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INSIGHTS

2016 YEAR IN REVIEW

U.K. TAX RESIDENCY RULES FOR INDIVIDUALS AND COMPANIES

A YEAR OF GUEST FEATURES

THE 2016 U.S. MODEL INCOME TAX CONVENTION

EUROPEAN STATE AID: THE MAKINGS OF A GLOBAL TRADE WAR

TREASURY DEPARTMENT RESURRECTS CODE §385 REVISING REGULATIONS ON RELATED-PARTY DEBT

Insights Special Edition

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EDITORS' NOTE

The Holiday Season is a time to reminisce on events of the past year and to look forward in anticipation to the coming year. The December edition of *Insights* follows that path. We begin by looking forward, with an article by Richard Holme and Simon Tadman of Creaseys, U.K., addressing the rules now in effect in the U.K. regarding the tax residence of individual and company taxpayers. Then, we reminisce on the best of 2016, with articles contributed by guest authors from around the world.

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This is followed by articles on several international themes that are highlights of 2016 – the new U.S. Model Income Tax Treaty, the brewing transatlantic trade war disguised as European Commission attacks on illegal State Aid given to U.S.-based groups, and the debt-equity regulations adopted under Code §385.

- **U.K. Tax Residency Rules for Individuals and Companies.** Richard Holme and Simon Tadman of Creaseys, U.K., explain the wonderfully complex set of rules that are applied to determine whether an individual is a resident of the U.K. for income tax purposes and whether a company is a tax resident for corporation tax purposes. Can the new Statutory Residence Test bring certainty to the determination in light of the increase in complexity?

A Year of Guest Features

- **European Commission Rocking the Boat at Arm's Length.** Transfer pricing economists Theo Elshof, Olaf Smits, and Mark van Mil of Quantera Global, Amsterdam, explore the European Commission's definition of the term "arm's length" in recent State Aid cases. Tax advisers with experience in transfer pricing matters will be surprised to find that reliance on practices of global competitors in the same or similar industry is not relevant when the matter relates to tax rulings comprising State Aid.

- **Goods and Services Tax: A Game Changer.** The passage of the Constitution Act, 2016, has brought India one step closer to adopting a national G.S.T. as its new indirect tax structure. The G.S.T. will replace central and state levies with a goal of eliminating multiple taxation of the same transaction.

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Sakate Khaitan of Khaitan Legal Associates, Mumbai, explains the rates, the coordination among jurisdictions, and the anticipated effect on business. A paradigm shift in the Indian economy is anticipated at both the micro and the macro levels.

- **Spanish Tax Implications of Nonresident Private Investment in Spanish Real Estate.** Spanish real estate has become an attractive investment opportunity for those in search of high-quality real property at reasonable prices. Local knowledge of taxes is key for an unsuspecting, nonresident investor to avoid various tax traps. María Manzano, a partner specializing in tax at Altalex in Madrid, Spain, explains the main Spanish tax consequences that arise during the investment cycle of nonresident private investment in Spanish real estate.

- **Further Developments for U.K. Non-Dom Individuals.** A significant claw back of benefits for individuals with Non-Dom status was first announced in the Summer Budget of 2015. In August, H.M.R.C. proposed implementing legislation in a follow-up consultation document. Specific benefits covered included inheritance tax for shares of envelope companies owning U.K. residential real property, deemed domicile rules for long-term U.K. residents, and several provisions to lessen the impact of these changes. Gary Ashford of Harbottle & Lewis, London explains.

- **The End of the Negotiation: Protocol to India-Mauritius Tax Treaty Finally Released.** After several years of negotiations, a new protocol to the Mauritius-India Income Tax Treaty has been agreed between the parties. In a nutshell, India benefits from amended provisions that are in line with other bilateral treaties, while Mauritius benefits from the adoption of grandfathering provisions regarding capital gains from the disposition of certain shares. Investors in both countries will benefit from greater certainty in taxing outcomes. Anurag Jain and Parul Jain of Attorneys BMR & Associates L.L.P., Gurgaon, address the highlights of the new provisions.

- **Italy Modernizes Tax Treatment of L.B.O. Transactions.** In a Circular Letter issued in March by the *Agenzia delle Entrate*, the Italian tax authority, rules were issued providing for rational tax treatment of costs and gains arising in the context of leveraged buyout transactions. Luca Rossi and Marina Ampolilla of Studio Tributario Associato Facchini Rossi & Soci explain the changes and bring good news to investment bankers and their clients.

- **Canada Adopts Changes to Trust & Estate Taxation Rules.** On January 1, 2016, new income tax rules came into effect regarding the Canadian taxation of trusts and estates. Use of graduated tax rates for multiple trust, charitable donation credits for estates, and allocation of gains at death are the targets. Amanda Stacey, Nicole D'Aoust, and Rahul Sharma of Miller Thomson LLP, Toronto explain.

- **U.K. Adopts Public Register of People with Significant Control Over U.K. Corporations.** Think you can hide behind a corporate shell in order to avoid notoriety? Think again if you own a company or L.L.P. formed in the U.K. These entities are now being required to maintain a statutory register setting out the individuals who are considered "persons with significant control," and beginning in July, the registers are to be made available to the public. Naomi

Lawson and Melanie Jory of Memery Crystal, London, explain of this new, transparency-seeking legislation and provide commentary on the multitude of potentially adverse consequences.

- **Exchange of Information: Israel Inches Toward International Norms.** The State of Israel depends on immigration for growth in population and capital. Favorable tax rules and confidentiality rules are key pillars of the policy to promote immigration. In a world that is obsessed with B.E.P.S., Israeli policy towards confidentiality is experiencing change. Boaz Feinberg and Ofir Paz of ZAG-S&W, Tel Aviv discuss the scope of that change.

- **India Budget 2016-17.** On February 29, 2016, the Indian Finance Minister presented Budget 2016-17 and Finance Bill, 2016 to the Indian Parliament. Significant amendments to the tax law reflecting several B.E.P.S. recommendations and key economic policy proposals were announced. Jairaj Purandare, the Founder and Chairman of JPM Advisors Pvt. Ltd. explains the winners and losers.

- **B.E.P.S. Initiative Spawns Unfavorable Permanent Establishment Court Decisions.** Two court cases in different parts of the world attack tax plans premised on the absence of a permanent establishment. Pertinent U.S. income tax treaties, with Japan and India respectively, were effectively ignored in each case. Taketsugu Osada, Christine Long, and Stanley C. Ruchelman explain.

- **The Meanderings of the Taxation of U.K. Real Estate: Where Are We Going?** For those who are considering the acquisition of U.K. real property for personal use, an unhappy surprise awaits. The U.K. government is actively waging a tax campaign against structures commonly used for these acquisitions and referred to derisively as "Enveloped Dwellings." Increased stamp duty on land transactions, annual tax on Enveloped Dwellings and related capital gains charges, and extended scope of inheritance tax take the sizzle out of high-value purchases. Naomi Lawton of Memery Crystal L.L.P., London ruminates on this puzzling development.

