferences into account, an individual look at the likely tax results under the applicable *forfait* regime.

8. <u>As a *forfait* taxpayer, do I benefit from income tax treaties entered into by Switzerland?</u>

Any income for which treaty protection is claimed will need to be included in the control calculation addressed in the answer to Question 5.

Income tax treaties with several treaty partner jurisdictions do not treat a taxpayer who benefits from a *forfait* regime as tax resident in Switzerland. Withholding taxes on income arising in those countries are not reduced. Other treaties contain specific provisions in respect of *forfait* taxpayers under which income from those countries must be included in the normal Swiss tax base. Income tax treaties with Germany, Belgium, Norway, Italy, Austria, Canada, and the U.S. contain this type of provision. In addition, there is some uncertainty in practice as to the treatment of French source income.

9. **If I live the balance of my life in Switzerland and pay income tax under the *forfait* regime of a specific canton, what is the likely inheritance exposure for my heirs?**

Inheritance tax remains a matter for the cantons to decide. Switzerland held a national vote in 2015 in which nearly 70% of the people voted against the introduction of a federal inheritance tax applying at 20% across the board.

All cantons offer full spousal exemption, and in the vast majority cantons, both lifetime and death transfers to descendants are not subject to tax. Vaud levies a relatively moderate inheritance tax on transfers to children. The same is true for Geneva if the decedent was subject to the *forfait* regime.

"Inheritance tax remains a matter for the cantons to decide."

Bequests to unrelated donees may be subject to gift or inheritance tax of up to approximately 54% depending on the canton. The cantons of Schwyz and Obwalden (German-speaking) have no inheritance tax at all, meaning that gifts and bequests to unrelated donees are free of tax.

10. **If I benefit from the *forfait* regime, am I subject to social security taxes?**

Forfait taxpayers under the age of 65 are subject to social security contributions. Depending on an individual's wealth, the annual contribution may be as much as CHF 25,700 plus approximately 5% administrative costs.

11. **How do I obtain my *forfait* and what do I have to disclose?**

Obtaining the *forfait* is usually less of an issue than immigration, especially for persons who are not E.U. nationals.

Once the residence canton and commune of choice have been identified, the local cantonal tax authorities issue the *forfait* ruling. Information to be provided in conjunction with an application for a *forfait* ruling includes an individual's worldwide living expenses and an approximation of his or her wealth. The level of detail requested by the authorities varies greatly among the cantons.

Once all required information is provided, a ruling may be issued within a couple of weeks. On an annual basis, a simplified annual tax return will normally have to be filed.

12. **Which Cantons offer *forfait* regime tax rulings?**

Forfait taxation is available in most cantons, including

- Geneva,
- Vaud,
- Valais,
- Berne,

- Schwyz,
- Zug,
- Grison, and
- Ticino.

Zurich and Basel are among the cantons having abolished the regime.

13. How complicated is it to obtain an immigration permit?

The relevant criterion in determining the complexity of obtaining an immigration permit is the nationality of the applicant. The primary distinction is the one between E.U. nationals and nationals of countries outside the E.U. Nationals of the 27 E.U. Member States are entitled to a residence permit, provided they demonstrate the ability to finance their lifestyle, and obtain valid health insurance within three months from the arrival date. The procedure for nationals of other countries is somewhat more burdensome. Typically, an applicant must fit within one of three categories:

- The applicant must demonstrate a particular connection to Switzerland (*e.g.* childhood or holidays regularly spent, family members resident, or education in Switzerland).
- The applicant is 55 years old or older.
- The applicant qualifies for a statutory exemption. Statutory exemptions can include a cultural exemption or a fiscal exemption, which is similar to an investor visa in other countries.

Nationals of countries that are not E.U. Member States may also seek a permit for education or medical reasons. For *forfait* purposes, such permits are not relevant except for the stays of an extended period.

An applicant's family will normally be granted the right to join the *forfait* taxpayer once he or she has obtained a residence permit.

14. Will Swiss forced heirship rules apply to my estate?

Swiss forced heirship rules are optional for foreign nationals, who may select the law that applies to the devolution of their property. If an individual is a national of an E.U. Member State, the E.U. Succession Regulation will be applicable.

15. Am I allowed to buy an apartment to serve as my residence?

The right to purchase real estate is unrelated to an individual's tax status. The rules apply equally to a holder of a *forfait* as to a foreign national that is an ordinary taxpayer.

Switzerland has enacted a statute restricting the acquisition of real property by persons who are not Swiss nationals. The statute is known as "Lex Koller." More or less, it provides as follows:

- A national of a Member State of the E.U. or the E.F.T.A. who resides in Switzerland is not subject to any restriction under Lex Koller.
- A national of Member States of the E.U. or the E.F.T.A. who is not a Swiss resident must obtain a Lex Koller permit for the acquisition of a holiday home.
- A national of a country outside the E.U. or the E.F.T.A. who holds a permanent residence permit (a “C permit”) is not subject to any restriction under Lex Koller.
- A national of a country outside the E.U. or the E.F.T.A. who holds an ordinary residence permit (a “B permit”) is entitled to purchase a primary home without a Lex Koller-permit. The purchase of a second home will require a Lex Koller permit.
- A holiday apartment inherited from a parent is not subject to Lex Koller.

In addition, Switzerland has enacted second home legislation, that applies regardless of nationality. The legislation essentially restricts the quota of holiday homes within a commune to 20% of the housing stock in the commune.

CONCLUSION

Many European countries compete to be attractive jurisdictions for the wealthy or near wealthy. The list grows from year to year, but also shrinks. In comparison to the “wannabe’s,” Swiss voters approved the existence of the *forfait* regime in a national vote by over 60% of the population voting favorably. Of equal importance, the tax regime is controlled locally on a canton-by-canton basis, meaning that the regime is beyond the reach of a central government, which is the case in other jurisdictions. It may not be the non-dom regime with the lowest annual tax payment, but for those who can afford it, the Swiss *forfait* regime is here to stay.

ISRAEL PROPOSES MODIFICATIONS TO TAX REPORTING OBLIGATIONS OF *OLIM*[1]

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Tags
Aliyah
Exchange of Information
F.A.T.F.
Global Forum
Israel
Olim
Reporting Exemption
Transparency

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INTRODUCTION

On April 2, 2024, the Israeli Parliament (the "Knesset") enacted a law to modify existing tax reporting provisions contained in the Israeli Income Tax Ordinance [New Version], 5721-1961 (the "I.T.O."). The new law will affect Israeli entities, certain trusts, and Israeli "Residents for the First Time" and "Senior Returning Residents." Senior Returning Residents are those individuals who immigrated back to Israel after being considered foreign residents for Israeli tax purposes for at least 10 consecutive years prior to the date of return to Israel. In this article, Israeli Residents for the First Time and Senior Returning Residents are referred to as "*Olim*."[2]

O.E.C.D. GLOBAL FORUM

The new law was enacted following recommendations of the O.E.C.D. Global Forum on Transparency and Exchange of Information for Tax Purposes. The new law is part of a wider effort by the State of Israel to comply with the international requirements on information exchange set forth by the Global Forum. The mission statement of the Global Forum is to promote the adoption of tax transparency on a global basis and to monitor the rules and practices of countries. In principal, the goal is to prevent tax evasion, money laundering, and terrorist financing. With 171 members, the Global Forum is `the leading international body working on the implementation of global transparency and exchange of information standards around the world. It issues peer review reports on transparency and exchanges of information on request. In performing a peer review of Israel, the Global Forum identified deficiencies in Israel's current information reporting standards. If not corrected, Israel would risk being included in the O.E.C.D. blacklist of noncompliant countries. Blacklisted countries are exposed to significant sanctions by European Union countries. Examples are excessively high withholding tax rates on transfers of dividends and investments from E.U. countries to Israel.

THE FINANCIAL ACTION TASK FORCE

In 2016, the Global Forum adopted recommendations 24-25 of the Financial Action Task Force (the "F.A.T.F."). The F.A.T.F. is the global money laundering and terrorist

1 Royi Heilig, an associate at Arnon, Tadmor-Levy, and Ximena Silberman, an L.L.M. candidate at Tel Aviv University, contributed to this article. This article was first published at the time when changes to the law in Israel were proposed. Ultimately, the changes were adopted with certain modifications. The article is revised the to reflect to the law as adopted.

2 Individuals who move to Israel permanently are said to "go up to Israel." The word "*Olim*" is the Hebrew word for those individuals.

financing watchdog. It sets international standards that aim to prevent these illegal activities and the harm they cause to society. The issues that the F.A.T.F. works on include the following:

- Methods and trends
- Recommendations
- Mutual evaluations
- High-risk and other monitored jurisdictions

The F.A.T.F. works on the following areas in carrying out its mission:

- Asset recovery
- Beneficial ownership
- Corruption
- Digitalization
- Environmental crime
- Financial inclusion and N.P.O. issues
- Proliferation financing
- Terrorist financing
- Virtual assets

INFORMATION ON U.B.O.'S OF CORPORATIONS

The new law does not alter tax liabilities in Israel or eliminate preferred tax treatment of *Olim*. Rather, it revises certain reporting obligations in order to increase transparency. According to the explanatory note published by the Ministry of Finance, the Global Forum identified two main transparency deficiencies under existing Israeli law:

- The lack of accessibility of state authorities to information about ultimate beneficial owners ("U.B.O.'s") in entities, legal arrangements, and certain trusts operating in Israel.
- The lack of reporting obligations imposed on *Olim*.

The recommendations of the F.A.T.F. concern the necessity of identifying the U.B.O. or U.B.O.'s in entities and other legal arrangements. The Global Forum asserted that similar provisions to identify U.B.O.'s governing money laundering and terrorist financing are also required to ensure that entities and legal arrangements are not being used to evade income taxes and to enable the tax authorities to receive full information regarding taxpayers. Under prior law, Israel did not require corporations to include information regarding U.B.O.'s in corporate income tax returns. Any corporation that generated taxable income was liable to submit an annual report to the Israel Tax Authority ("I.T.A."). Under the new law, the tax return requires inclusion of a list of its U.B.O.'s, their identifying details, and their countries of residence for tax purposes.

U.B.O. OR CONTROLLING PERSON DEFINED

The new reporting provisions would apply beginning with tax returns filed for the tax year 2025. For this purpose, a U.B.O., referred to as a controlling person in the I.T.O., would be one of following individuals:

- An individual who has the ability to direct the corporation's activities alone or together with others, either directly or indirectly, including the ability arising from such corporation's articles of association, or from any other source, excluding the ability arising from the role of an officer.
- Without detracting from the provisions of the first paragraph, an individual who owns 25% or more of any type of the corporation's means of control, and no other individual holds a larger portion of control, either alone or in concert with others.
- Without detracting from the above two paragraphs, if a corporation has no one individual that falls under the descriptions above, the controlling person would be the chairman of the board, any officer or the C.E.O. If none of the above exists in the corporation, the backstop provision looks to the officer who has effective control over the corporation. The proposed amendment requires that each U.B.O. or controlling person must provide the corporation with relevant information about his or her identity in order to promote compliance in the tax return.

REPORTING OF U.B.O.'S IN CERTAIN TRUSTS

Under prior law, an Israeli resident trustee of a foreign resident trust, or a foreign beneficiary trust was not required to submit annual tax returns to the I.T.A., provided the trust do not generate Israeli-source income. According to the Global Forum review, these circumstances may create a transfer of cash or other assets by Israeli trustees without submitting information to any tax authority regarding the U.B.O.'s. According to the new law, Israeli resident trustees who are not required to submit annual tax returns to the I.T.A., will be required to submit a list of controlling persons within 120 days from January 1, 2026.

PROPOSED AMENDMENT REGARDING *OLIM*

Through 2002, taxes in Israel were imposed under a territorial regime, looking only on income generated in the State of Israel. Beginning in 2003, taxes in Israel have been imposed on a global basis, looking to worldwide income in addition to income generated in Israel. In order to encourage immigration by both new arrivals and returning individuals, Israel granted certain tax benefits to individuals in both categories of *Olim*. Initially, they benefitted from an exemption on passive income and capital gains generated from sources outside Israel. In 2008, *Olim* were granted a tax exemption regarding all income generated from sources outside Israel for a period of 10 years from the start of Israeli tax residence. Moreover, *Olim* were not required to file tax returns or to provide information regarding foreign source income and assets during the 10- year period of exemption. The Global Forum determined that the reporting exemption during the 10-year period of exemption creates transparency deficiencies. To remedy the deficiency, the proposed amendment eliminates the reporting exemption. *Olim* who arrive in Israel on or after January 1, 2026, must report worldwide income and assets during the 10-year period of their tax exemption. The explanatory note to the proposed amendment highlights that these changes are ultimately beneficial for law-abiding *Olim*. The basic rationale for this position is that, if the proposed amendment was not to be adopted, Israel could have been blacklisted by the O.E.C.D. Were that to occur, access to foreign investments by *Olim* would be impaired. It is relevant to emphasize that at this point in time, the 10-year tax exemption remains in full force. The new law affects only the reporting exemption. According to the explanatory note to the proposed amendment, it is expected the I.T.A. would allow *Olim* to comply with the new reporting obligations by presenting income tax returns from the jurisdiction in which the income originates and in the original language in which the foreign tax return was prepared.

CONCLUSION

The extent to which the current reporting exemption is a driving factor to immigrate to Israel is an open question. It is likely that some *Olim* immigrate to Israel principally to benefit from the reporting exemption. The effect of the elimination of the reporting exemption on the future level of immigration is yet to be seen. In the short run, immigration may spike through the end of December 2025. Thereafter, only time will tell.

ADVENTURES IN TRANSFER PRICING – PRACTICAL EXPERIENCE IN GERMANY

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INTRODUCTION

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

GERMAN ECONOMIC AND REGULATORY LANDSCAPE

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

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

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

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

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

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

INCREASING TRANSFER PRICING CONTROVERSY IN GERMANY

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

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

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

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

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

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

Regarding tax litigation, the statistics are blurred as many cases are settled before a decision is issued. This often arises when judges assigned to a case indicate to the parties the argument they may tend to favor, pointing out remaining uncertainties, especially when it comes to economic quantification in the grey zone of transfer pricing. Judges often recommend an out-of-court settlement in order to reduce their workload and to avoid having to make quantitative decisions for which they have no proper economic expertise. Recent Financial Court decisions primarily related to financial transactions and business restructurings are relatively favorable to the taxpayer, which is fairly good news given that the lower Financial Courts are generally presumed to have a bias in favor of the German tax authorities.