- **The Common Reporting Standard – A Global F.A.T.C.A.?** The Common Reporting Standard ("C.R.S.") for the automatic exchange of information by financial institutions is now in effect for the 56 jurisdictions that are Early Adopters. How will the C.R.S. work and who will be affected? How does it interact with F.A.T.C.A. I.G.A.'s? Richard Addlestone of Solomon Harris, Grand Cayman answers these and other questions.

The 2016 U.S. Model Income Tax Treaty

- **U.S. Treasury Announces New U.S. Model Income Tax Treaty.** On February 17, 2016, the U.S. Treasury Department released its 2016 Model Treaty. The model serves as the baseline from which the U.S. initiates treaty negotiations. Stanley C. Ruchelman examines several provisions, pointing out various areas of super-complexity that are encountered in the 2016 Model Treaty in order to prevent double non-taxation. This is a byproduct of B.E.P.S.

- **2016 Model Treaty – Special Tax Regimes.** A new provision of the 2016 Model Treaty attacks special tax regimes. Treaty benefits are denied for payments to connected persons who benefit from such provisions. Patent box regimes and regimes that allow for notional interest deductions are specifically targeted. Christine Long and Stanley C. Ruchelman explain.

- **2016 Model Treaty – Limitation on Benefits Revisions.** Those who thought that the limitation on benefits ("L.O.B.") provision under the U.S.-Netherlands Income Tax Treaty was complex will find that the level of complexity in the 2016 Model Treaty has been raised several levels. Some taxpayers will be losers and others will be winners. Philip R. Hirschfeld and Galia Antebi explain how the revised provision will work.

- **2016 Model Treaty – Mandatory Arbitration.** Taking a cue from the U.S.-Canada Income Tax Treaty, the 2016 Model Treaty provides for mandatory arbitration as part of the article on Mutual Agreement Procedures. I.R.S. statistics indicate that under the Canadian treaty 80% of cases were resolved by the competent authorities in lieu of risking an adverse decision through arbitration. Kenneth Lobo explains the revised provision and places it in context.

- **2016 Model Treaty – B.E.P.S. and Expatriated Entities.** The 2016 Model Treaty adopts certain B.E.P.S. provisions, including those that eliminate double non-taxation through a splintered operation, which divides a long-term project among several related parties and each party maintains the project for a limited time. That type of planning no longer works, while other B.E.P.S.-related revisions are missing. Sheryl Shah and Elizabeth V. Zanet explain what is out and what is in, and address the way payments from expatriated entities are treated. It is not all bad news.

European State Aid: The Makings of A Global Trade War

- **E.U. State Aid – The Saga Continues.** For several years, the European Commission has been on a mission to raise on a retroactive basis the income tax of large corporations that received favorable tax rulings from national authorities. Using as its tool the rules prohibiting State Aid, the Commission has gone after Fiat Chrysler, McDonald's, Starbucks, and others. Christine Long and Beate Erwin explore the Commission's latest push and the outcry it is causing on both sides of the Atlantic. Luxembourg and the Netherlands have appealed recent rulings and the mood in Washington, D.C. is chilly, at best.

- **Treasury Attacks European Commission on State Aid – What Next?** On August 30, 2016, the European Commission ordered Ireland to claw back €13 billion ($14.5 billion) plus interest from Apple after favorable Irish tax rulings were deemed to be illegal State Aid. The U.S. Treasury Department issued a white paper shortly before the decision staking out the reasons why the European Commission crusade is unjustified, especially in relation to its retroactive effect. This trans-Atlantic conflict is placed in context in an article by Kenneth Lobo and Beate Erwin.

- **European State Aid and W.T.O. Subsidies.** Recent European Commission rulings have attacked tax rulings granted by Ireland and the Netherlands to Apple and Starbucks, respectively. These rulings are not meaningfully different from those granted for decades by various E.U. Member States. To the shock of these countries, the tax rulings distorted trade. At the same time, the World Trade Organization ("W.T.O.") determined that several E.U.

Member States have granted actionable subsidies to Airbus in order to assist the company in a way that distorts trade among W.T.O. members. Fanny Karaman, Stanley C. Ruchelman, and Astrid Champion explain (i) the basic internal procedures within the E.U. that outlaw State Aid and (ii) the applicable provisions of the global trade agreement embodied in the W.T.O. in connection with actionable subsidies. In light of the W.T.O. ruling, the question to be answered is whether the E.U. is being disingenuous by not recovering the European subsidies given to Airbus.

The Resurrection of Code §385: Treasury Department Revises Regulations on Related-Party Debt

- **Related-Party Debt: Proposed Code §385 Regulations Raise Major New Hurdles.** Phillip R. Hirschfeld offers a detailed analysis of new debt/equity regulations. Mind-boggling complexity is proposed for rules in an area of the tax law that lay dormant for almost 40 years.

- **Uproar Over Proposed §385 Regulations: Will Treasury Delay Adoption?** Earlier this year, the U.S. Treasury Department issued comprehensive and detailed proposed regulations under Code §385 that address whether a debt instrument will be treated as true debt for U.S. income tax purposes or re-characterized, in whole or in part, as equity. Not surprisingly, significant pushback has been encountered from members of Congress, professional bodies, and affected taxpayers. It seems that the one-size-fits-all approach contains many defects. Philip R. Hirschfeld and Stanley C. Ruchelman explain.

- **§385 Regulations Adopted with Helpful Changes, but Significant Impact Remains.** On October 13, 2016, the Treasury Department released final and temporary regulations under Code §385 relating to the tax classification of debt. The new rules were proposed initially in April and were followed by a torrent of comments from Congress, business organizations, and professional groups. In the final portion of his trilogy on debt-equity regulations, Philip R. Hirschfeld explains the helpful provisions that appear in the final regulations and cautions that not all controversial proposals were modified.

We hope you enjoy this issue.

- The Editors

U.K. TAX RESIDENCY RULES FOR INDIVIDUALS AND COMPANIES[1]

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Statutory Residence Test
Tax Residency
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INDIVIDUALS – RESIDENT OR NOT? THREE YEARS INTO THE STATUTORY RESIDENCE TEST

Background

If an individual becomes resident in the U.K. for tax purposes, *prima facie* liability arises regarding U.K. tax on worldwide income and gains. In normal circumstances, therefore, an individual will endeavor to avoid U.K. tax residency, particularly as the taxation of nonresidents is confined to certain U.K.-source income, such as rent, and capital gains tax is generally confined to U.K. residential property and assets used in the individual's branch or agency in the U.K.

The U.K. statutory residence test has applied since April 6, 2013, and has brought a considerable degree of clarity to previously confused rules. Prior to April 2013, statutory law was virtually nonexistent. Instead, extensive case law and published guidance from H.M. Revenue and Customs ("H.M.R.C.") governed the establishment or relinquishment of residence.

In many cases, this guidance extended far beyond the principles set out in the law. For example, individuals looking to leave the U.K. apparently needed to made a "clean break" and sever most, if not all, connections with the U.K. in order to achieve nonresident status for U.K. tax purposes. Individuals who kept poor records of visits to and from the U.K. were particularly vulnerable, as physical presence was the main residency criterion prior to April 2013.

Statutory Residence Test – Main Principles

The statutory residence test ("S.R.T.") brings clarity for most individuals, although, there are some areas of uncertainty, particularly with regard to definitions of "only home" and "full time work." Nonetheless, the tests to determine whether an individual is tax resident are applied in a straightforward manner. Consequently, tax planners may plan for an individual to be nonresident prior to the disposal of a business or receipt of a significant amount of income, provided appropriate client cooperation exists.

S.R.T. – Part A

This test will "conclusively" determine that an individual is *not* resident in the U.K. for a given tax year if *any* of the following conditions are applicable:

- The individual was resident in the U.K. for one or more of the preceding three

[1] The authors would like to acknowledge the contribution of Matt Boggis, assistant client manager at Creaseys, in the preparation of this article.

tax years and is present in the U.K. for fewer than 16 days in the current tax year.

- The individual was not resident in the U.K. in all of the previous three tax years and is present in the U.K. for fewer than 46 days in the current tax year.
- The individual works full time abroad, provided that presence in the U.K. is limited to fewer than 91 days, not more than 30 days are spent working in the U.K. in the current tax year, and the individual is does not work in international transportation.

S.R.T. – Part B

Provided Part A of the test, above, does *not* apply, an individual will be resident conclusively for the tax year under Part B if *any* of the following conditions are met:

- The individual is present in the U.K. for 183 days or more in a tax year.
- The individual has only one home and that home is in the U.K. If the individual has two or more homes, all are in the U.K.
- The individual carries out full-time work, as defined, for a sufficient number of hours in the U.K. in the year and does not work in international transportation.

S.R.T. – Application to Other Cases

If Part A and Part B are inapplicable, or an individual is neither *conclusively* nonresident nor conclusively resident for a tax year, the determination is made by reference to the "ties" that exist with the U.K. and physical presence in the U.K. Here, the analysis can be complex, as it requires the advisor to probe quite deeply into the individual's affairs in order to provide correct advice in support of the residency position claimed on the tax return.

For these cases, the determination is based on the number of ties to the U.K. and days spent in the U.K., applying an inverse relationship. As the ties increases in number, residence will exist with fewer days of presence in the U.K. The ties to consider are as follows:

- Family – This tie supports resident tax status if the individual's spouse, civil partner, or common law equivalent is resident in the U.K., provided the individual is not separated from that person. Also, this tie includes the residence status of minor children, although exclusions are provided for minor children undertaking full-time education in the U.K.
- Accommodation – This tie supports resident tax status if the individual has available accommodation in the U.K. and makes use of it during the tax year. There are exclusions for some types of accommodation. The accommodation may be owned, rented, or otherwise provide free of charge, as when the premises are owned by a family member.
- Substantive Work in the U.K. – A tie may exist if the individual performs "substantive" work in the U.K. but does not work in the U.K. full time. Specifically, there will be a tie if the individual does more than three hours of work per day in the U.K. on at least 40 days in that year (whether continuously or

intermittently). Special rules apply to individuals who are involved in international transportation.

- Time Spent in the U.K. v. Other Countries – In this case, one must scrutinize the number of days spent in the U.K. and in other countries, as a tie will exist if more time is spent in the U.K. than in any other country. However, this tie is considered only when the individual was resident in the U.K. in one or more of the three previous tax years.
- Time Spent in the U.K in Prior Years – The last tie will apply if the individual spent more than 90 days in the U.K. in either of the two preceding years. Consequently, it will be possible to return to the U.K. to a greater extent, without having a tie exist, once two years of nonresidence have been achieved.

The following chart sets forth the relationship of days, ties to the U.K., and residence in prior years that lead to tax residence in the U.K. for the current year.

Impact of U.K. Ties on Residency Status		
Days Spent in the U.K.	**Individuals *Resident* in ≥ 1 of the Previous 3 Tax Years**	**Individuals *Not Resident* in Previous 3 Tax Years**
< 16	Always Nonresident	Always Nonresident
16 – 45	Resident if individual has 4 factors	Always Nonresident
46 – 90	Resident if individual has ≥ 3 factors	Resident if individual has 4 factors
91 – 120	Resident if individual has ≥ 2 factors	Resident if individual has ≥ 3 factors
121 – 182	Resident if individual has ≥ 1 factor	Resident if individual has ≥ 2 factors
≥ 183	Always Resident	Always Resident

Claiming Nonresident Status

An individual who is nonresident, or an individual who is a dual resident in the U.K. and another country, claims nonresident status based on the above factors in a U.K. tax return, whether issued by H.M.R.C. or otherwise required because, for example, of chargeable U.K.-source income was derived. There is a specific "residence, remittance basis, etc." section on a U.K. tax return where an individual must report nonresident status and answer 22 or more questions regarding U.K. ties, physical presence, and other relevant criteria. The 22 questions may seek information that goes beyond what is needed to determine residence status, and there are points that might then be checked with the relevant overseas tax authority or used to gather information about a taxpayer, such as residence status in another country.

Days on which the individual is in the U.K. at midnight count for residence determination purpose. Also counted are days spent working for more than three hours in the U.K. and any days attributable to exceptional circumstances such as a serious illness. All such days must be reported, although the days attributable to exceptional circumstances are normally excluded.

There are some circumstances whereby days in which the individual is present in the U.K. at midnight are disregarded. Transit days during which the individual is travelling from one country outside the U.K. to another, but arrives in the U.K. as a passenger whilst en route to the final destination may not count as days spent in the U.K. Note that activities engaged in by the individual while in the U.K. on a transit day may count towards residence if activities unrelated to transit through the U.K. are undertaken. This may include catching up with friends or family and visiting tourist attractions.

"H.M.R.C. expects taxpayers to keep accurate records of both ties and visits to the U.K., and cases have been lost by taxpayers who were not able to prove presence outside the U.K. because record keeping was not up to the mark."

In addition, in some circumstances where an individual is present in the U.K. on more than 30 days during a tax year without being in the U.K. at midnight, subsequent days may count as days spent in the U.K. under a deeming rule.

H.M.R.C. expects taxpayers to keep accurate records of both ties and visits to the U.K., and cases have been lost by taxpayers who were not able to prove presence outside the U.K. because record keeping was not up to the mark.

Split Year Treatment

Normally, an individual is either resident or nonresident for the *whole* of the U.K. tax year, which runs to April 5 – an historical anachronism from when income tax was introduced as a "temporary measure" in 1798. One of the most complex aspects of the S.R.T. is where an individual is entitled to "split" the tax year into the residence portion and the nonresidence portion.

Split Years – Concessions

Prior to April 2013, a tax year could be split only in accordance with concessions granted by H.M.R.C. Concessions do not have the force of law and were not applied in abusive fact patterns. Usually, these concessions only allowed a splitting of the year of arrival in or departure from the U.K. in limited circumstances, where the individual was taking up permanent residency in another country or undertaking full-time employment abroad spanning a full tax year. Under the old regime, the rules for split years for capital gains were significantly different to those for income tax.