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

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

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

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

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

Amazingly, despite having become the principal for the German market, Swiss-Co was loss-making in the relevant tax audit period. The reason was that, in those years, Swiss-Co invested significant amounts to expand in other European markets, while economic circumstances for the relevant products became less favorable. However, the client management information system of Swiss-Co was not able to provide a proper P&L segmentation demonstrating the segment profits Swiss-Co was making in relation to the German market. The German authorities became completely distrustful of the submitted P&L data, and raised a general suspicion that profits had been shifted from Switzerland to some Caribbean island known to host a group subsidiary.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

G-Co operated as a sales affiliate for the German market. In a tax examination covering the 2013 to 2016 period, German tax authorities challenged the intercompany pricing setup and rejected the transfer pricing analysis of the Big Four consultants, contending that it was flawed. The tax authorities determined that the group effectively applied the T.N.M.M. method by setting a royalty rate and product transfer pricing mix that held the German operating margin at 3% of sales. As a matter of policy, German tax authorities accept the T.N.M.M. as the best method only if the activities of the German taxpayer are purely routine. In comparison, when a distributor operates as licensee, German tax authorities assert that the distributor effectively becomes entrepreneurial and conducts non-routine D.E.M.P.E. functions to promote the trademarks in the German market. The field tax inspectors identified several business operations supporting that view.

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

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

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

The puzzle was solved through the following steps:

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

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

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

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

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

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

OUTLOOK

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

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

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

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

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Tags
Anti-Hybrid Rules
Hybrid Dossier
Legislative Decree 209/2023
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INTRODUCTION

Italian anti-hybrid were enacted by Legislative Decree no. 142/2018 (the "Italian A.T.A.D. Decree"), which transposed A.T.A.D. 1 and A.T.A.D. 2 into the Italian tax system without significant deviation. It provided rules to combat base erosion and the shifting of profits. The Italian anti-hybrid rules apply to fiscal years beginning on or after January 1, 2020, except for the provisions targeting the reverse hybrid mismatches, which will apply to fiscal years beginning on or after January 1, 2022.

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

BACKGROUND

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

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

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

- **Deduction and Non-Inclusion Mismatch ("D/N.I.").** This arises when a payment results in a deduction in one jurisdiction with no corresponding inclusion in the taxable base of the recipient located in the other jurisdiction. The D/N.I. must be derived from differing tax treatment in the two jurisdictions involved in an instrument, payment, entity, or branch arrangement, irrespective of the legal labels used.

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

- **Double Deduction ("D/D").** This occurs when taxpayers are entitled to a deduction in two countries for the same payment.
- **Indirect D/N.I.** This relates to payments that are deductible by the payor under the rules of the jurisdiction of residence but are not subject to tax in the jurisdiction of residence of the payee.

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

In line with point 11 of the Preamble to A.T.A.D. 1, the Explanatory Note to the Italian A.T.A.D. Decree clarifies that the Italian anti-hybrid rules are intended to address only cross-border mismatches and do not apply to mismatches arising between two taxpayers resident in Italy. In this respect, mismatches involving taxpayers considered to be controlling or controlled enterprises located in different jurisdictions or arising in the context of a structured arrangement between two independent enterprises, wherever located, are covered by the Italian anti-hybrid rules.

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

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

SCOPE

Mismatches Covered

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

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

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

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

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

Taxes Covered

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

Regional tax ("*Imposta regionale sulle attività produttive – I.R.A.P.*") is generally imposed at the rate of 3.9%. Where an income tax treaty covers local taxes such as regional and municipal taxes, the Italian anti-hybrid rules only consider taxes applied at the national or highest level (*e.g.*, at the federal level in Switzerland).

Nature of Anti-Hybrid Rules

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

PENALTY PROTECTION

The Hybrid Dossier

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

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

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

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

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

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

The Reason Behind the Policy

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

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

Content and Format

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

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

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

Fiscal Years Covered by the Penalty Protection

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

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

COMMENTS AND TAKEAWAYS

Tax Benefit

The introduction of the new penalty protection regime for hybrid mismatches represents a significant forward step in Italy for promoting cooperation between taxpayers and Italian tax authorities. While the hybrid dossier may be viewed as an additional compliance burden, its preparation generates significant advantages both in terms of penalty elimination and tax risk management.

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

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

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

Is This Big News?

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

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

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

Groupwork

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

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

Limitations for Prior Fiscal Years

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

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

This means that the effect of the hybrid dossier for covered fiscal is precluded where the Italian tax authorities have already initiated a tax audit, investigation activities, or similar actions. This means that the deadline for Italian tax authorities to begin an examination of the years 2020-2022 is the date for the submission of the I.R.E.S. tax return for fiscal year 2023, currently set at October 15, 2024.

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

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

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

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

Criminal Shield

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

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

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

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

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INTRODUCTION

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

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

DIFFERENT LEGAL SYSTEMS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

ESTATE PLANNING OPTIONS AND INSTRUMENTS

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

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

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

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

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

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

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

PRACTICAL EXAMPLE

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

Facts

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

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

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

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

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

Problems That May Be Encountered

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

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

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

Steps To Be Taken During Lifetime

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

Other Issues

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

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

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

FORMAL REQUIREMENTS FOR A SWISS WILL

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

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

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

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

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

RECOMMENDATIONS

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

FRENCH REPORTING OBLIGATIONS FOR FOREIGN FINANCIAL TRUSTS

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Tags
Annual Declaration
Event-Based Declaration
Foreign Finanical Trusts
U.S.D.M.T.N.

INTRODUCTION

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

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

BACKGROUND

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

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

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

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

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

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

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

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

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

SCOPE AND CONTENT OF FRENCH REPORTING OBLIGATIONS REGARDING TRUSTS

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

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

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

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

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

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

[3] Art. 750 ter.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

RECENT RULINGS ISSUED BY THE F.T.A.

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

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

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

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

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

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

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

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

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

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

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

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

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

OUTSTANDING ISSUES

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

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

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

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

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

PATH FORWARD

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

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

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

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

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

CONCLUSION

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

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

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

NETHERLANDS: NEW LEGISTLATION TO COMBAT HYBRID MISMATCHES

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INTRODUCTION

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

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

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

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

BACKGROUND OF THE PROPOSAL

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

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

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

Key elements of the proposal include the following:

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

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

CURRENT CLASSIFICATION RULES

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

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

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

NEW RULES: TWO SUPPLEMENTARY METHODS

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

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

Fixed Method

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

Symmetric Method

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

APPLICATION

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

Personal Income Tax (*Inkomstenbelasting*)

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

Corporate Income Tax (*Vennootschapsbelasting*)

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

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

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

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

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

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

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

Dividend Tax (*Dividendbelasting*)

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

Withholding Tax (*Bronbelasting*)

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

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

Related Party

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

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

Low Tax Jurisdiction

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

Coordination with Dividend Tax

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

Effect on Offshore Funds

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

TESTING COMPARABILITY OF FOREIGN ENTITIES

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

Draft Decree

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

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

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

legislation.

IMPACT ON STRUCTURE

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

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

On a very general note, all of the entities listed above should not be affected by these new rules, except for L.P.'s and L.L.P.'s that are transparent from a U.S. tax perspective. Those entities will be considered to be transparent for Dutch tax purposes, while pre-2025, these entities would almost always be considered to be nontransparent.

DUTCH TAX CONSEQUENCES FOR CHANGES IN TRANSPARENCY

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

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

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

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

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

DUTCH TAX IMPLICATIONS FOR U.S. INVESTORS

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

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

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

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

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

DEMISTIFYING KEY COMPLEXITIES OF THE INDIA BUDGET 2024-25

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INTRODUCTION

The Indian finance minister ("F.M.") presented Budget 2024-25 (the "Budget") on July 23, 2024, This was the current F.M.'s record-breaking seventh consecutive budget and the first budget after the Modi-led N.D.A. 3.0 government was back in power. Subsequently, on August 7, 2024, amendments were made to some of the direct tax proposals announced in the Budget.

BUDGET AT A GLANCE

During financial year ("F.Y.") 2023-24, the Indian economy emerged strong and resilient with a gross domestic product ("G.D.P.") growth rate of 8.2%. Surpassing the United Kingdom, India has sprinted to the position of the fifth largest economy in the world, and is not far from overtaking Japan and Germany to attain the third spot.

Budget 2024-25 continues to focus on four major categories: (i) the poor, (ii) women, (iii) youth, and (iv) farmers. Some of the noteworthy policy proposals announced in the Budget include the following areas of focus:

- Agriculture
- Five schemes for employment and skill upgrading
- The development of road connectivity projects
- Women-led development
- Irrigation and flood mitigation
- The promotion of tourism
- The simplification of foreign direct investment
- Opportunities to use the Indian Rupee for overseas investments

Overall, Budget 2024-25 is testimony to the fact that the Indian economy continues to grow. With a growth rate of over 7% for the third consecutive F.Y., the economy is on track to achieve its goal of "Viksit Bharat," or "Developed India," by 2047, which is the centennial anniversary of India's independence.

KEY AMENDMENTS IN THE DIRECT TAX SPACE

On the tax front, the Budget offered a blend of promising measures and some less favorable elements.

This article discusses some of the significant direct tax proposals announced in the Budget. The direct tax proposals discussed below are effective for F.Y. 2024-25, *i.e.*, from April 1, 2024, onwards, unless otherwise stated.

Corporate Tax Rate

Generally, Indian domestic tax law provides different base tax rates for domestic and foreign companies. Earlier, domestic companies were taxed at a base rate of 30% and smaller domestic companies with a turnover of up to INR 4 billion (~$50 million) were taxed at a base rate of 25%. In addition, domestic companies were required to pay a dividend distribution tax ("D.D.T.") at a base rate of 15% on profits distributed by way of dividends. The base rate of tax for foreign companies has been 40% since F.Y. 2002-03, with no additional taxes on the distribution of profits.

Both domestic and foreign companies are required to pay a surcharge, as applicable, on top of the base tax, as well as a health and education cess[1] of 4%, which is levied on the aggregate of the base tax and surcharge, if any. The surcharge is an additional tax that must be paid by taxpayers earning a higher level of income, determined based on their legal entity status and in accordance with the income thresholds specified in the tax law. The health and education cess is required to be paid by all taxpayers and is an additional tax collected to specifically fund the government's health and education initiatives.

Domestic as well as foreign companies were also subject to the provisions of the minimum alternate tax ("M.A.T."), which is computed at the base rate of 15% on book profits.

The applicability of the D.D.T. to domestic companies narrowed the gap between the headline tax rates for foreign companies and domestic companies.

In September 2019, a new optional tax regime was introduced for domestic companies. Under this optional regime, the rate of tax for domestic companies was reduced from 30% to 22%, subject to a taxpayer meeting certain conditions. This resulted in a maximum tax rate of 25.17% (including the surcharge and health and education cess) for domestic companies which opted for the new regime. Domestic companies which opted for this regime were also not subject to M.A.T. provisions.

Subsequently, from F.Y. 2020-21 onwards, the D.D.T. was abolished and the taxation of dividend was shifted to the recipients of the dividend.

The reduction in the corporate tax rate for domestic companies along with the elimination of the D.D.T. significantly widened the gap between the base tax rates applicable to foreign companies (40%) and domestic companies (22%). Globally, the general practice is to have a tax rate parity across all kinds of entities within the same industry.

The Indian government has reviewed various proposals to reduce the corporate tax rate applicable to foreign companies and address this disparity. The tax law was amended to lower the base corporate tax rate for foreign companies from 40% to 35% as of April 1, 2024. With this decrease in the base rate, the maximum effective tax rate for foreign companies is reduced from 43.68% to 38.22%. This long-awaited amendment brings considerable relief for foreign companies.

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[1] A cess is a form of charge that is used to fund a specific purpose.

TAXATION OF CAPITAL GAINS

In General

As per the domestic tax law, income is computed under five headings, one of which is capital gains. Income arises under this heading when a person transfers a capital asset as defined in the tax law.

Capital gains are further categorized as either long-term capital gains ("L.T.C.G.") or short-term capital gains ("S.T.C.G.") based on the holding period of the asset.

The taxation of capital gains in India is quite complex as compared to global markets, and requires the taxpayer to consider various aspects, including

"Capital gains are further categorized as either long-term capital gains or short-term capital gains based on the holding period of the asset."

- the type of asset;
- the holding period of the asset;
- differences in the rates of tax for different asset classes, including specific provisions for financial assets (equity and debt);
- differences in the rates of tax based on the residence status of the transferor; and
- the availability of an indexation benefit.

Further, the capital gains tax regime has undergone various revisions over the past few years. In order to attract foreign investments and create a vibrant Indian economy, simple and predictable tax treatment is of paramount importance.

With a view towards simplifying the capital gains tax regime, various amendments have been introduced in the Budget which will take effect from July 23, 2024. Some of the key amendments are discussed below.

Holding Period of Asset

Firstly, the tax law has been amended to provide for only two holding period rules to determine whether a capital gain is an S.T.C.G. or an L.T.C.G. The holding period for L.T.C.G. treatment is 12 months for listed securities. The term "listed securities" under Indian domestic tax law refers to securities which are listed on a recognized stock exchange in India. For all other assets, the holding period for L.T.C.G. is 24 months. The 24-month holding period applies to unlisted securities and to securities which are listed on foreign stock exchanges.

Base Rates of Tax

L.T.C.G.

Under the earlier tax law, L.T.C.G.'s were taxed at a base rate of either 10% or 20% depending on the asset class. The Budget has amended the base rates of tax on L.T.C.G.'s to create uniformity across all asset classes.

Under the amended provisions, the base rate of tax on an L.T.C.G. has been standardized at 12.5% for all asset classes. On one hand, this provision has resulted in a favorable change for certain assets, such as unlisted shares and real estate, which were generally taxed at 20% under prior law. However, for assets such as listed shares and units of equity-oriented mutual funds, the rate of tax was increased from 10% to 12.5%.

S.T.C.G.