For example, an individual leaves the U.K. in September 2012 and in the following December sells a business at a substantial gain. Here, it would have been critical to utilize the relevant concession to ensure nonresident status at the time of the disposal in December 2012.

Split Years – S.R.T.

Under the S.R.T., one of eight defined cases must be met for split year treatment to apply for both income and capital gains tax. The S.R.T. rules will often require that various conditions must be met in the tax year in issue and in the preceding and subsequent years. Although complex, the S.R.T. gives greater certainty. Split year treatment is granted by law and applies in broader fact patterns than the concessions that existed prior to S.R.T.

The cases where an individual can split the tax year are numerous and include starting to have full-time employment overseas, ceasing to have a home in the U.K., starting to have a home in the U.K., or being the partner or spouse of someone who is in one of these situations. It will be much harder to split the tax year where the individual is not moving to take up full-time employment. However, it should be possible, with planning, for an individual who leaves the U.K. in, say, September 2016 to feel quite confident that they are not resident in the U.K. when a large capital gain arises in, say, December 2016, on which they would look to avoid U.K. tax.

There can be substantial amounts of tax on the line for internationally mobile clients and substantial risk and reward for their tax advisors. More than ever, advisors must understand the full circumstances of a client's affairs in order to provide appropriate advice – usually, requiring a far better understanding than would be normal for preparing a simple domestic tax return. Adding to the complexities, advisors must carefully consider matters such as whether employment constitutes "full-time" work and whether accommodation counts as a "home" under the *still* rather uncertain definition included in the S.R.T. legislation and associated H.M.R.C. guidance.

For purposes of the S.R.T., a person's home is generally considered to be a place that a reasonable onlooker with knowledge of the material facts would regard as that person's home. A home can be a building, vehicle, vessel, or structure of any kind. It will be a property that an individual uses with a sufficient degree of permanence. However, H.M.R.C. guidance states that a place can remain a home even if the individual does not stay there continuously. The guidance uses the example of an individual who moves out temporarily and whose spouse and children continue to live in that property. If an individual moves out of a home completely and makes it available for leasing, it will not be the individual's home. In addition, a place that has never been capable of functioning as a home cannot be a home (*e.g.*, a property in a state of disrepair that is not habitable). A property that is used periodically and as nothing more than a holiday home or temporary retreat does not count as a home.

Temporary Nonresident

The U.K. is mindful that individuals may seek to leave the U.K. for a short period in order to crystallize a capital gain or an item of significant income while nonresident. There are now quite wide ranging rules that charge such a "temporary nonresident" on capital gains and certain items of income (*e.g.*, a dividend from a closely-held company) if the individual is nonresident for less than five years.

For example, Bruno leaves the U.K. in September 2016 and achieves nonresident status. In May 2017, he sells shares in his U.K. business and derives a gain in the amount of £1 million while nonresident. He returns to the U.K. in June 2021. He has not been away for a full five years. Hence, the capital gain on the £1 million is charged in the tax year of his return to the U.K. (*i.e.*, 2021/22).

CORPORATIONS – RESIDENT OR NOT?

When Will a Company Be Tax Resident in the U.K.?

Background

This is an area of increasing interest for the U.K. tax authorities. Beyond companies incorporated in the U.K., a company registered overseas will be regarded as tax resident in the U.K. if its place of "central management and control" is in the U.K. Subject to limited exception, U.K. statutory law has been largely unchanged in this area for 28 years. However, case law has developed during that period such that considerable care must be taken to prevent a company registered outside the U.K. from becoming U.K. tax resident. This is a problem for a company registered abroad that is run by a dominant U.K.-based entrepreneur or has significant operations in the U.K.

A U.K.-resident company will be liable to U.K. tax on worldwide profits and gains, whereas a nonresident company can be charged only on the following:

- Profits from a permanent establishment in the U.K.
- Certain types U.K.-source income (such as rent)

U.K.-resident companies are normally liable to corporation tax, which is currently imposed at the rate of 20% and will fall to a 17% rate by 2020.

Occasionally, a company will seek to be treated as U.K. tax resident. The purpose may be to benefit from treaty reliefs or low corporate tax rates, or to facilitate shareholder tax benefits if, for example, a loan made to such a company proves irrecoverable. Normally though, the worldwide group may be at pains to avoid a company being regarded as U.K. tax resident, particularly if it is registered in a low-tax jurisdiction.

Central Management and Control

Since 1988, when statutory provisions were introduced, any company – wherever registered – can be regarded as tax resident in the U.K. if its place of central management and control is in the U.K. We are looking, here, at the highest level of decision making, and this will normally be where the directors meet and make key decisions.

The principles have been expounded in a number of leading U.K. tax cases. For example, in an old case dating from 1935, a South African company was held to be resident in the U.K. as the controlling board of directors exercised its powers in the U.K. As the judge stated, "A company resides . . . where its real business is carried on . . . and the real business is carried on where the central management and control actually abides."

"H.M.R.C. is mindful that non-U.K. companies based in low-tax countries may not be controlled by the local board of directors."

To avoid U.K. residence, worldwide groups should arrange for directors' meetings to be held outside the U.K. and for key decisions to be recorded and minuted at these meetings. Following the recent *Laerstate* case, it is helpful if the minutes can also include the information that the directors used in order to make the decisions. Wherever possible, all directors should physically attend board meetings rather than attend by telephone or video cam.

H.M.R.C. is mindful that non-U.K. companies based in low-tax countries may not be controlled by the local board of directors. Recent press commentary has focused on certain directors who claim to be directors of thousands of companies and cannot therefore have, or be expected to have, an intimate knowledge of the companies and their activities.

The U.K. tax authorities from time to time issue clarification of their practices in certain areas, and Statement of Practice 1/90 still has considerable influence and continues to be studied by tax advisers. One important point made by the statement is that H.M.R.C. will first attempt to ascertain whether the directors in fact exercise central management and control. If they do, the tax authorities will endeavor to determine the location where the directors exercise central management and control. This is not necessarily where they meet.

In cases where the directors apparently do not exercise central management and control, the tax authorities will look closely to establish where and by whom it is exercised. For privately held companies, it may be where a dominant owner is located if the owner usurps the power of the board in relation to decision making. The difficulty with many of the older central management and control court cases is that most were decided at a time when electronic communication was either in its infancy or lacking altogether.

The Laerstate BV Case – A Reminder of Principles and Proper Administration

A Dutch registered company, Laerstate BV, was adjudged to be resident in the U.K. as central management and control was exercised in the U.K. The company owner was U.K. resident and seems to have taken key decisions with little or no recourse to the other director, who was Dutch resident and adjudged to be a mere cypher.

This leads to an interesting dichotomy. Where the board of directors of a non-U.K. company is local and consists of local advisers, local management personnel, and a representative of the parent company, the practical need for formalities may be significantly less than where the local board consists of a trust company officer and a local managing director. Non-U.K. companies in the latter group may find it prudent to emphasize steps demonstrating that the board meets outside the U.K., and makes all major strategic decisions. For these companies, the following steps may be taken to support non-U.K. residence:

- Regular minutes should be prepared to evidence local decision making.
- Board of directors meetings that are pre-printed in advance of the meeting should be avoided.
- Sound or video recordings of board meetings should be undertaken to prove that all directors actually participate in decision making.
- The board should comprise directors of proper experience, meet regularly, and receive sufficient information to make decisions.
- The majority of the board of directors should consist of individuals who are not resident in the U.K.

Impact of Double Taxation Agreements

As with individuals, a company may find itself resident in two or more countries. It will therefore be a dual tax resident. Quite often, the relevant U.K. double taxation agreement will contain a tiebreaker provision determining the country in which the company will be treated as tax resident for treaty purposes. Normally, this will deem the company to be tax resident in the country where the place of effective management is situated. Although this is a similar phrase to central management and control, commentary on the O.E.C.D. model suggests that it is really where the day-to-day operations of the business are conducted.

It could be, for example, that a company is treated *prima facie* as tax resident in the U.K., as the directors meet there and make key strategic decisions. If it is deemed to also be resident in another jurisdiction, say France, perhaps this is the "place of effective management," as the executives and workforce operate there. So, for treaty purposes the company is resident in France. It should be noted that the U.K.-U.S. Income Tax Treaty does not have a place of effective management provision but determines that corporate residence for treaty purposes will be resolved by "mutual agreement" between the two tax authorities. Ordinarily, U.S. income tax treaties provide an ultimate tiebreaker based on place of incorporation.

CONCLUSION

The U.K. provisions concerning the tax residence of both individuals and companies are important both for mobile individuals and worldwide groups. It may be expensive in tax terms to become resident in the U.K., although occasionally there are benefits in deliberately triggering residence.

For individuals, the position in the vast majority of cases is much clearer since the introduction of the S.R.T. in April 2013. Although, there are some areas of practical difficulty, such as exists in the definition of the term "home." In total, the provisions are complex, but at least statutory provisions and implementing guidance are available for use by advisers.

For companies, the U.K. tax authorities are becoming increasingly vigilant, and the nebulous concept of central management and control requires due consideration by worldwide groups. Recent case law suggests that directors should be aware of the information used in making decisions and should record the steps in the decision-making process in the minutes of a meeting of the board of directors of the local company. As with many provisions of tax law that are based on economic substance, the decision is made based on facts. This places undue emphasis on the importance of following form that will be helpful in demonstrating substance, especially in fact patterns that are not clear in themselves. Boards of directors or subsidiary companies are themselves subsidiary to the decision of the principal investor.

A YEAR IN GUEST FEATURES

EUROPEAN COMMISSION ROCKING THE BOAT AT ARM'S LENGTH

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Tags
Apple
Arm's Length
European Commission
Starbucks
State Aid

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INTRODUCTION

Many may recall the British parliamentary committee that interviewed top managers of the M.N.E.'s Google, Amazon, and Starbucks in 2012. Margaret Hodge, chairman of the committee at the time, together with other members, grilled the top managers over the tax avoidance schemes of their respective companies. The findings of the committee set things into motion and sparked the O.E.C.D. to initiate the B.E.P.S. Project. Its results were published in the autumn of 2015. Soon after, the European Commission (the "Commission") rolled up its sleeves and adopted the Anti-Tax Avoidance Package ("A.T.A.P."). Even before the introduction of the A.T.A.P., the Commission started using another approach to combat the tax avoidance schemes of M.N.E.'s: the State Aid argument. By now, various M.N.E.'s have been accused of receiving State Aid through publications that – to put it mildly – prompted some strong responses.

Because the Commission's decisions seem to be based on certain new transfer pricing rules for checking the fulfilment of the requirements of State Aid, we – as transfer pricing specialists – would like to share with you our current understanding and views on what we can derive from two specific cases: Starbucks and Apple. We will elaborate on these cases and discuss similarities and differences in the approach taken by the Commission and the O.E.C.D.

We will first describe briefly the legal framework of State Aid and our findings on the Commission's general approach to combatting the tax avoidance schemes of M.N.E.'s. Thereafter, we will expound on the Starbucks and Apple cases. We will describe the key facts of each case followed by the Commission's approach and our comments. Before arriving at our conclusion, we will comment on the O.E.C.D.'s interpretation of the arm's length principle ("A.L.P.") versus the Commission's interpretation of the A.L.P. We will conclude by making some final remarks about the Commission's approach in both cases.

LEGAL FRAMEWORK OF STATE AID

Pursuant to Article 107 T.F.E.U., the "Commission Notice on the Notion of State Aid" and the case law of the European Court of Justice, the six constituent elements of the notion of State Aid are as follows:

1. The existence of an undertaking
2. The immutability of the measure to the Member State
3. Its financing through Member State resources

4. The granting of an advantage

5. The selectivity of the measure

6. Its effect on competition and trade between Member States

Each of the constituent elements has always been assessed separately, from one to six, both by the Commission in its decisional practice and by the European Court of Justice in its own cases. In practice, the most disputed elements are economic advantage and selectivity. On the other hand, if the six requirements are met, Article 107 T.F.E.U. stipulates certain exemptions that allow Member States to achieve certain policy objectives. However, these exemptions do not apply to the Apple and Starbucks cases.

THE COMMISSION'S APPROACH

After the publication of the O.E.C.D.'s findings about the 15 B.E.P.S. action items, the Commission pursued its crackdown on tax avoidance schemes by M.N.E.'s. The Commission's insistence on adopting uniform legislative measures in respect of the implementation of Country-by-Country Reporting and the introduction of the A.T.A.P. underlines its goal. Although it is difficult to fully grasp the approach of the Commission in its State Aid decisions, the Commission appears to have chosen favorable Advanced Pricing Agreements ("A.P.A.'s") as the vehicle to set its own approach. This approach focuses on "the market prices that a stand-alone company would pay under normal business circumstances" as a new A.L.P. definition used by the Commission in State Aid cases. The Commission seems to reject the A.L.P. of the O.E.C.D. by arguing that the O.E.C.D.'s A.L.P. only applies to M.N.E.'s. As a result, stand-alone companies, which always have to pay market prices for their individual transactions, are not covered by this A.L.P. Subsequently, a comparison is made between the scrutinized company and a stand-alone company.

The general approach of the Commission's assessment regarding State Aid may be described as follows:

- The basis for a State Aid analysis is the local regulations (tax law and guidance) of the Member State, the so-called reference system.

- The Commission considers that the O.E.C.D.'s A.L.P. is only applicable for M.N.E.'s and does not apply to independent stand-alone companies. Therefore, this principle must be replaced with the Commission's own principle: the market conditions of a stand-alone company under similar business circumstances. As such, the Commission applies its own definition of the A.L.P. when performing its State Aid analyses.

- Based on this set of principles, the State Aid analysis is performed.