Under the existing tax law, the base rate of tax on an S.T.C.G. was either 15% or the relevant tax rate applicable to the respective taxpayer (which could range from 5% to 40%, depending on legal entity status and income level). Now, the base rate of tax on S.T.C.G.'s will be 20% or the relevant tax rate applicable to the taxpayer. This amendment has resulted in an increase in the tax rates applicable to the transfer of certain short-term capital assets, such as equity shares, units of equity-oriented mutual funds, and units of a business trust, from 15% to 20%. Gains arising from the transfer of other short-term capital assets will continue to be taxed at the relevant rates applicable to the respective taxpayer.

Further, under the revised provisions, capital gains from the transfer, redemption, or maturity of certain classes of assets will be taxed as S.T.C.G.'s irrespective of the period of holding. Assets subject to S.T.C.G. treatment include

- unlisted bonds and debentures;
- market-linked debentures; and
- units of specified mutual funds that invest more than 65% in debt and money market instruments.

The rate of tax on these assets will be the relevant tax rate applicable to the taxpayer. For units of specified mutual funds, grandfathering provisions have been introduced for units purchased before April 1, 2023, and these units will continue to be taxed as either an S.T.C.G. or an L.T.C.G. based on the actual holding period.

Indexation of Cost

Under prior domestic tax law, taxpayers were permitted to reduce L.T.C.G. by applying the indexed cost of an asset instead of the original cost for certain assets. Indexation is essentially a mechanism to adjust the purchase price of assets for inflation.

In the initial Budget announcement, the F.M. announced the withdrawal of the indexation provisions. Thereafter, perhaps taking into consideration the backlash from taxpayers, the provisions relating to indexation were grandfathered for certain assets in the amendments to the Finance Bill.

As per the revised provisions, the benefit of indexation is now available only to resident individuals and certain other resident taxpayers ("Hindu Undivided Families") on the transfer of immovable property which was acquired before July 23, 2024. Accordingly, L.T.C.G. tax on the transfer of immovable property acquired before July 23, 2024 will be computed as the lower of either

- 12.5% on L.T.C.G.'s computed without indexation, or
- 20% on L.T.C.G.'s computed with indexation.

No benefit of indexation will be available in any other case.

The removal of the indexation benefit will potentially increase the amount of taxable L.T.C.G.'s for assets purchased after July 23, 2024, especially for real estate, which typically are held for long periods of time. This amendment affects many taxpayers.

Basic Exemption Limit for L.T.C.G.

A small increase has been provided in the basic exemption limit on the taxation of L.T.C.G.'s, from INR 100,000 (~$1,200) to INR 125,000 (~$1,500). Accordingly, L.T.C.G.'s will be taxed only if they exceed INR 125,000 (~$1,500) in an F.Y. This exemption is applicable only to L.T.C.G.'s arising from the transfer of certain assets such as equity shares, units of equity-oriented mutual funds, and units of a business trust, which have been subject to payment of securities transaction tax ("S.T.T.")

Parity Between Residents and Nonresidents

In order to bring parity between the taxation of residents and nonresidents, there will be no difference in the rates of tax paid by residents and nonresidents on capital gains. With this amendment, the tax rate on L.T.C.G.'s arising on the transfer of certain classes of assets has been increased from 10% to 12.5%. Assets affected by this rule include:

- Units acquired by an offshore fund in a foreign currency, and
- Bonds of an Indian company or global depository receipts acquired by a non-resident in a foreign currency.

This revision may influence investment and tax planning strategies.

Overall Comment

It may be observed that sweeping amendments have been made to the capital gains tax regime in the Budget. While some of the above amendments, such as a uniform holding period, help in simplifying the capital gains tax regime, the result of certain other amendments may actually be an additional tax burden, such as the withdrawal of the indexation benefit in most cases, or the increase in base tax rates for certain assets. Therefore, there are mixed reactions among taxpayers to these amendments.

ABOLITION OF ANGEL TAX

Over the past few years, India has experienced an unprecedented surge in the creation and funding of start-up companies. However, the growth of the start-up ecosystem was somewhat hampered by the introduction of the "angel tax," starting from F.Y. 2012-13. This was part of various measures introduced to curb the generation and circulation of unaccounted money.

The term "angel tax" refers to the income tax levied on funds raised by unlisted domestic companies in excess of the fair market value ("F.M.V.") of equity shares issued by such companies. This tax generally impacts angel investment in start-ups. For that reason, it is popularly referred to as the "angel tax." The angel tax is required to be paid by unlisted domestic companies. Venture capital undertakings were kept outside the purview of the angel tax. Complex valuation rules were introduced for the determination of the F.M.V. of shares of such companies.

The angel tax provisions were relaxed slightly in F.Y. 2018-19, to reduce the burden on smaller start-ups. Start-ups having an aggregate share capital and share premium up to INR 100 million (~$1.2 million) were outside the purview of the provisions of the angel tax. The relaxation was effective from April 11, 2018. This limit was further raised to INR 250 million (~$3 million) as of February 19, 2019. However, due to the low exemption threshold, a majority of businesses remained subject to angel taxation.

Initially, the scope of the angel tax was restricted to funds raised by unlisted companies from Indian residents. However, the scope of the angel tax was expanded to cover funds raised from nonresidents, effective from F.Y. 2023-24.

In nascent stages when start-up companies have their greatest need fort funds to build their businesses, start-up companies generally do not have significant value. Consequently, most start-up businesses would fall within the scope of the angel tax. Hence, over the years, angel taxation has continued to be a hindrance to the fundraising capacity of start-ups.

"To boost the start-up ecosystem further and to encourage innovation, the Budget abolishes the angel tax across all classes of investors."

To boost the start-up ecosystem further and to encourage innovation, the Budget abolishes the angel tax across all classes of investors. This amendment is effective for F.Y. 2024-25 onwards. The elimination of the angel tax is viewed as a significant reform that will simplify the funding process for start-ups in India and in turn boost job creation.

TAXATION OF BUYBACK OF SHARES

A buyback of shares or a share repurchase scheme is a corporate action under which a company buys back its own shares from existing shareholders. A buyback is usually undertaken to maintain a majority stake or to distribute surplus cash available within the company.

In general, a company that has distributable profits has two options in order to distribute them to its shareholders: a *pro rata* buyback of shares or a distribution of dividends. Earlier, both modes of distribution were subject to tax in the hands of the company. However, in the past few years, the tax law has been amended to subject the shareholders to tax in both cases.

Prior Law

Prior to its repeal, companies distributing dividends were required to pay a D.D.T. at 15% on the amount of the dividends. The dividends were exempt in the hands of the shareholders. Subsequently, the tax law was amended to abolish the D.D.T. with effect from F.Y. 2020-21. Hence, dividends are now taxed in the hands of the shareholders at their respective tax rates.

On the other hand, net buyback proceeds were taxable in the hands of the shareholders in the form of capital gains at lower tax rates. Since there was no D.D.T. under this mode of distribution, the buyback of shares was a favored mode for distribution of profits by companies.

In order to bring parity to the taxation of the distribution of profits, the tax law was amended with effect from June 1, 2013, to introduce a tax on the buyback proceeds paid to shareholders. Companies were required to pay tax at a flat rate of 20% plus the applicable surcharge and health and education cess on such buyback proceeds. Consequently, the income arising from the buyback was exempt in the hands of the shareholders.

Budget Amendment

The Budget has now amended the tax law to align the taxation of buyback proceeds with the dividend regime. Effective October 1, 2024, the flat tax rate of 20% on buy-back proceeds has been eliminated, and buyback proceeds are now treated akin to "deemed dividend income" in the shareholders' hands. No deduction for expenses will be allowed against this deemed dividend and hence, the gross receipts will be subject to taxation at the respective tax rates applicable to the recipient. The domestic company is required to withhold tax at applicable rates on the amount paid to shareholders on the buyback of shares.

Further, under the amended provisions, when a company undertakes a buyback, it will result in the transfer of a capital asset for the shareholder. For the purposes of computing the capital gains on such a transfer, the value of consideration received by the shareholders on a buyback of shares will be deemed to be nil, resulting in a capital loss for the shareholders equivalent to the cost of the shares.

Shareholders will be eligible to set off the above loss against other eligible capital gains earned, in accordance with the provisions of the tax law. This new provision may be less tax efficient for many shareholders. For instance, a shareholder may pay tax on buyback proceeds at the applicable tax rates which could go up to 30% for residents, depending on legal entity status and income level, and 20% for non-residents, including foreign companies subject to tax treaty benefits. However, if this is a long-term asset for the taxpayer, the capital loss on buyback will be permitted to be set off only against L.T.C.G.'s which would have been otherwise taxed at a rate of 12.5%.

The intention of this amendment appears to be to ensure that both methods of distribution of accumulated reserves are taxed similarly. However, frequent amendments in the taxation of buybacks and dividends over the past few years have not gone down well with taxpayers, leading to a sense of uncertainty.

EQUALIZATION LEVY

With the advent of the digital economy in the last decade or so, new business models have given rise to fresh tax challenges globally. The Organization for Economic Co-operation and Development ("O.E.C.D.") issued Base Erosion and Profit Shifting ("B.E.P.S.") Action Plan 1 to address the tax challenges of the digital economy, and set up various task forces to help resolve this issue.

One of the recommendations of the O.E.C.D. was the introduction of the "equalization levy." This levy was intended to tax the significant economic presence of a nonresident enterprise in another country.

India introduced an equalization levy ("E.L.") of 6% on certain online advertising and related services effective from F.Y. 2015-16. Subsequently, India expanded the scope of the equalization levy to include the e-commerce supply of certain goods or services by a nonresident e-commerce operator. An E.L. of 2% ("E.L. 2.0") was introduced on consideration received or receivable by e-commerce operators from the e-commerce supply of goods or services. The expansion took effect from F.Y. 2020-21.

E.L. 2.0 is payable by an e-commerce operator who does not have a permanent establishment in India if its turnover from e-commerce operations during the relevant F.Y. exceeds INR 20 million (~$240,000).

Income of nonresidents which has been subject to E.L. and E.L. 2.0 is exempt from other provisions of domestic income tax of India. However, since E.L. as well as E.L. 2.0 were not introduced in the domestic tax law but under a separate Finance Act, taxpayers face a challenge in claiming a foreign tax credit for these levies in accordance with the provisions of double taxation avoidance agreements, causing undue hardship to nonresident taxpayers.

Due to the broad definitions of the terms "e-commerce operator" and "e-commerce supply or services," and a low monetary threshold for applicability of the E.L., many business transactions were covered under the scope of the levy.

In order to address the above issues, E.L. 2.0, *i.e.*, the 2% levy on e-commerce transactions, has been withdrawn with effect from August 1, 2024. However, the E.L. of 6% on specified online advertising services will continue to apply.

The withdrawal of E.L. 2.0 is indicative of the Indian government's intention to ease compliance requirements, encourage the expansion of digital commerce, and guarantee fair tax treatment across various transaction channels. The withdrawal of E.L. 2.0 is expected to provide a major relief to global e-commerce operators.

ANTICIPATED DEVELOPMENTS

Based on the current global developments and the move towards a global minimum tax, the Budget was expected to lay down the roadmap for the implementation of Pillar Two provisions. Contrary to expectations, the Budget is silent on this issue. Equally, the absence of tax reforms for the electric vehicles sector is notable.

In addition, it was expected that the time limit for the concessional tax regime of 15% allowed to certain new manufacturing companies would be extended with a view to spur employment generation. However, the Budget did not address this provision.

The F.M. has announced in her Budget speech that a comprehensive review and complete overhaul of the income tax law will be undertaken within a period of six months. Accordingly, we may see more simplification and rationalization of the tax law in the next Budget, which will be announced in February 2025.

DESIGN AND IMPACT OF THE COLOMBIAN "SIGNIFICANT ECONOMIC PRESENCE" REGIME

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INTRODUCTION

Before and after joining the O.E.C.D. in 2020, Colombia was an enthusiastic adopter of international tax policies promoted by the O.E.C.D.'s B.E.P.S. Project. Two motivations spurred this action. First, the government wished to overcome technical gaps in the domestic legislation of cross-border taxation. Second, the government sought additional revenue from nonresident companies doing business with clients based in Colombia. This process began with the adoption of the inclusion of the permanent establishment and place of effective management regimes, the controlled foreign entities regime, and the imposition of V.A.T. on services provided from abroad.

However, the Significant Economic Presence ("S.E.P.) regime breaks with the tradition of adopting modifications in a way that is consistent with O.E.C.D. policies. It deviates from fiscal policy recommended by the O.E.C.D. by expanding the scope of domestic source income in order to tax suppliers of goods and services from abroad even when the suppliers maintain no permanent establishment in the country. Thus, Colombia has reacted unilaterally to impose tax on foreign suppliers of goods and services.

Colombia created the S.E.P. regime as a unilateral alternative to the global proposal of Pillar 1, rejecting this proposal based on two strategic considerations. The first was the low probability of global implementation. The second was the expansion of the tax base beyond that provided by Pillar 2.

Both reflect the policies of the Minister of Finance, Dr. José Antonio Ocampo, who developed a significant international reputation for fiscal activism for developing countries. Under his auspices, Colombia took a significant leadership role in the *Regional Platform for Tax Cooperation for Latin America and the Caribbean* that has as one of its main objectives the redistribution of tax powers of member states. His economic policies are reflected in the adoption of the S.E.P. regime.

THE S.E.P. AND INCOME TAX SYSTEM

At the international level, the proliferation of digital services tax ("D.S.T.") regimes in developing countries reflects the rejection of a bilateral approach to income taxation in favor of unilateral approach to expand the tax base. In the case of Colombia, the S.E.P. regime is clearly located in the area of income taxation. It simply expands the concept of national source, while adopting specific taxable elements of tax base and rates.

The purpose of the S.E.P. regime is to tax services that were not previously taxed by applicable legislation. Thus, for example, management and administration services provided from outside Colombia that already is subject to withholding tax of 33% is not covered by the S.E.P. regime. In the end, S.E.P. is a special form of national income tax that focuses solely on revenue generated from Colombian sources. It does not expand the concept of a permanent establishment. Had it done so, the S.E.P. theoretically could have allowed Colombia to tax the worldwide income like the country did with permanent establishments of foreign companies in 2019.

PROTECTION OF DOUBLE TAXATION TREATIES

In harmony with the recognition of S.E.P. as an income tax regime, the legislation includes an explicit reference to income tax treaties, confirming their priority in cases of S.E.P. This means that in those cases where a provider of taxable services under the S.E.P. regime is a resident of a country having an income tax treaty in effect with Colombia, the S.E.P. regime will not be applied by Colombia. This is due to the typical prevalence of Article 7 (Business Profits) focused on corporate profits, whereby only the country of residence would have the power to tax income not expressly covered under other articles of the income tax treaty.

This clear prevalence of the income tax treaty over the S.E.P. is not only valuable for the effect of digital services, but even more so for goods. As a result, business groups that are likely to come within the S.E.P. tax regime may restructure their internal supply chain so that sales to customers in Colombia will be made by subsidiaries located in an income tax treaty jurisdiction.

COVERAGE OF DIGITAL SERVICES OR SERVICES SOLD IN THE DIGITAL MARKETPLACE

The legislative process of the tax reform bill that included the S.E.P. regime left open the debate on whether the S.E.P. regime covered only digital services and services sold through a digital market or was intended to cover any services performed abroad for the benefit of a Colombian resident. The latter expansive reading would suggest that the S.E.P. is akin to a V.A.T. applied to services performed abroad by nonresidents.

This uncertainty was not resolved by the draft Regulatory Decree that was circulated in November 2023 or its final version. It was the Colombian Tax Administration, commonly referred as the "D.I.A.N.," that concluded the S.E.P. regime taxes only digital services or those services sold through a digital market. The conclusion of the D.I.A.N. is well supported by the analysis of the legislative evolution of this particular reform. So long as it does not change, any service that is not digital and not sold through a digital market is excluded from the S.E.P.

COVERAGE TO GOODS IN GENERAL

When Colombia adopted a D.S.T., it covered the generic category of "goods" without any conceptual restrictions or clarifying guidelines. As a result, goods include both tangible and intangible assets. The D.I.A.N. has simply confirmed its understanding that there is a generic coverage of goods in the S.E.P. regime. Consequently, Colombia adopted an expansive deviation from the international standard of not imposing income tax on the import of goods.

The sensitivity to a possible payment of income tax to the exporter of goods from another jurisdiction cannot be underestimated. Income tax is imposed at the rate of 3% on gross sales to Colombian customers if the supplier files a tax return or at a 10% withholding rate, which is both a final tax. With different source of income rules applied in Colombia and abroad, double taxation would exist, distorting Colombia's competitive position from the perspective of a supply chain.

The alternative to mitigate such inefficiency would be a gross-up of the sales price so that the seller achieves the same amount of after-tax profit.[1] It follows that this would generate an inefficient increase in cost structure for the Colombian importer. Ironically, this if this ultimately shifts the economic cost of the tax to the Colombian importer, contrary to the intent of the government.

In the case of suppliers from the U.S., where there is no S.E.P. antidote in the form of an applicable income tax treaty with Colombia, a Free Trade Agreement exists that restricts tariffs and nontariff measures that affect trade. Already, statements have been made by American trade associations about the potential violation of the Agreement resulting from the enactment of the S.E.P. regime. To the extent that the door to goods is kept completely open and the criteria on "deliberate and systematic interaction" – the threshold that must be reached in order for the S.E.P. regime to apply – remain very vague, the impact of the S.E.P. implies a risk of litigation with countries that fit the situation of the U.S.

In the circumstances, we believe that the Colombian Treasury and the D.I.A.N. have room to limit the coverage of S.E.P. on a discretionary basis so that it applies only to goods sold through a digital market, consistent with the interpretation regarding services. It would help the Colombian economy if this fine tuning is considered sooner rather than later in order to avoid inconvenient distortions in the structuring of businesses, international supply chains and Colombia's competitive position.

THE DEFINITION OF "SIGNIFICANT ECONOMIC PRESENCE"

The S.E.P. regime sought to extend the borderline of income taxation for those companies that sell digital services and/or goods to Colombian clients from a base that is located abroad without triggering a permanent establishment in Colombia. The configuration of the S.E.P. implies something innovative. It is therefore worth asking whether the legislation enacting the S.E.P. regime is clear and predictable.

Under the final legislation, taxpayers targeted by the S.E.P. regime are nonresident persons and nondomiciled entities. The latter covers companies, trusts, and private foundations established abroad. The legislation generically mentions the commercialization of goods or services without any qualification or restriction on the type of goods or services that are covered. Consequently, the term "services" was not restricted to "digital services." The legislation goes on to establish the rates of tax under the S.E.P. regime. Rates are provided for goods and digital services. No rate is provided for physical services. According to the D.I.A.N., this confirms that physical services are outside the scope of the S.E.P. regime.

[1] A gross-up of prices is discussed in greater detail in the last portion of this article.

Two combined features trigger the S.E.P. taxable event. The first is the notion of "deliberate and systematic interaction" with clients or users in Colombia. The second is gross revenues in relation to clients or users based in Colombia in the current year or in the previous year of 31,300 tax value units. In 2024, that represents approximately US$ 355,000. If either trigger is not met, the S.E.P. regime would not apply to the foreign supplier. Regarding the gross income metric, it is worth asking whether, as of January 1, 2024, certain foreign companies were already taxpayers via the S.E.P. regime, having exceeded the respective threshold during the 2023 fiscal period.

The trigger based on deliberate and systematic interaction contains no conceptual description of the type of interaction that would trigger a significant economic presence. Conceptually, it should be something less than a permanent establishment. But it should be enough to differentiate it from those services that are materially executed from abroad or from goods produced in another country that would not normally generate income from Colombian sources. In any event, every foreign provider of services or goods interacts with clients or users. No standard is provided to differentiate "deliberate and systematic" interactions from interactions that are less than deliberate and systematic.

There are, however, two explicit presumptions that may be used to determine whether a foreign supplier has interactions that are deliberate and systematic. The first presumption is the following:

> The non-resident person or entity not domiciled in the country maintains an interaction or marketing deployment with three hundred thousand (300,000) or more clients and/or users located in the Colombian territory during the previous taxable year or the current taxable year * * * .

This may mean that the interaction is a marketing display, without specifying that it must be through digital media, typically a website or social network. In this context, advertisements in newspapers or magazines, billboards, or advertisements in movie theaters might be viewed to be marketing displays. Accepting that the principal target is digital marketing, it appears that marketing on social networks such as X, Instagram, or Facebook converts the performance of extraterritorial services or the extraterritorial sale goods physically located abroad into territorial services and sales in Colombia.

This validity of the presumption is open to question because the method by which the threshold is achieved is not clear. It requires that the marketing display with target clients or users be maintained throughout at least one of the years in the two-year measuring period. Arguably, reaching 300,000 contacts on certain days of the year but not on all days or many days may not be sufficient. The above leads to compliance and oversight challenges because no guidance is provided as to how an exact measurement of the clients or users contacted by the marketing deployment will be executed.

The second presumption is very specific and easily verifiable.

> The non-resident person or entity not domiciled in the country maintains or establishes the possibility of viewing prices in Colombian Pesos (COP) or allowing payment in Colombian Pesos (COP).

Typically, website or social media posts aimed at Colombian residents will include prices denominated in Colombian Pesos, or will provide access to a Colombian Pesos conversion tool, or will allow payment in Colombian Pesos. This would cause a foreign supply to meet the presumption.

In this context, substantive legal questions remain that are not easily answered:

- If neither of the two presumptions are met, is the foreign company removed from coverage by the S.E.P. regime?
- How can the risk of coverage by the S.E.P. regime be ruled out when there is no conceptual definition of activity constituting deliberate and systematic interaction?
- Can the D.I.A.N. apply the S.E.P. regime to a Colombian client company that did not apply the 10% withholding tax by arguing that deliberate and systematic interaction occurred even if one of the two presumptions was not met?

"In sum, when advising a foreign supplier to confirm or rule out the application of the S.E.P., uncertainty as to the scope of the law should be emphasized."

In sum, when advising a foreign supplier to confirm or rule out the application of the S.E.P., uncertainty as to the scope of the law should be emphasized. For a Colombian company making payment to a foreign supplier, the situation is much simpler when the foreign supplier confirms having activated the S.E.P. regime and registers as an income tax payer in the tax registration system.

THE RATE DESIGN OF THE S.E.P. REGIME

The income tax system in Colombia for nonresidents, aligned with the dominant practice of Colombian income tax treaties, provides for the collection of withholding tax on gross income derived from Colombian sources. But in the case of permanent establishments of foreign companies, the system allows for the taxation of net profits by tax return through a special method of calculating the attributable profits.

The S.E.P. regime covers income not covered by this system, which means that there will be an additional dimension of income from national sources. Recall that the law allows nonresident to pay a 10% withholding rate on gross income or an income tax declaration of 3% on gross income. However, under the S.E.P. regime, the alternative calculation of profits is not allowed as the tax base is gross income. This restriction explains the selection of the relatively low rate of 3%, but this impossibility of deducting costs or expenses raises a constitutional concern, given that there are no precedents for an income tax return with this limited structure.

The Treasury encourages nonresident companies to establish subsidiaries or branches in Colombia in order to access a profits taxable base, an argument that would also be applicable to the application of fixed percentages of withholding on gross income. However, there would be a counterargument that the simplicity of the definitive withholdings is a legitimate option that at least is applied equitably. In contrast, the S.E.P. regime represents special treatment between those nonresidents that declare income tax subject to a 35% tax on profits, while nonresidents under the S.E.P. would pay 3% on strict gross income. To the extent that the cost and expense structure is heavier, and the profit margin is narrowed, the 3% might actually generate a higher effective tax rate than the other nonresidents that use the 35% nominal rate, without a clear tax policy justification.

Even accepting for the sake of argument that nonresidents could have different tax rules in relation to residents, the possible asymmetry generated by the option of declaring tax under the S.E.P. regime could fuel an intense debate before the Constitutional Court.

For now, it is likely that the majority of foreign companies will opt for the Income Tax return instead of the withholdings, unless the alternative of the 10% withholding can be better mitigated through the "gross up" mechanism that we explore below.

THE "GROSS UP" ALSO EXISTS

Use of a gross-up clause in contract negotiations is not an uncommon practice when a foreign supplier bills a domestic client. Certainly, this is prevalent in cross-border lending transactions and different types of services. Under a typical gross-up provision the price charged by the supplier is increased, so that after withholding tax is collected, the supplier is able to receive its target price, net of all taxes. In the context of the S.E.P. regime, where 10% withholding is applied, it cannot be ignored that the contractual position of the foreign supplier will be to demand a gross-up of the transaction price to arrive at a targeted after-tax amount. The formula used is straightforward, as follows:

The target price sought by the supplier ÷ (1 – the total tax rate)

In this manner, the Colombian tax cost is transferred to the Colombian customer. If the gross-up formula is part of the sales order, the traditional interpretation of the D.I.A.N. is that the amount of the gross up does not constitute a deductible expense for the customer. Ultimately, the tax is an expense of nonresident. The position of the D.I.A.N. likely is not enforceable where the gross-up computation is embedded in a simple price that is charged to Colombian resident customers without the application of the explicit gross up clause.

FINAL THOUGHTS

The S.E.P. regime likely was thought to be an easy way to tax digital companies based in other countries notwithstanding the difficulty of adopting Pillar One. However, it is not clear that the revenue target will be met. Even if met, use of embedded grossed-up prices may result in an effective tax increase for consumers in Colombia. This paradox should lead to the tax policy argument that any expansion of domestic source income should have the option of applying the income tax on a profits taxable base, which might mitigate the gross-up distortion.

BLUNDERS IN INTERNATIONAL ESTATE PLANNING

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Tags
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Form 3520-A
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U.S. Federal Estate Tax
Wills (U.S. and Foreign)

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BACKGROUND

This article explores the rarified world of U.S. estate planning for non-U.S. persons owning property in the U.S., uncovering potential pitfalls, and providing insights to navigate the complexities. Five main topics are addressed:

- The risk of two wills inadvertently revoking each other
- The importance of holding cash in the right type of accounts
- Forgetting to file international tax forms
- The complications of leaving assets in the U.S. after moving abroad
- Ensuring a will's cover matches its content

BLUNDER #1: TWO WILLS THAT REVOKE EACH OTHER

U.S. individuals may acquire vacation homes and other assets in Europe. In turn, European individuals may acquire vacations homes in the U.S. Florida has become a popular winter destination for Europeans. Also, Europeans often may have opportunities to work for a few years in the U.S. and acquire homes and investment accounts in the U.S. In each of those fact patterns, estate planning will require international considerations. The simplest plan that comes to mind would be one Los Angeles office person having two wills, one will for the assets in each country. Care must be taken any time a person has two wills.

A will drafted in the U.S. may not be enforceable in another country, and some clients may own property in multiple jurisdictions. The gold standard for international estate planning involves offshore trusts and companies. However, these structures come with hefty costs for drafting and ongoing maintenance. Annual trustee fees and corporate registration expenses are not insignificant and increase with time as the scope of legally mandated responsibilities expands. Many international clients seek to avoid these costs, especially if their estates will not be subject to substantial U.S. estate taxes.

An affordable alternative involves executing two wills, each specifying the specific property covered.

The Case For Having Two Wills

While some attorneys are hesitant about using two wills, when precisely drafted and approved separately by attorneys in both jurisdictions, use of two wills offer a concise method for bequeathing property in multiple locations. This approach simplifies probate for a U.S. will that is limited to specific property, in contrast to the complexity of obtaining ancillary probate in the U.S. of a foreign will that covers worldwide assets.

Potential Blunder

One red flag to note is the revocation clause of each will. Normally, a will opens with a revocation statement as follows:

> I, JANE DOE, of the City, County and State of New York, publish and declare this to be my Last Will and Testament and revoke all former Wills and Codicils.

If there are two wills, does the will signed second revoke the first will signed. To prevent this, revocation clauses in both wills are crucial and must be carefully coordinated.