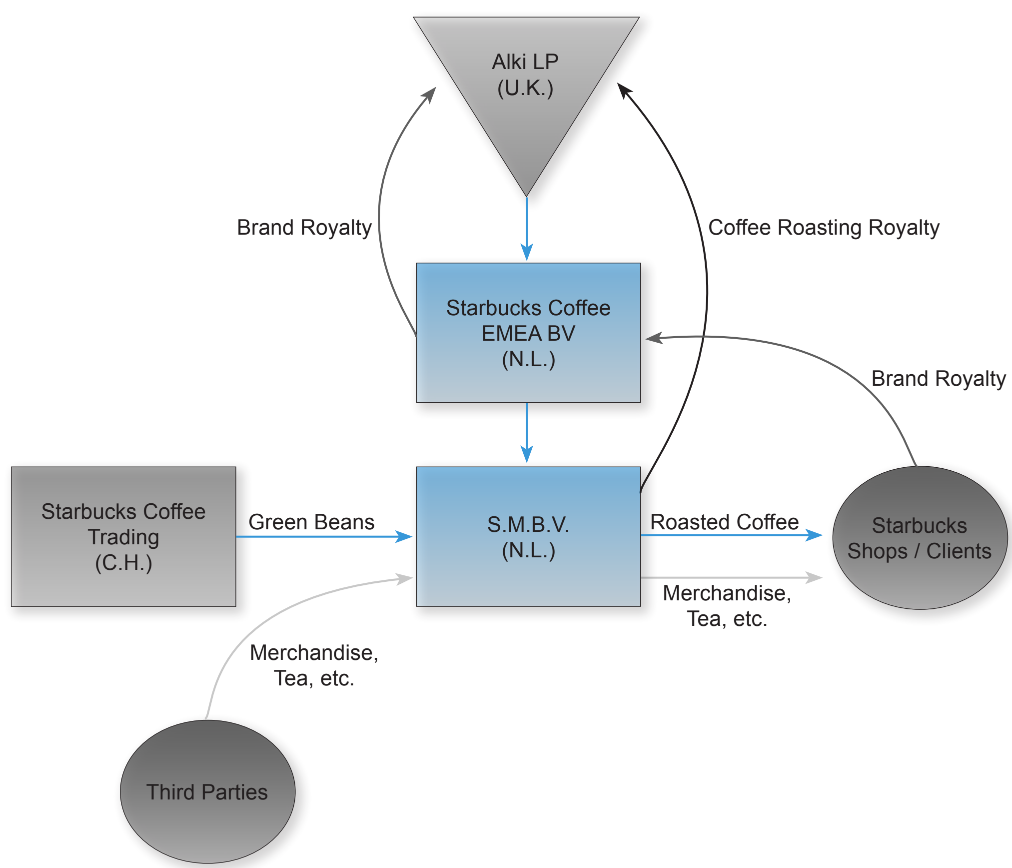
The State Aid instrument grants the Commission the authority to influence the corporate income tax paragraph within the E.U. The Commission uses that grant of authority to set aside the O.E.C.D. guidance provided in the B.E.P.S. reports and the A.L.P., and replaces that guidance with its own version (the "E.U. A.L.P."). The Commission has explicitly stated that the E.U. A.L.P. is not based on Article 9 of the O.E.C.D. Model Convention, as is the A.L.P. supported by the O.E.C.D. In other words, according to the Commission, the battle against State Aid overrides the standard of Article 9.

HOW DOES THE COMMISSION APPROACH WORK OUT IN THE CASES OF STARBUCKS AND APPLE?

The Starbucks Case

Facts

Starbucks started its activities as a coffee-roasting facility in the Netherlands in 2002, through its subsidiary Starbucks Manufacturing BV ("S.M.B.V."). The main activities of S.M.B.V. are the roasting of green coffee beans and the packaging, storage, and sale of roasted beans to Starbucks shops across Europe. S.M.B.V. purchased green coffee beans from a Swiss associated company and paid a royalty to a U.K.-based group company ("Alki LP") for licensing intellectual property rights, which are necessary for the production process and the supply to shop operators. The picture below provides a simplified overview of the transactions relevant to the Dutch A.P.A.



In 2008, an A.P.A. was granted by the Dutch tax authorities to S.M.B.V. for the arm's length remuneration of its main activity as a coffee roasting facility. The Commission concluded that the A.P.A. violated Article 107 T.F.E.U.

“The Commission defines its own principle – the E.U. A.L.P. – from the perspective of a stand-alone company, which always pays market prices for all its individual transactions.”

The Commission’s Decision

In the case of Starbucks, the report of the Commission began with an analysis of the Dutch system of corporate tax and the A.L.P. that is incorporated in Article 8(b) of the Dutch Corporate Income Tax Act (“C.I.T.A.”). In its analysis, the Commission appears to have accepted the Dutch system of corporate tax as the reference system but not the incorporated A.L.P. of the O.E.C.D. The Commission defines its own principle – the E.U. A.L.P. – from the perspective of a stand-alone company, which always pays market prices for all its individual transactions. Therefore, the E.U. A.L.P. criteria can be described as “the market prices a stand-alone company pays under similar business circumstances.” The Commission determined the market prices through the use of information requested from Starbucks’ competitors.

Based on the E.U. A.L.P., the Commission rejected the use of the transactional net margin method (“T.N.M.M.”) to determine an A.L.P., since this O.E.C.D. method can only be applied by M.N.E.’s and not by stand-alone companies that must always pay market prices. Instead, the Commission separately scrutinized all identified intercompany transactions and endeavoured to identify and apply market prices. Available market information was gathered, and competitors of Starbucks were requested to provide relevant information to determine market prices. Without going into specific details, the conclusion of the Commission was that the intercompany transactions of S.M.B.V. did not meet the E.U. A.L.P. applicable to State Aid cases.

The Commission concluded that State Aid was granted to Starbucks for the following reasons. First, the intercompany prices and recent price increases for the green beans from the associated Swiss entity could not be explained when compared to market prices. Second, a stand-alone company would not have paid any royalty to Alki LP since the latter company had virtually no business substance when measured by people and facilities. In that respect, the Commission noted that a license agreement is not an ordinary transaction for a coffee roaster.

Apparently, the granted State Aid was calculated by multiplying the differences in the pricing of green beans and the royalty payment with the Dutch tax rate. As a result, the Commission reasoned that the ruling constituted a form of State Aid that amounted to €20 to €30 million.

Our Remarks

The rejection of the O.E.C.D.’s A.L.P. in State Aid cases raises questions about the formal positioning of the E.U. A.L.P. and its effects on daily discussions between M.N.E.’s and national tax authorities.

Such questions should be handled with great care. The O.E.C.D.’s A.L.P. has been developed over a period of more than 50 years and through the recent work of the O.E.C.D. on B.E.P.S. Thus, it is more than suitable to face challenges and offer solutions to M.N.E.’s and tax authorities. The basis of the O.E.C.D.’s A.L.P. is a thorough understanding of the relevant facts to determine and test the comparability of the conditions of intercompany transactions with transactions between comparable third parties. Therefore, there is no need for another A.L.P. We even regard the creation of the Commission’s own E.U. A.L.P. as a missed opportunity to utilize the full potential of the O.E.C.D. guidance on transfer pricing.