Proposed Revocation Clause

A clause that clearly delineates the scope of each will's bequests and safeguards against unintended revocation is essential. I suggest the following clause:

> I, ANTONIO GONZALES, being a citizen of the United States of America and a resident of the City, County and State of New York, publish and declare this to be my United States Last Will and Testament, to control the disposition of the property hereinafter described and defined as my Estate, and I hereby revoke all Wills and codicils at any time heretofore made by me with respect to such Estate. This United States Will shall not revoke or otherwise interfere with the disposition of any property which is situated in the Republic of Freedonia.[1] This United States Will can only be revoked by another Will, which is later in date than this United States Will. This United States Will may not be revoked unless the revocation clause of another Will specifically refers to this United States Will by date of execution and explicitly revokes this United States Will.

The will continues with a clause that defines "the Estate" that is bequeathed under New York will. In this case, it would be the individual's worldwide assets other than property that is located in Freedonia. A complementary will clause would appear in the will that is drafted to bequeath solely property that is located in Freedonia.

Conclusion

The goal is to safeguard the estate and ensure that the U.S. will does not inadvertently revoke the foreign will or vice versa, safeguarding the intended distribution of assets across jurisdictions. With precise drafting and thorough review by attorneys in the respective jurisdictions, two wills can effectively distribute property situated in different countries.

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1 In the 1933 film "Duck Soup," Groucho Marx portrays the newly installed president of the fictional country of Freedonia. Throughout this article, Freedonia is the foreign country to which a decedent has a significant contact.

BLUNDER #2: OVERLOOKING THE ROLE OF CASH IS KING

There are numerous proverbs and sayings regarding money:

- You can't take it with you.
- Money makes the world go round.
- Throwing good money after bad.
- Money talks.
- Time is money.
- A penny for your thoughts.
- A fool and his money are soon parted.
- Money does not grow on trees.
- Cash is King.

In the realm of international estate planning, the last proverb takes precedence.

Understanding the U.S. Federal Estate Tax

In the U.S., a Federal estate tax exist that is imposed on the estate of the decedent. The top rate of estate tax is 40%. Fortunately for U.S. citizens and noncitizens who are domiciled in the U.S., there is a generous exclusion from the estate tax. For 2024, the exclusion is $13.61 million for an individual and $27.22 million for a married couple jointly. By contrast, for an individual who is neither a U.S. resident nor a U.S. citizen (sometimes referred to as an "N.R.N.C. individual") who owns property in the U.S., the estate tax exclusion is only $60,000. When two N.R.N.C. individuals are married, each is entitled to a separate $60,000 exclusion. An estate tax treaty between the United States and a client's home country may expand that $60,000 exclusion so that it matches an exclusion for U.S. citizens and U.S. residents for estate tax purposes.

Additional Estate Tax Exclusions for N.R.N.C. Individuals

A few additional exclusions exist from the Federal estate tax for N.R.N.C. individuals. For example, the death benefit from a life insurance policy that insures the life of a N.R.N.C. individual is not subject to the federal estate tax.

However, the most commonly used exclusion for N.R.N.C. individuals is cash on deposit with a U.S. bank. The cash that an N.R.N.C. individual leaves in a checking account, savings account, or certificate of deposit with a U.S. bank is exempt from the Federal estate tax.

The Blunder

Cash that an N.R.N.C individual leaves in a mutual fund, money market fund, or brokerage account held with a U.S. financial institution is not exempt from the Federal estate tax. Any sum of cash in a mutual fund, money market fund, or brokerage

account will be added to other items of U.S. situs property that is subject to Federal estate tax in the U.S. to the extent total assets exceed the $60,000 exemption.

Knowledge is power, especially when it comes to preserving your wealth across borders.

BLUNDER #3: FORGETTING TO FILE INTERNATIONAL FORMS

". . . while penalties for domestic tax returns can be potentially substantial, most of the time, the penalties are nominal amounts."

There are many penalties imposed by the Internal Revenue Service ("I.R.S."). For example, the penalty for failing to file a tax return is 5% of the unpaid tax per month. The penalty for a failure to file an informational return for which no tax is paid, such as the failure by an employer to issue a W-2, typically is a fixed dollar amount, which ranges between $60.00 to $630.00 for each form not filed. As one can see, while penalties for domestic tax returns can be potentially substantial, most of the time, the penalties are nominal amounts.

However, the penalties for failure to file international informational returns are far more burdensome than the penalties for domestic informational returns. Foreign forms include

- Form 8938 (Statement of Specified Foreign Financial Assets);
- Form 3520 (Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts);
- Form 3520-A (Annual Information Return of Foreign Trust With a U.S. Owner);
- FinCEN Form 114 (Report of Foreign Bank and Financial Accounts (F.B.A.R.));
- Form 5471 (Information Return of U.S. Persons With Respect To Certain Foreign Corporations) – in particular, the penalty for failure to file a Form 3520 is likely the most significant of any penalty issued by the I.R.S. other than those related to tax fraud; and
- Form 8865 (Return of U.S. Persons With Respect to Certain Foreign Partnerships).

Understanding the 3520 and 3520-A

There are four instances in which a U.S. person is required to file a Form 3520:

- A U.S. person transfers money or property to a foreign trust.
- A U.S. person is treated as an owner of a foreign trust under Code §§671-679.
- A U.S. person receives a distribution from a foreign trust or used property of a foreign trust without providing sufficient compensation.
- A U.S. person receives a gift or bequest from a foreign person.

The penalties for failing to file Form 3520 depend on the event that triggered the filing requirement and are as follows:

- If the reportable transaction is a transfer of money or property to a foreign trust, the penalty is 35% of the gross value of the property transferred to a foreign trust.

- If the reportable transaction is the treatment of a U.S. person as an owner of a foreign trust, the penalty is 5% of the gross value of the portion of the foreign trust's assets treated as being owned by a U.S. person.

- If the reportable transaction is the receipt of a distribution or the use of property of a foreign trust without providing sufficient compensation, the penalty is 35% of the gross value of the distribution received from a foreign trust.

- If the reportable transaction is the receipt of a gift or bequest from a foreign person, the penalty is 5% of the amount of the foreign gift with a maximum penalty of 25%.

The Blunder

First, let's give an example of the 25% penalty for failure to report the receipt of a gift or bequest from a foreign person. Let's say that, in 2016, a U.S. person received $5.0 million as a gift from a close relative who is not a citizen and who lives in Freedonia and has never resided in the U.S. The U.S. person did not know of the requirement to file Form 3520 to report the gift. Fast forward to the present day when Form 3520 is filed late upon the advice of a tax return preparer. The I.R.S. will automatically issue a notice for penalty and interest related to the failure to file a Form 3520 to report a gift from a foreign person. The penalty is $1.25 million, to which seven years' worth of interest will be added.

Next is an example of the 35% penalty for failure to report the transfer of property to a foreign trust. Let's say that, in 2016, a U.S. person transferred $5.0 million to a trust established under the laws of Freedonia. Again, the U.S. person did not know of the requirement to file Form 3520 to report the transfer to and the interest in the foreign trust. Fast forward to the present day when Form 3520 is filed late upon the advice of a tax return preparer. The I.R.S. will automatically issue a notice for penalty and interest related to the failure to file a Form 3520 to report the transfer of property to a foreign trust. The penalty is $1.75 million, to which seven years' worth of interest will be added.

Avoiding the Blunder

It is hard to fathom the size of these penalties. The easiest way to avoid the blunder is to remember the four instances in which a Form 3520 must be filed. Even if the error is that of the tax return preparer who failed to ask the relevant questions the I.R.S. may not view the error of the C.P.A. as an exoneration of the taxpayer. A taxpayer is required to carefully choose a tax return preparer or adviser based on that person's knowledge and expertise as to reporting obligations for international transactions. In other words, not all tax return preparers are created equal.

Streamlined Domestic and Offshore Procedures

U.S. taxpayers residing in the U.S. facing huge international tax form penalties may be eligible to enter into the Streamlined Domestic Offshore Procedures. If the taxpayer is eligible, rather than the 25% or 35% penalty outlined above, the penalty for the Streamlined Procedures is 5% of the highest aggregate balance/value of the taxpayer's foreign financial assets that are subject to the miscellaneous offshore penalty related to the F.B.A.R. filing obligation.

In order to be eligible for the Streamlined Domestic Offshore Procedures, the taxpayer must meet the following four requirements:

- The taxpayer is not be eligible for the Streamlined Offshore Procedures discussed below.
- The taxpayer filed a U.S. tax return for each of the most recent three years for which the U.S. tax return due date has passed.
- The taxpayer failed to report gross income from a foreign financial asset, failed to pay tax as required by U.S. law, and may have failed to file one or more international information returns with respect to the foreign financial asset.
- The compliance failure of the taxpayer resulted from nonwillful conduct.

If the U.S. taxpayer resided outside the U.S., the Streamlined Foreign Offshore Procedures may be applicable. Under those Procedures, no penalty is imposed. In order for a U.S. taxpayer to be viewed as residing outside the U.S., the taxpayer must meet two tests in at least one year of the three-year period:

- The taxpayer did not have a U.S. abode.
- The taxpayer was physically outside the United States for at least 330 full days.

Conclusion: Consult a Competent Attorney or Accountant

If a U.S. person who receives gifts from a foreign person, has interests in a foreign business entity, has an interest in a foreign trust, or owns or has signatory authority over one or more foreign bank accounts, an adviser with international tax experience should be retained to review U.S. tax compliance obligations. The I.R.S. has no sympathy and a noncompliant taxpayer may be embroiled in the equivalent of a high-stakes poker game.

BLUNDER #4: LEAVING THE UNITED STATES? TAKE YOUR ASSETS WITH YOU

When an N.R.N.C. individual who may have spent time working or residing in the U.S. decides to return to his or her country of origin, failing to liquidate U.S. investment assets may lead to expensive procedures for foreign beneficiaries.

Understanding the U.S. Federal Estate Tax

The U.S. has a Federal estate tax that is imposed on death. The top rate of estate tax is 40%. Fortunately for U.S. citizens and noncitizens who are domiciled in the U.S., there is a generous U.S. exclusion from the estate tax. For 2024, they have a $13.61 million exclusion for an individual and a $27.22 million exclusion for a married couple. By contrast, for an N.R.N.C. individual. who owns property in the U.S., the estate tax exclusion is only $60,000 and an aggregate of $120,000 for a married couple. An estate tax treaty between the U.S. and a client's home country may occasionally expand that $60,000 exclusion.

Who Must Pay the U.S. Federal Estate Tax

If the estate of a U.S. or non-U.S. citizen owes estate tax, the estate is generally liable for the estate tax. However, the estate may not have sufficient liquid cash, or the I.R.S. may be unable to access liquid assets outside the U.S. The I.R.S. has other recourse.

- An executor may be held *personally* liable for the estate tax if the executor distributed estate funds to the beneficiaries without retaining an amount to pay the U.S. estate tax.
- Beneficiaries of the estate who have received distributions from the estate can be personally liable for the estate tax, to the extent of the assets received.
- A U.S. bank, investment manager, mutual fund, or cooperative apartment house that gives estate property to the estate beneficiaries may be liable for the estate tax. Even if the decedent signed a transfer-on-death or beneficiary designation, or if the account or property is held jointly, the I.R.S. can impose the estate tax on the bank, investment manager or co-op apartment corporation that gave the property to the beneficiary before the estate tax was paid.
- A purchaser of U.S. real estate owned by the estate or heir of an N.R.N.C. individual should be certain that no U.S. or state estate tax lien exists on the real estate. An estate tax lien can remain attached to the property, and a title company may refuse to insure the title to the property.

This problem arises in the context of an N.R.N.C. individual who worked or resided in the U.S. for a time and returned home. To a lesser extent, the issue will also be relevant to the estate of a U.S. citizen who, during life, decide to retire outside the U.S.

Documentation Required to Distribute Real Property and Funds

It may be years before a decedent's estate tax is settled and the I.R.S. issues a closing letter to confirm that all U.S. estate tax has been paid. However, the estate beneficiaries may want or need their inheritance as soon as possible.

There are a few ways that a bank, investment manager or property manager can distribute estate property to beneficiaries and limit the institution's liability for the estate tax.

- **Local Executor or Estate Administrator.** Financial institutions can require the estate to petition a local probate court for the appointment of a U.S. executor or estate administrator. Where that occurs, a financial institution may distribute estate funds to the U.S. executor or estate administrator. This is possible because the executor or estate administrator will assume any liability for the estate tax, instead of the financial institutions. However, the financial institutions generally will not distribute estate funds to an executor or estate administrator who was appointed by a court outside of the U.S. Such a foreign executor or estate administrator would have to commence an ancillary court proceeding in the U.S. and be appointed the U.S. estate fiduciary by a U.S. court.
- **I.R.S. Transfer Certificate.** An alternative to a U.S. court proceeding is for the estate to apply for an I.R.S. "transfer certificate." This is a protracted

procedure which requires the preparation of a U.S. estate tax return and the payment of any estate tax that is due. A transfer certificate can be required for the estates of both U.S. citizens and non-U.S. citizens who resided outside the U.S.

Each of the above procedures may also be available to a real estate manager such as a cooperative apartment house or a condominium association. They can require the court appointment of a local executor or estate administrator, an I.R.S. transfer certificate, and a release of any state estate tax lien. They all have some discretion. Banks, investment managers, co-op apartment houses, and real estate managers may require only a local executor or a transfer certificate. They could also require a Federal transfer certificate, state release of lien, and a court appointed U.S. executor or estate administrator.

The result can be a total stalemate and paralysis. A bank may not release any funds in advance of the issuance of an I.R.S. transfer certificate. However, the I.R.S. may not issue a transfer certificate until the estate pays the Federal estate tax. This becomes extremely problematic when the bank holds the only cash available to pay the estate tax.

Blunder

The estate or the heirs may incur extensive legal fees to liberate the estate funds and any U.S. real estate which the decedent owned at the conclusion of life.

Conclusion: Getting Money to Beneficiaries

If a departing U.S. citizen or N.R.N.C. individual wishes heirs to receive their inheritance in a timely way with minimal legal fees, financial assets should be transferred to a bank or investment manager outside the U.S. Real estate in the U.S. should be owned directly or indirectly by a foreign entity, which raises other issues that are beyond the scope of this article.

"The estate or the heirs may incur extensive legal fees to liberate the estate funds and any U.S. real estate which the decedent owned at the conclusion of life."

BLUNDER #5: DO NOT JUDGE A WILL BY ITS COVER

Occasionally, an attorney may draft a U.S. will for an international client who holds assets in more than one country. The attorney may pull a model will out of their file cabinet or off the computer and change the first page. This could involve adding a preamble on the first page stating that this will pertains only to U.S. property. The printed back of the will may declare that this is the client's "United States Will." Thus, both the front and back covers of the will indicate that it covers only U.S. property.

Inside the Will: Residuary Clause

While the will may contain several bequests or legacies, every well-drawn will invariably incorporates an omnibus clause called the Residuary Clause. This clause consolidates all property not explicitly bequeathed and distributes it to one or more individuals or charities, either outright or in trust.

Most Residuary Clauses begin with the phrase, "All the rest, residue and remainder of my property, wherever situated, I hereby give, devise, and bequeath to X, Y, and Z." The challenge arises in reconciling the declaration on page one of the will, specifying coverage limited to U.S. property, with the Residuary Clause, which covers all my property "wherever situated."

Blunder

The discrepancy between the front and back covers of the will and its contents poses a significant issue. An attorney or client might mistakenly assume that converting a standard will to one covering only U.S. property is straightforward, merely requiring a preamble on page one of the will. However, conflicts with other clauses within the will can arise, undermining the efficacy of such a preamble.

We recently administered the estate of a man born in a European country who spent over 20 years working in the U.S. During his time here, he established bank and brokerage accounts in the U.S. Before retiring and relocating to his home country, he signed a U.S. will. The preamble on the first page of this will indicated that it covered only his U.S. assets. However, the Residuary Clause contained conflicting language, stating that he bequeathed all remaining property "wherever situated" to a specific group of relatives.

Following the conclusion of the European individual's life, his family in Europe informed us that, as a young man, he prepared a will in Europe that left his European property to a select group of relatives. Those excluded from the earlier European will now sought inclusion in the Residuary Clause of his subsequent U.S. will, which bequeathed "all his property wherever situated" to include them and his European property.

The disappointed relatives under the early European will and those who received specific bequests under the decedent's later U.S. will have already spent tens of thousands of dollars on legal fees. Despite the passing of more than two years from the date of the decedent's death, not a single cent of the U.S. funds has been distributed to any of the relatives. There is yet to be a discussion of compromise or settlement in the U.S., and we are unaware of such negotiations taking place in Europe.

Conclusion: Avoiding the Blunder

In conclusion, the case of misaligned covers and content in will drafting serves as a stark reminder: never judge a will by its cover. The discrepancy between the Preamble and the Residuary Clause can lead to legal battles and financial strain for heirs.

To prevent such blunders, it is imperative for attorneys and international clients to meticulously examine every aspect of the will. Mere statements on the cover, both back and front, asserting the limitation of the will to property in the U.S. are inadequate. Each sentence must align with the intended scope and jurisdiction of the estate. Remember, the true essence of a will is not in its cover but in its content – a lesson vital for preserving the integrity of estate planning in the global arena.

FRENCH LIFE INSURANCE "101" – FOR U.S. PERSONS, RUN AWAY

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Tags
Foreign Life Insurance Policy
France
French Life Insurance Policy
French Taxation
Guideline Premium Limitation
P.F.I.C.
U.S. Taxation
Value Accumulation Test
Value Corridor Test

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INTRODUCTION

An individual takes out life insurance in order to provide for his heirs and to obtain peace of mind. Tax treatment for the individual during life and the heirs is straightforward when everyone resides in one country. But when a life insurance policy is written in France and the insured or the heirs are U.S. citizens or residents, what the policy holder, his estate, or the beneficiaries may encounter is anything but peace of mind. To their chagrin, each may find that he or she is in the crosshairs of contrary laws in two countries resulting in sub-optimal tax results. This article discusses the French and U.S. tax rules applicable to a French life insurance policy.

FRENCH LIFE INSURANCE POLICIES

A French life insurance policy is a contract under which the insurer receives payment of one or more premiums and undertakes the obligation to pay a capital sum or an annuity to a specified person at a specified date in the event of the death of the insured. The policy accumulates investment income, and the value grows tax-free.

Different Types of French Life Insurance Policies

The policy holder has choices between a single-support policy that is denominated in euros or a multi-support policy.

Single-support euro contracts offer policy holders the opportunity to invest their savings in a general or segregated asset commonly known as a "euro fund." The asset is managed by the insurance company and backed by a capital guarantee. The capital is protected from day-to-day no stock market fluctuations. Each year, the interest generated in the euro fund is distributed by the insurer to the policy holders. Corporate bonds represent more than 80% of the investments held by euro funds. In return for the security provided by these investments, returns are limited.

Multi-support contracts are not based on the euro, but on one or more units of account, the value of which may rise or fall. These contracts are known as "variable capital" contracts. Their value varies according to changes in the value of the units of account, themselves reflecting fluctuations in the benchmark stock or real estate markets. The insurer guarantees the number of units of account, but not their value during the term of the contract. The policy holder bears the investment risk.

Purpose of French Life Insurance Policies

Life insurance can be used for alternative purposes.

- It can be used for savings purposes to supplement retirement income. The policy holder saves the income generated under the policy while working and makes partial withdrawals from the policy to supplement income during retirement. It can also be used as precautionary savings vehicle that can be mobilized in the short term in case of need.

- It can be used to manage capital over the long term in a tax-privileged environment in order to supplement income through regular withdrawals or a life annuity.
- It can be used to pass on assets to surviving relatives in order protect loved ones in the event of death: It can provide appropriate solutions for preparing one's estate.

In France, the rules of civil inheritance law applies to the distribution of a decedent's assets. Forced heirship rules mandate that a certain portion of the estate – the "*reserve héréditaire*" – cannot be disposed during lifetime or at death to persons other than descendants, and under certain conditions, to a surviving spouse. But life-insurance policies are not covered by that rule. Policy holders can designate beneficiaries under certain conditions and limits, thereby bypassing French forced heirship laws.

DESIGNATION OF PARTICIPANTS

A life insurance contract brings together an insurer, a policy holder, an insured who usually is the policy holder and the beneficiaries.

The Policy Holder

The policy holder is often referred to as the "stipulator," the "contracting party," or the "subscriber." The policy holder is the person who signs the insurance policy and undertakes to pay the premiums stipulated in the insurance contract. He or she also has the exclusive right to designate the beneficiary.

The premium is calculated by the insurer, considering the insured's age, the duration and characteristics of the policy taken out, and its own administrative costs. Premium payment terms are purely contractual. The policy holder may be offered the choice of paying

- a single premium, payable at once when the policy is taken out;
- programmed premiums, paid regularly over the life of the contract; or
- premiums paid in instalments at the policy holder's discretion.

The latter is the most common option chosen at the present time.

When spouses are married under the French matrimonial regime of community of property ("*communauté de biens*"), a difficulty may be encountered regarding the power to dispose of joint funds by designating a beneficiary other than the surviving spouse. In comparison, the difficulty disappears if the premiums are paid from the policy holder's separate funds. An individual is free to dispose of separate funds to take out the life insurance policy. However, the subscriber must make a declaration of reinvestment if he wishes the life insurance policy itself to retain the status of separate property.

Payment of premiums is optional, even if scheduled. The issuer of the policy has no means of compelling the policy holder to make payment.[1] In the event of non-payment of premiums, the insurer has several options:

- It may cancel the contract if the surrender value is insufficient.
- It may advance the policy holder the unpaid premium or fraction thereof, up to the surrender value the surrender value.
- It may reduce the contract if the surrender value is less than half the monthly minimum wage.[2]

The designation of the beneficiary belongs to the subscriber. It is a personal right, attached to the policy holder's status. In the event of the death of the policy holder before designation of the beneficiary, the solution depends on whether or not the policy holder is also the insured.

- If the policy holder is also the insured, the option to designate a beneficiary terminates. The contract is unwound, and its acquired value becomes part of the estate of the policy holder, with all related tax consequences. The policy holder's successors cannot act on his behalf retroactively.
- If the policy holder is not the insured, the contract is not terminated by death. The policy holder's heirs become joint policy holders of the life insurance unless one of the heirs is awarded the policy following a division of the estate. The new policy holders have the option of designating the beneficiary.

The Insured

The insured is the person whose death triggers the payout of the amount of the insurance contract. The policy holder and the insured are often the same person, but it is also possible to take out a policy on the life of another person. For example, a grandparent wishing to insure an annuity for grandchildren in the event of the death of their father will indicate the latter as the insured. In this case, the insured is the father and he must consent in writing to the capital or annuity initially guaranteed under the contract. Without that consent, the contract is null and void.[3]

The policy holder is not entirely free to choose the insured. The insured can only be a natural person. Moreover, the insured may not be a minor under the age of 12, an adult under guardianship, or a person placed in a psychiatric hospital.[4] Failure to comply with the limitations on the insured person renders the contract null and void. Moreover, the insurer and the policy holder are also liable to a fine of €4,500.

The Beneficiary

At the death of the insured person, the amount provided for in the contract is paid to the designated class of beneficiaries. The beneficiary can be either a natural person such as a descendent or a legal person such as an association, a foundation or an endowment fund. Only two rules limit the freedom to choose the beneficiary of a life insurance contract.

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[1] Article L132-20, al. 1 of the French Insurance Code.

[2] Article R132-2 of the French Insurance Code.

[3] Article L 132-2 of the French Insurance Code.

[4] Article L 132-3 of the French Insurance Code.

- The beneficiary may not be a member of a class prevented from being beneficiaries of the decedent, such as a physician who treated the insured individual during the final illness.
- The beneficiary must not have an immoral or illicit purpose.

In the event that the beneficiary clause is deemed null and void, the contract is deemed to have been drawn up without a named beneficiary. In that case, the beneficiary is the person or persons who are in a class that has been sufficiently defined in the stipulation to be identified when the guaranteed capital or annuity becomes payable.

"In the event that the beneficiary clause is deemed null and void, the contract is deemed to have been drawn up without a named beneficiary."

For example, the following meets the condition of designated beneficiary:

- The designation relates to the born or unborn children of the contracting party, the insured, or any other designated person.
- The designation relates to the surviving spouse.
- The designation relates to the "heirs of the insured or of a predeceased beneficiary.[5]

A beneficiary clause that is imprecise or ambiguous as to the identity of the beneficiary can place the insurer in a delicate situation. If the insurer wrongfully refuses to pay the designated beneficiary, the insurer may be liable to pay penalties of up to three times the legal interest rate.[6] Moreover, if the insurer pays the funds to the wrong beneficiary, the insurer is not released from its obligation toward the actual beneficiary.

It is not mandatory to include a beneficiary clause in a policy. Nonetheless, it is almost always included. In the absence of a specific or determinable beneficiary, the amount to be paid out goes to the policy holder's estate and is subject to inheritance tax. In comparison, a life insurance payout receives favorable tax treatment when it is linked to a specified beneficiary.[7] Once a beneficiary is designated, the capital or annuity does not form part of the insured's estate.[8]

While the absence of a beneficiary designation is most often involuntary and results from an oversight or a combination of unfavorable circumstances, it can sometimes be voluntary. For example, a choice may be made in favor of a transfer subject to inheritance tax, rather than life insurance, when the latter is lower than the 20% or 31.25% levy, or when the beneficiaries are resident in France and the insured policy holder has moved to a foreign country where the value of the life insurance policy is subject to inheritance tax.

The beneficiary's acceptance is not required for the contract to be valid. Nor is it necessary for the beneficiary to be informed of the existence of the contract drawn up for his or her benefit. But the beneficiary's acceptance has important consequences, since the policy holder cannot change the identity of the accepted beneficiary without the latter's agreement and no withdrawal or advance can be made without the agreement of the accepting beneficiary.

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5 Article L 132-8 of the French Insurance Code.

6 Article L 132-23-1 of the French Insurance Code: see no. 28427.

7 Article L 132-11 of the French Insurance Code.

8 Article L 132-12 of the French Insurance Code.

When the policy is terminated, the capital sum or annuity is paid to the beneficiary, provided the latter accepts the benefit of the policy. A beneficiary has three months to accept the benefit of the policy once formal notice has been given.[9] Beneficiaries have ten years to claim any sums due to them, from the date on which they became aware of the death.

FRENCH TAXATION AT VARIOUS POINTS

In terms of French life insurance taxation, three situations can be distinguished: (i) withdrawals (ii), the death of the policy holder, and (iii) and the conversion of the capital into a life annuity.

French Taxation Upon Withdrawal

Policy Outstanding Not More Than Eight Years

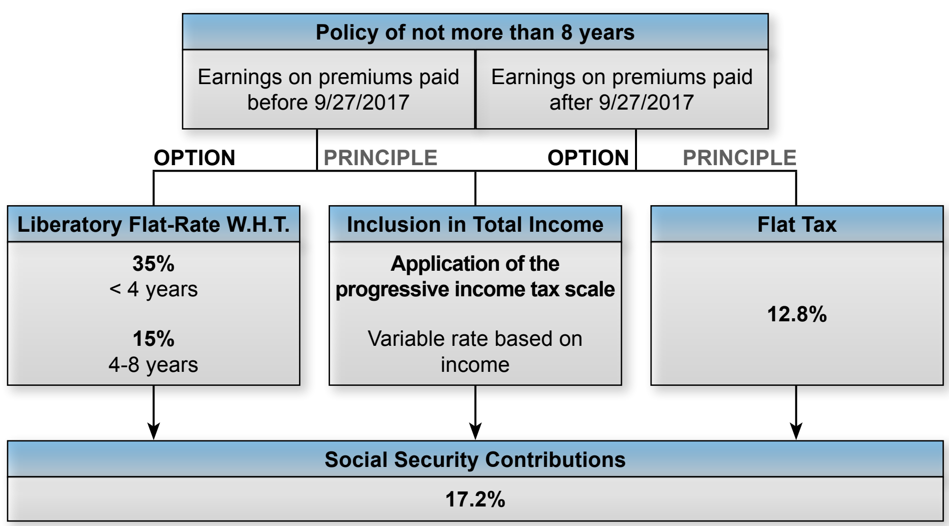
The tax treatment arising from a withdrawal depends on the date of payment of the premiums and the date of the withdrawal.