The Commission is not primarily a tax body. Its goal is to ensure a level playing field within the European Single Market, and its officials are sensitive to *sub rosa* government actions that distort trade. In comparison, the standard of the O.E.C.D. reflects the life experience of government officials who have devoted their careers to matters related to tax policy. It should not be unexpected that tax professionals are sympathetic to tax concepts and trade administrators are sympathetic to trade law. Seen in this light, the Starbucks case indicates that winning arguments in one forum – where all M.N.E.'s can obtain comparable tax rulings – turn out to be losers in the other forum – where the business model of the smaller company sets the standard to be followed by M.N.E.'s.

Ultimately, the problem encountered by Starbucks reflects a bureaucratic disjuncture: Which of two competing competencies will control? Still to be heard are anti-trust administrators who may have a third view when an entire industry carries on business in a uniform way.

A disturbing aspect of the Commission's approach in determining market prices is the active participation of competitors in determining an acceptable business model to be imposed on Starbucks. For Starbucks, information from competitors would normally not be available. In O.E.C.D. Transfer Pricing Guidelines parlance, the use of information that is not available to taxpayers is called secret comparables. The Commission's approach leads, from a pure transfer pricing perspective, to all kinds of concerns about the comparability, intercompany effects, and lack of a more detailed understanding of the facts presented by these competitors. As a result, it is hard to determine a correct market price. Furthermore, the comparables, in this case, were not only secret but also tainted – because the comparable information was introduced by competitors responding to a request that would affect Starbucks. Therefore, the O.E.C.D. has stipulated in its Transfer Pricing Guidelines to take caution with the use of secret comparables.

"Ultimately, the problem encountered by Starbucks reflects a bureaucratic disjuncture: Which of two competing competencies will control?"

The Apple Case

Facts

Apple has two subsidiaries in Ireland, namely Apple Sales International and Apple Operations Europe. Both manufacture Apple products in Europe and hold the right to use Apple's intellectual property, for which they contribute considerable amounts for research and development ("R&D") to their U.S. parent company. The sales structure was set up in such a way that customers were contractually buying products from Apple Sales International. The Irish tax authorities granted a similar A.P.A. to both entities. The A.P.A. endorsed a split of the profits for tax purposes in Ireland between the head offices and Irish branches. The vast majority of the profits was allocated to the head offices, which did not have any employees or own premises. The head offices only held occasional board meetings. Moreover, only the Irish branches were subject to tax in Ireland. The head offices were not located in Ireland and, hence, not subjected to tax in Ireland.

The Commission's Approach

Until now, the Commission published only a summary of its reasoning to conclude that the Irish tax rulings amount to State Aid. The full reasoning is not expected to become public before 2017.

In the Apple case, two entities were under scrutiny. The Commission started by analysing the Irish system and determined that the two entities made use of sliding scale pricing. The two head offices seemed to exist on paper only, and as a result, it was unclear where they actually were located. Additionally, the head offices lacked any relevant substance. Consequently, the Commission reasoned that the A.P.A.'s provide an economic benefit to the two entities, because the branches in Ireland never would have paid that amount of profit to a third party, given the lack of relevant substance in the head offices. Finally, the Commission based the amount of State Aid on the Irish corporate income tax rate on the profits allocated by the branches to the residual Irish entities minus the minor functions, which can be allocated to the head offices.

What the Commission refused to accept is the concept that actual services were provided by affiliates in the U.S., or elsewhere, so that at the level of the Irish branches the expenses reflected value provided by the affiliates. Looked at in this manner, the issue was not an Irish issue but an issue at the level of the head offices and, in that jurisdiction, the methodology was accepted pursuant to a qualified joint cost sharing agreement.

Before issuing its decision, the Commission stated that the amount of State Aid could be lowered if more profit was allocated to the sales entities or more costs for the R&D activities were allocated in the U.S. It seems that an "always-somewhere principle" was used by the Commission, entailing that the profits should always be taxed somewhere and, if not, they will be allocated to the jurisdiction that provides the greatest tax within the E.U.

Our Remarks

To date, a complete assessment of the Apple case cannot be made because too many questions remain unanswered in the absence of a published report. Where are the head offices located? If in the U.S., a trade or business should exist. If none existed, an unacceptable tax gap has likely occurred because neither Ireland nor the U.S. levied tax. But is the existence of a tax gap sufficient justification to conclude that Ireland has granted State Aid to Apple? If the head offices are not located in the U.S., on what basis did the Commission determine that State Aid existed in Ireland?

At this point, it is not clear whether the Commission's decision is aligned with the O.E.C.D. guidelines on profit attribution with regard to allocations between head offices and branches, and how this interacts with the analysis of State Aid. Furthermore, the suggestion of the Commission to make use of an always-somewhere principle suggests that the Commission is mostly concerned that the profits are taxed and less concerned with where the profits are taxed and whether double taxation exists.

Finally, the Commission again seems to have use its own A.L.P., as it did in the Starbucks case. Remarkably, it did not scrutinize all the other intercompany transactions – like the royalties received or the lack of payments to other group companies in Europe or the U.S.

THE O.E.C.D. V. THE COMMISSION

Back in 2013, the O.E.C.D. was requested by the G-20 to start the B.E.P.S. Project. This request came after the U.K. hearings to which we referred at the beginning of this article. While the O.E.C.D. was working hard at developing its 15 B.E.P.S.

action items, the Commission did not want to wait for the outcomes and implementation. Therefore, the Commission adopted the A.T.A.P. The A.T.A.P. is meant as a B.E.P.S.-plus package and, therefore, goes even further than the outcomes of the B.E.P.S. Project.

The O.E.C.D., as the guardian of the A.L.P., seems to struggle with the recent State Aid cases of the Commission. In a recent news article, Pascal Saint-Amans, the director of the Centre for Tax Policy and Administration of the O.E.C.D., mentioned that the bulk of Apple's profits belongs in the U.S., as the profits should be aligned to R&D. Although the O.E.C.D. only provided high-level input on the recent cases, it seems that the O.E.C.D. does not agree with the new E.U. A.L.P. introduced in the State Aid cases, and it has pointed out that the functions, assets, and risks of an entity should be remunerated according to the A.L.P. established by the O.E.C.D.

"By defining a separate E.U. A.L.P. and going its own way, the Commission creates undesired confusion."

FINAL REMARKS AND CONCLUSION

We would like to add a few general comments to the Commission's approach. First, the Commission states that, as a condition for the State Aid to exist, the targeted company should be evaluated on a stand-alone basis. By doing so, the Commission ignores, or even disqualifies, the T.N.M.M. and would throw taxpayers back to the time when searches were required for exact comparables to measure the arm's length price. Thus, it regards all facts it deems to be relevant and not just specific transactions. Consequently, a similar discussion would ensue based on transfer pricing rules.