- For premiums paid up to September 26, 2017, a choice must be made between a flat withholding tax and the tax bracket of the individual. The flat rate of withholding tax is 35% if the withdrawal takes place in the first four years of the policy. If the withdrawal is made in years five through eight, the flat rate of withholding tax is 15%. If the flat rate of withholding tax is chosen, no further tax is due.

- For premiums paid beginning on or after September 27, 2017, a choice must be made between a single flat-rate withholding tax of 12.8% and the and the tax bracket of the individual.

In all circumstances, social charges of 17.2% must be paid.

The following diagram illustrates the tax that may be due for withdrawals of premiums held for not more than eight years and made before September 27, 2017, and for comparable withdrawals made on or after that date.



[9] Article L 132-9, I-al. 2, of the French Insurance Code.

Policy Outstanding More Than Eight Years

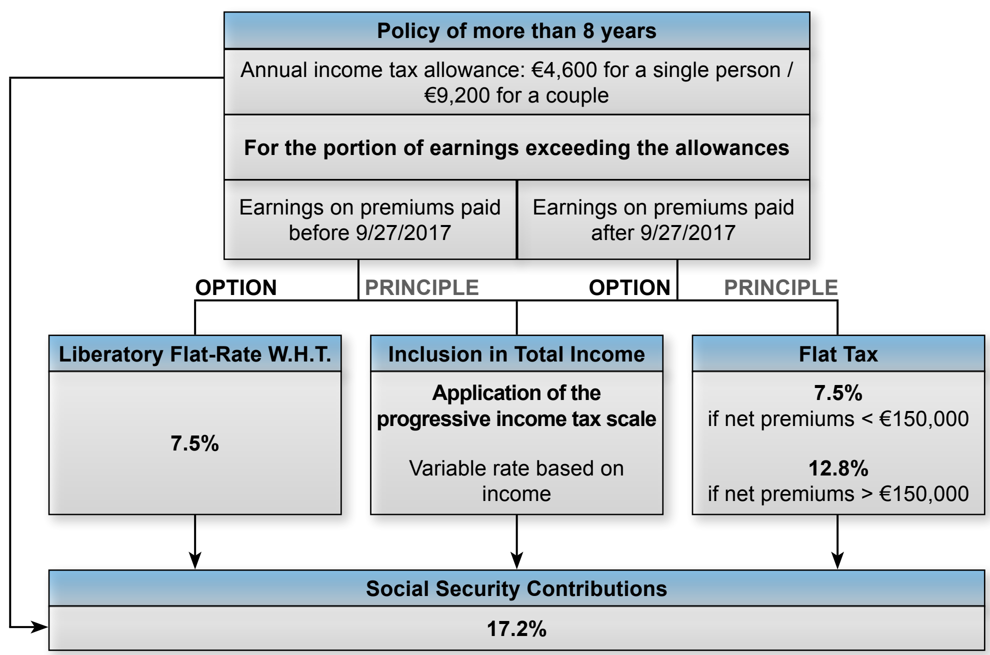
The tax treatment arising from a withdrawal depends on the date of payment of the premiums and the date on which premiums are paid.

- For premiums paid up to September 26, 2017, an annual tax-free allowance of €4,600 is allowed for single individuals. The tax-free annual allowance is €9,200 for married couples or couples that register a civil union. Gains in excess of the annual allowance are subject to a flat rate of withholding tax of 7.5%.

- For premiums paid on or after September 27,2017, an annual tax-free allowance of €4,600 is allowed for single individuals. The tax-free annual allowance is €9,200 for married couples or couples that register a civil union. Gains in excess of the annual allowance are subject to a flat rate of withholding tax of 7.5% withholding tax for the portion of the gains related to to net premiums paid of not more than €150,000. The rate increases to 12.8% withholding tax for the portion of the gains related to net premiums paid in excess of €150,000.

In all circumstances, social charges of 17.2% must be paid.

The following diagram illustrates the tax that may be due for withdrawals of premiums held for more than eight years and made before September 27, 2017, and for comparable withdrawals made on or after that date.



In the U.S.-France tax context, the treaty provisions relating to interest income apply for life insurance income. Article 11 generally provides that interest income is taxable only in the state of residence of the recipient. Article 11 applies to income from the withdrawal of premiums under a life insurance policy. If the recipient of the income resides in the U.S., French tax will not be imposed.

Taxation upon Death of the Insured

The date and age of the insured at the time the premiums are paid will determine whether the capital can be transferred to beneficiaries at the date of death of the insured individual with or without inheritance tax.

- For premiums paid before the age of 70 years old, inheritance tax of 20% is due, capped at €700,000, then 31.25%, after an allowance of €152,500 per beneficiary.[10]
- For premiums paid after the age of 70 years old, inheritance tax is due for all such premiums that are in excess of an overall allowance of €30,500.[11]

Interest and capital gains on life insurance policies are exempt from inheritance tax at the policy holder's death.

The France-U.S. Estate, Inheritance, and Gift Tax Treaty does not apply to this specific taxation. The levy is not owed when, on the date of death, the policy holder was not a resident of France for inheritance tax purposes unless the beneficiary is a resident of France on the date of death and was a resident of France for at least six of the ten years preceding the death.

French Taxation at the Conversion to a Life Annuity

Life insurance allows the conversion of the capital into a life annuity: the insurer guarantees to pay the policy holder an annuity until death. Payments may be made on a monthly, quarterly, or half-yearly basis. The conversion to a life annuity is irreversible. The policy holder permanently loses control of the capital accumulated in the life insurance policy and the life insurance policy cannot be transferred to beneficiaries at death of the insured.

The amount of the annuity depends on the amount of capital in the contract and the age of the policy holder at the time of conversion. The annuity payments are subject to income tax and social contribution when and as made. The taxable portion of the annuity depends on the subscriber's age when the annuity is triggered, and is fixed for the balance of the annuitant's lifetime. The taxable portion of the annuity payment is fixed as follows:

- 70% if the conversion occurs under the age of 50 years
- 50% if the conversion occurs between the ages of 50 and 59 years
- 40% if the conversion occurs between the ages of 60 and 69 years
- 30% if the conversion occurs over the age of 69 years

USUFRUCT/BARE LEGAL TITLE ARRANGEMENT

Under French law, ownership of an asset may be divided into two portions. One is the ownership of the income from the property, known as a *usufruct* interest. The holder of the *usufruct* interest is often referred to as the "*usufructuary*." The other

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[10] Article 990 I of the French General Tax Code.

[11] Article 757 B of the French General Tax Code.

is the bare legal ownership of the asset itself. In very broad terms, the bare legal ownership can be analogized to a tree and the *usufruct* interest can be analogized to the fruit of the tree. Where property is owned pursuant to a *usufruct* arrangement, ownership is said to be "dismembered." Typically, the split ownership is united at the death of the holder of the *usufruct* interest.

Ownership of a life insurance product can be dismembered. The *usufruct* interest can be created at the time of an asset's acquisition .Similarly, it can be created during t he course of ownership. Both are discussed below.

Ab Initio **Dismemberment**

In an *ab initio dismemberment*, one of the subscribers to a life insurance policy subscribes to the *usufruct* interest and the other subscribes to the bare ownership interest. The funds that are used to subscribe generally come from the reinvestment of the sale proceeds received from the sale of another dismembered asset. As mentioned above, the *usufruct* is extinguished by the death of the *usufructuary*, and the joint bare-owner becomes the full owner of the policy.[12]

From a tax point of view, inheritance tax is not payable under article 1133 of the French General Tax Code, which states that the reunification of *usufruct* and bare ownership does not give rise to any tax when this reunification takes place at the end of the period initially set for the *usufruct* arrangement or at the death of the *usufructuary*.

Dismemberment of the Beneficiary Clause

On the other hand, the full owner of the life insurance policy may decide to divide the beneficiary clause between a bare owner and a *usufructuary*. In the most common case, where the policy is settled in cash rather than units of account, the dismemberment of the beneficiary clause gives the beneficiary a quasi-*usufruct* over the sums paid in.[13] On the death of the insured, the insurer must pay the guaranteed capital sum to the *usufructuary*, who must then return an equivalent sum to the designated bare owner at the end of the *usufruct*.

The bare owner and the *usufructuary* are considered beneficiaries in proportion to their share of the sums paid out by the insurance company. This share is determined in accordance with the life *usufruct* scale set out in article 669 of the French General Tax Code. For premiums paid before the age of 70 years old, the €152,500 allowance is also distributed according to the scale set out in article 669 of the French General Tax Code.

However, where one of the beneficiaries is exempt from the levy, such as where the surviving spouse is designated as the *usufructuary* beneficiary, the tax authorities refuse to allow the exempt beneficiary's share of the allowance to be used by the non-exempt beneficiaries.[14]

For premiums paid after the age of 70 years old, the deduction of €30,500 – which is shared when there are several beneficiaries – must be divided between the *usufructuary* and the bare owner according to the same scale that appears in article 669 of

[12] Article 617 of the French Civil Code.

[13] Article 587 of the French Civil Code.

[14] BOI-TCAS-AUT-60 no. 310.

the French General Tax Code. If one of the joint beneficiaries is exempt – again as is the case of a surviving spouse designated as the *usufructuary* – the bare owner can benefit from the full €30,500 allowance.[15]

Tax Treatment of the Restitution Claim

On the death of the *usufructuary*, the split-ownership of the beneficiary clause can result in the recognition of a liability that can be deducted under certain conditions from the estate when calculating inheritance tax. The amount of the liability corresponds to the amount due to the bare owners in respect of their restitution claim.

“. . . a French life insurance policy is not disqualified per se from being a life insurance policy for U.S. tax purposes, however, it must meet at least one of the two tests mentioned above to qualify for beneficial U.S. tax treatment.”

LIFE INSURANCE DEFINED FOR U.S. TAX PURPOSES

A life insurance contact for U.S. tax purposes is a contract that is a life insurance contract under the “applicable law,” provided one of the following two tests are met.[16] The tests are the cash value accumulation test and the Guideline Premium Limitation / Cash Value Corridor Test.

Applicable Law

The phrase “applicable law” has not been defined in the Code, however, the General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, JCS-41-84 (December 31, 1984), prepared by the Staff of the Joint Committee of Taxation (“J.C.T.”), states that the law may be foreign law.

> A life insurance contract is defined as any contract, which is a life insurance contract under the applicable State or foreign law, but only if the contract meets either of two alternatives: (1) a cash value accumulation test, or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement.[17]

Therefore, a French life insurance policy is not disqualified *per se* from being a life insurance policy for U.S. tax purposes, however, it must meet at least one of the two tests mentioned above to qualify for beneficial U.S. tax treatment.

Cash Value Accumulation Test

This test is intended to allow traditional whole life policies, with cash values that accumulate based on reasonable interest rates, to continue to qualify as life insurance contracts.

The cash value accumulation test looks to the cash surrender value of the contract which is compared to the net single premium amount.[18] The cash value accumulation test is met if the cash surrender value of the contract, by its terms, may not exceed the net single premium that would have to be paid at such time to fund the future benefits under the contract assuming that the contract mature no earlier

[15] BOI-ENR-DMTG-10-10-20-20 n° 220.

[16] Code §7702(a).

[17] JCS-41-84 at page 646.

[18] *Id.* at page 647.

than age 95 for the insured.[19] The test must be met at all times during the life of the insurance contract. The net single premium is a one-time payment that guarantees coverage for the policy holder without any additional expenses or fees.[20]

The cash surrender value is computed without regard to any surrender charges, policy loans, or reasonable termination benefits.[21]

Whether a contract meets this test of a life insurance contract will be determined on the basis of the terms of the contract. In making the determination that a life insurance contract meets the cash value accumulation test, the net single premium for any time is computed using a rate of interest that is the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on the issuance of the contract. To be consistent with the definitional test reference to the cash surrender value, the "rate or rates guaranteed on the issuance of the contract" means the interest rate or rates reflected in the contract's nonforfeiture values (*i.e.*, the cash surrender value), assuming the use of the method in the Standard Nonforfeiture Law.

Guideline Premium Limitation / Cash Value Corridor Test

The second alternative test under which a contract may qualify as a life insurance contract has two requirements; the guideline premium limitation and the cash value corridor. The guideline premium portion of the test distinguishes between contracts under which the policyholder makes traditional levels of investment[22] through premiums and those which involve greater investments by the policyholder. The cash value corridor disqualifies contracts which allow excessive amounts of cash value to build up (*i.e.*, premiums, plus income on which tax has been deferred) relative to the life insurance risk. In combination, these requirements are intended to limit the definition of life insurance to contracts which require only relatively modest investment and permit relatively modest investment returns.

The test is a two-part test that applies to both the premiums and the cash value.

The guideline premium requirement requires that the net premiums paid at any time cannot exceed the greater of (1) the single premium that would have been required upon issuance of the policy that is needed to fund the future benefits under the contract[23] or (2) the sum of the level annual premiums that would be required for that purpose over the life of an insured who lives until at least age 95.[24] A premium payment that causes the sum of the premiums paid to exceed the guideline premium limitation will not result in the contract failing the test if the premium payment is necessary to prevent termination of the contract on or before the end of the contract year, but only if the contract would terminate without cash value but for such payment.

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19 Code §7702(b)(2). The future benefits to which this rule refers include death benefits, endowment benefits, and additional benefits for which the insured has paid.

20 The net single premium is computed using the rate guaranteed in the contract that cannot fall below 4% and the mortality charges specified in the contract. If the contract is silent on the charges, the mortality charges used for computing statutory reserves are used to compute the premium amount.

21 Code §7701(f)(2).

22 JCS-41-84 at page 649.

23 Code §§ 7702(a)(2)(B), 7702(c)(1), 7702(c)(2)(A), 7702(c)(3)(A).

24 Code §§ 7702(a)(2)(A), 7702(c)(1), 7702(c)(2)(B), 7702(c)(4).

The cash value corridor test requires that the death benefits under the contract must always be more than an applicable percentage of the cash surrender value. The percentages appear in a statutory table that looks to the insured's age at the beginning of the contract year and provides a percentage that must be used, ranging 250% for individuals who are not over age 40 on the first day of the contract year to 100 to 105% for individuals who are between age 90 and age 95 on the first day of the contract year.[25] The legislative history illustrates the application of the cash value corridor as follows.

> Applicable percentages are set forth in a statutory table. Under the table, an insured person, who is 55 years of age at the beginning of a contract year and has a life insurance contract with $10,000 in cash surrender value, must have a death benefit at that time of at least $15,000 (150 percent of $10,000). [26]

The two tests are extremely complicated and require actuarial estimations beyond the ability of most tax advisers. Thus, it is best to have the assistance of the insurance company's own actuaries.

If a life insurance policy meets at least one of the two tests, it is treated as a qualified policy subject to preferential tax treatment in the U.S. including the benefit of tax deferral. If a policy is an unqualified policy, the benefit of tax deferral is not available and the policy holder may be subject to immediate taxation.

U.S. TAXATION OF A QUALIFIED LIFE INSURANCE POLICY

A qualified life insurance policy is granted preferential tax treatment. The most substantive benefit is the nonrecognition of any annual appreciation in the surrender value and full exemption from tax on the proceeds on death to the extent they represent death benefits. A total list of benefits is as follows:

- **Annual Build Up:** The year-to-year increase in the cash value is not subject to income tax.
- **Death Benefit:** Proceeds attributable to the death benefit of the life insurance contract are not subject to income tax in the hands of the estate or heirs receiving the payment.[27]
- **Dividends:** No U.S. tax is imposed if dividends are retained by the insurer as a premium. If not retained by the insurer, a distribution reduces the investment in the contract and is not taxed to the and is not taxed until the full investment is returned to the insured. At that point, the excess is fully taxed as ordinary income at rates of up to 37% under current law. The investment in the contract is the aggregate amount of premiums paid into the policy reduced by the aggregate amount received as distributions under the contract that were previously excluded from gross income (*e.g.*, prior tax-free withdrawals).

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[25] Code §7702(d).

[26] JCS-41-84 at pages 650-651.

[27] Code §101(a).

- **Withdrawal or Surrender:** Upon a payout before death, the amount in excess of the "*investment in the contract*" is subject to U.S. tax as ordinary income at the rate of up to 37%.

- **Sale of Policy:** Proceeds from the sale of a life insurance contract to a third party are taxed as follows. Amounts received are exempt from U.S. tax up to the investment in the contract. Any amount received above the investment in the contract (tax basis) up to the cash value is taxed as ordinary income. All remaining proceeds are taxed as capital gains.

U.S. TAXATION OF AN UNQUALIFIED INSURANCE POLICY

As discussed above, a French life insurance contract typically is not designed to provide a death benefit. Rather, it serves as an investment tool for the owner of the policy. Consequently, it likely will not meet either test relevant to determine whether a policy is a qualified policy for U.S. tax purposes.

In general, a contract that is a life insurance contract under applicable law that fails to meet the tests under Code §7702 continues to be a life insurance contract for all purposes of the Code except for the following two purposes:[28]

Annual Build-Up in the Policy Value is Subject to U.S. Tax

The income on the contract for any taxable year of the policy holder is taxed as ordinary income by the policy holder during such year.[29]

The income on the contract is the increase in the net surrender value of the contract during the taxable year as (i) increased by the cost of life insurance protection provided under the contract during the taxable year and (ii) reduced by the premiums paid under the contract during the taxable year.[30]

No foreign tax credit is available in the U.S. since no French income tax is due on the annual buildup.

Taxation of Death Proceeds

A portion of the death benefit will be received free of income tax, and the balance will be taxed as ordinary income at rates of up to 37%.[31] For this purpose, the death benefits are divided into two parts. The proceeds, to the extent of the net surrender value, are treated as amounts received under an annuity contract and are includible in the recipient's gross income as ordinary income.[32] The excess of the amount paid by the reason of the death of the insured over the net surrender value of the contract is received tax free under Code §101.

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28 Code §7702(g)(3).

29 Code §7702(g)(1)(A).

30 Code §7702(g)(1)(B).

31 Code §7702(g)(2).

32 Clarified by the French government here.

Withdrawal or Surrender

Upon a payout before death, the amount in excess of the "investment in the contract" is subject to U.S. tax as ordinary income. The excess is also taxed in France if the policy holder is a French resident. The income is treated as interest income taxed as ordinary income.

As mentioned above on page 32, Article 11 (Interest) of the France-U.S. income tax treaty grants exclusive right to tax to the country of residence of the recipient. Thus, a U.S. citizen who resides in France will be subject to French tax under the treaty. He or she will also be subject to U.S. tax under the saving clause of the treaty.[33] The income will be foreign source for U.S. tax purposes since interest is sourced to the country of payor. Therefore, the policy holder will be entitled to claim a foreign tax credit for the French taxes paid on that income.

Sale of Policy

Proceeds from the sale of an unqualified life insurance contract to a third party are treated as follows:

- Amounts received are exempt from U.S. tax up to the investment in the contract.
- Any amount received above the tax basis up to the cash value is taxed as ordinary income.
- All remaining proceeds are taxed as capital gains.

Article 13(6) of the Treaty grants exclusive right to tax to the country of residence of the seller. Thus. a U.S. citizen who is a French tax resident will be subject to French income tax under the treaty but will also be subject to U.S. tax under the saving clause. The income will be foreign source for U.S. tax purposes if U.S. citizen has a tax home in France.[34] Therefore, the policy holder will be entitled to claim a foreign tax credit of the French taxes paid against his U.S. income tax liability.[35]

However, French law allows only a partial withdrawal or a complete surrender of the policy. It does not allow for a sale of a policy.

Excise Tax on Foreign Life Insurance Premium

An excise tax of 1% is imposed on insurance premiums paid to a foreign life insurance company insuring U.S. risks.[36] At the same time, premiums subject to the excise tax are exempt from the 30% F.D.A.P. withholding tax.[37] The person making a premium payment files Form 720 (Quarterly Federal Excise Tax Return) and remits the excise tax to the I.R.S.

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33 Paragraph 2 of Article 29 (Miscellaneous Provisions).

34 Code §865(a).

35 Re-sourcing rules under the treaty must be examined if the policy holder has a tax home in the U.S.

36 Code §4371.

37 Treas. Reg. §1.1441-2(a)(7).

The excise tax does not apply in either of the following circumstances:

- The premiums generate effectively connected income for the foreign insurance company.
- The premiums are exempted from the excise tax under an applicable income tax treaty.

The France-U.S. Income Tax Treaty includes the excise tax as a covered tax.[38] Therefore, since the insurance premiums would be considered business profits in the hands of the insurance company, the excise tax exposure will not arise in the U.S. in the absence of a permanent establishment in the U.S.

To qualify for the exemption, the foreign life insurance company must meet three conditions:

- It must enter into a closing agreement with the I.R.S.
- It must be a resident of France.
- It must meet one of the tests under the Limitation on Benefits provision.

The I.R.S. publishes a list of foreign life insurance companies that have entered into qualifying closing agreements.[39]

U.S. Policy Holders / Form 8621 / P.F.I.C.'s Held by French Insurance Company

Premiums paid under a life insurance policy to a French insurance company are used by the company to make investments. If an investment takes the form of collective investment vehicles (among which are *Organisme de Placement Collectif en Valeurs Mobilières*, (O.P.C.V.M.'s)), the collective investment vehicle likely will be categorized as a Passive Foreign Investment Company ("P.F.I.C.").

However, a U.S. policy holder of a French life insurance policy will be required to report the P.F.I.C.s and include income therefrom only if he or she is treated as a direct or indirect shareholder in the P.F.I.C. The report is filed on Form 8621 (Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund.). In the circumstances, the question presented is whether the owner of the policy is considered to be an indirect shareholder of a P.F.I.C. in which the French insurance company holds shares. An indirect shareholder of a P.F.I.C. is determined based on certain attribution rules. Attribution of ownership of a P.F.I.C. from a foreign corporation to a shareholder is possible under two situations:

- The foreign corporation is itself a P.F.I.C.[40]
- The foreign corporation is not a P.F.I.C. and the shareholder owns 50% or more in the value of the foreign corporation.

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38 Article 2 (Taxes Covered), Paragraph 1(a) (ii). Note, however, the treaty benefit is lost if, and to the extent, the risk is reinsured with a company based in a country that has not entered into an income tax treaty with the U.S. that provides comparable benefits regarding the excise tax in the U.S.

39 See here.

40 In this case, the ownership percentage of a shareholder in the foreign corporation holding a P.F.I.C. is irrelevant.

In general, active foreign insurance companies are not considered to be P.F.I.C.'s under the active insurance exception to P.F.I.C. status.[41] As a result, a French life insurance company should not be treated as a P.F.I.C. and attribution under the first attribution rule is inapplicable. Attribution is also unwarranted under the second attribution rule because a French life insurance company is not a P.F.I.C. When a foreign company is not a P.F.I.C., its investment in a lower-tier foreign company that is a P.F.I.C. may be attributed only to a U.S. person that is a 50% shareholder of the foreign corporation, which is outside the fact pattern presented.

In view of the above, a policy holder of a French life insurance policy should not be viewed to be an indirect owner of shares in a P.F.I.C. held by a French life insurance policy. The policy holder should have no P.F.I.C. exposure in the facts presented.

The conclusion is buttressed by Rev. Rul. 2003-91, which addresses whether, for U.S. income tax purposes, the holder of a variable life insurance contract would be considered to be the owner of the assets that fund the variable contract. In the ruling, the policy holder purchased a life insurance contract under which he specified the allocation of the premium among available subaccounts maintained by the insurance company. The holder could change the allocation of premiums at any time within certain limitations, but had no legal or inferred rights regarding the investment strategy of any investment account or the assets to be held by a particular account. All investment decisions concerning the investment accounts were made by the insurance company and its investment advisor.

The I.R.S. concluded that the policy holder did not have any legal, equitable, direct, or indirect interest in any of the assets held in an investment account. Therefore, interest, dividends, and other income derived from the assets that fund the variable contract cannot be included in the holder's gross income when and as earned under the policy.

U.S. Reporting Obligation for the Foreign Life Insurance Policy

Every U.S. tax resident and every U.S. citizen must annually report all interests held in all foreign financial accounts if the aggregate value of all foreign accounts at any time exceed $10,000. The report is made to the Financial Crimes Enforcement Network ("FinCEN"), a bureau of the U.S. Treasury Department. FinCEN Form 114 (Report of Foreign Bank and Financial Accounts (F.B.A.R.)) is the form used to make the report.

The definition of "foreign financial accounts" includes an account that is an insurance or annuity policy with a cash surrender value. A French life insurance policy constitutes a foreign financial account for F.B.A.R. purposes. Consequently, a U.S. person who holds a French life insurance policy must report the investment in the policy on an F.B.A.R. if the dollar threshold is met.

In addition for F.B.A.R. reporting to FinCEN, a U.S. taxpayer must report the investment on I.R.S. Form 8938 (Statement of Specified Foreign Financial Assets) provided that the life insurance policy is a cash value insurance policy having a positive value and the aggregate value of all foreign financial assets held by the U.S. taxpayer exceeds a specified threshold that varies based on the marital status of the individual and place of physical residence.

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[41] Code §1297(b)(2)(B).

CONCLUSION

As the world gets smaller and investment opportunities cross borders, it is easy to ignore the complexities of tax laws and commercial laws in other countries. As evidenced in this article, a safe investment in a life insurance contract issued under the laws of a foreign country brings with it a world of complexities that are easy to miss in the absence of competent cross border tax planning.

". . . a safe investment in a life insurance contract issued under the laws of a foreign country brings with it a world of complexities that are easy to miss in the absence of competent cross border tax planning."

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.

Joshua Mangeot is a partner in the B.V.I. office of Harneys. His practice includes advising H.N.W.I.'s and M.N.E.'s on a broad range of corporate, finance, transactional regulatory, and tax matters. Josh is regarded as a leading specialist on the implementation of the B.V.I. economic substance requirements.

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

- 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
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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..

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

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).

- 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.*

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.

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[39] *Id.*

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.

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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C.O.P. 9
Criminal Tax
Deliberate Behavior
D.I.M.F.
F.I.G.
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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

- 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.

[* 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

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

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)

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].

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.

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.

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 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.

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.

THE EVOLUTION OF TAX ENFORCEMENT IN SWITZERLAND

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Tags
A.E.O.I.
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Crypto Assets
Effective Management
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Switzerland
Tax Avoidance

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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

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.

- 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").

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.

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.

- 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 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.

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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Tags
Decree No. 139
Fictitious Interposition
Italy
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,

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

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 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.

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

<u>Court Cases and I.T.A. Rulings</u>

<u>Ruling No. 267 of 2023 – Extension of Guardian's Powers</u>

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.

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.

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.

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.

- 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 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

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.

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.

RECENT DEVELOPMENTS TO COMBAT TAX AVOIDANCE IN GERMANY

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Tags
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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.

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.

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.

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*.

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.*

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 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.

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.

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

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.

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.

"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."

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

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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 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 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 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.

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.

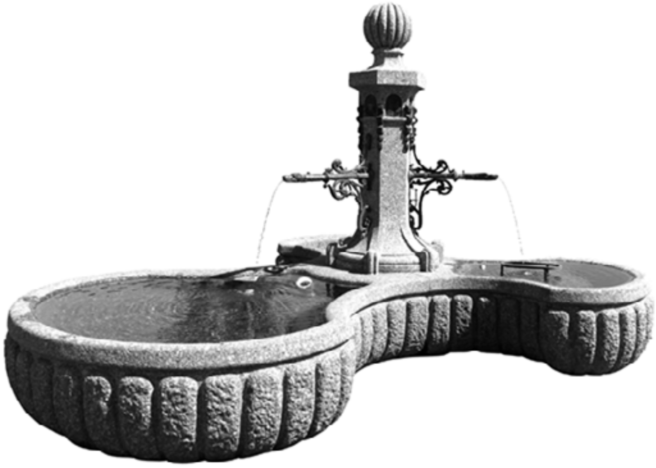
In practice, entities or persons receiving an information request should ensure that they understand their legal obligations. In most cases, it will be advisable to retain a competent attorney who can advise under the attorney-client privilege. The assignment is to check that the request is valid and 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.

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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Our firm provides a wide range of tax planning and commercial legal services to clients across the Americas, Asia, Europe, and the Middle East. Clients include global investors, multinational corporations expanding into the U.S., and U.S. businesses with international operations. Our core practice focuses on cross-border transactions.

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