Second, the Commission focuses solely on the economic advantage criterion and disregards the criterion of selectivity. It states that the granted rulings are selective, because the economic advantage can be provided only to M.N.E.'s and not to stand-alone companies. In this way, the Commission deems the selectivity requirement fulfilled if the economic advantage requirement is met, and as a result, these two criteria are merged. The reason why the Commission has merged these two criteria is evident: It has always been difficult to prove the selectivity of rulings because they are available to everyone that applies. The current approach of the Commission has created significant uncertainty for M.N.E.'s worldwide. This has led to concerns that investments in the E.U. will be withheld.

Finally, the Commission's use of its State Aid instrument as grounds for a new definition of an A.L.P. could be viewed as a politically driven act. The Commission is seemingly grabbing the power to control direct taxes. To date, this power remains with the sovereign members of the E.U. The transfer of sovereignty regarding direct taxes has been consistently opposed by the Member States. The Commission would do well to remember that the *raison d'être* of the State Aid tool is to prevent Member States from providing special advantages to domestic companies. The use of an A.P.A. is an excellent instrument for M.N.E.'s and tax authorities to safeguard arm's length remunerations and positions, based on robust transfer pricing documentation and professional judgments. By defining a separate E.U. A.L.P. and going its own way, the Commission creates undesired confusion in this field.

In conclusion, an old saying with roots in team play comes to mind: It is better to row together than each rock the boat separately. It is not clear that the Commission understands the true meaning of this saying.

GOODS AND SERVICES TAX: A GAME CHANGER[1]

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Tags
Goods and Services Tax
India
Value Added Tax
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With the passage of the Constitution ("One Hundred and First") Act, 2016, India is now one step closer to adopting a goods and services tax ("G.S.T.") as its new indirect tax structure. Although this is only the first step in the legislative process of transition of the indirect taxes in India to the G.S.T. regime, it is a major leap towards the final implementation of G.S.T. in India.

G.S.T. has been defined as "any tax on supply of goods, or services or both except taxes on the supply of the alcoholic liquor for human consumption." In essence, G.S.T. is a comprehensive single tax that is levied on the supply of goods and services in the country. It is a value added tax that is levied throughout the supply chain with permissible credits for tax paid on inputs acquired.

Once implemented, G.S.T. is expected to provide relief to businesses by adopting a more comprehensive and wider coverage of input tax set-off and service tax set-off. Additionally, G.S.T. will subsume a majority of the central and state levies within its fold, eventually phasing out the different taxes and levies and bringing them under the umbrella of G.S.T. The existing indirect tax laws have not been able to completely remove the cascading burden of taxes already paid at earlier stages. In addition to this, there are several levies by the central government and the states on the manufacture and sale of goods and the provision of services for which no set-off for input tax credit is available. G.S.T. is expected to mitigate these indirect tax inefficiencies currently prevalent under the existing framework.

G.S.T. is not merely a tax change, but is also expected to have a multifaceted impact on business. Given its omnipresence in almost every business transaction, any change in the indirect tax regime will impact almost every level of the value chain. The implementation of G.S.T. is expected to create a paradigm shift in the Indian economy at both the micro level and the macro level. At a macro level, G.S.T. will promote transparency, cost-effectiveness, and lead to a shift from unorganized to organized trade in India. At a micro level, G.S.T. will, *inter alia*, impact an organization's supply chain, procurement, logistics, finance, taxation, and pricing policies. The basic premise behind G.S.T. is to create a single, cooperative, and undivided Indian market, thereby making the economy stronger and more powerful.

BRASS TACKS

As mentioned above, G.S.T. will subsume central and state levies within its fold. To this end, G.S.T. will have three charging components: central G.S.T. ("C.G.S.T.") and state G.S.T. ("S.G.S.T."), levied together on intrastate supplies of goods and services, and integrated G.S.T. ("I.G.S.T.") on interstate supplies of goods and

[1] The following was originally published in *India Unleashed* by Khaitan Legal Associates and has been modified in a manner consistent with our format.

services. The rates would be prescribed keeping in mind revenue consideration and acceptability. While the G.S.T. model will be implemented through multiple statutes, the basic features of indirect tax law, including, *inter alia*, charge ability, the definition of taxable events and taxable persons, the measure of levy, and the basis of classification, would remain uniform across these statutes.

C.G.S.T. and S.G.S.T. will be applicable to all transactions of goods and services made for consideration except those specifically exempted or outside the purview of G.S.T. (*e.g.*, "alcoholic liquor for human consumption and petroleum products") and transactions which are below a prescribed threshold.

Every person who is engaged in an interstate transaction will have to be registered under G.S.T., irrespective of the turnover limits. Interstate transactions shall be subject to I.G.S.T., which shall be collected by the central government. The input tax paid, which may include I.G.S.T., C.G.S.T., and S.G.S.T., on goods or services acquired by a person can be utilized against the payment of I.G.S.T., C.G.S.T., and S.G.S.T., in that order. Thus, the biggest transition which G.S.T. seeks to bring is the free set-off provision and utilization of inputs available.

G.S.T. RATE STRUCTURE

With the government's intention to enforce G.S.T. from April 1, 2017, the rate of tax is likely to be decided in the upcoming winter session of the Parliament. The G.S.T. rate is to be recommended by the G.S.T. Council depending on various factors, such as economic conditions, revenue buoyancy, and revenue neutral state. The G.S.T. Council is also empowered to propose a "floor rate with band" to provide flexibility to states to levy tax at rates higher than the floor rate, but within the band.

"Every person who is engaged in an interstate transaction will have to be registered under G.S.T., irrespective of the turnover limits."

COMPENSATION TO STATES

Setting aside value added tax and merging it with G.S.T. may reduce the revenue generated by states. To provide some relief, for the first five years of G.S.T.'s implementation, the central government will compensate the loss of revenue (if any) which the states may incur due to such implementation.

IMPACT ON BUSINESS

In general, G.S.T. is expected to provide a welcome relief to businesses by providing a wider coverage of input tax set-off by subsuming several central and state levies. Further, by providing a continuous chain of set-off from the manufacturer to the retailer, the tax burden of goods and services on the end-consumer is expected to reduce. This reduced tax burden will also reduce the price of exports, thereby increasing the competitiveness of Indian goods and services in international markets.

Below are some impacts that organizations will need to consider under the proposed G.S.T. regime.

Finance and Working Capital

Organizations may need to rework their budgets and working capital expectations based on the G.S.T. tax rate applicable to them in order to appropriately meet working capital requirements.

Increased Compliance

With state-wide registration required wherever an organization has an establishment, along with increased filings on a monthly basis, it is expected that compliance requirements will increase under the G.S.T. regime.

Supply Chain Management

Most goods have a multi-layered value chain structure with several layers between the manufacturer and the ultimate customers. Typically the value chain would comprise of Manufacturer → Warehouse → Wholesaler → Retailer → Customer. In this value chain, historically, warehousing was a layer largely meant to facilitate interstate branch transfers to avoid the incidence of central sales tax.

Under the G.S.T. regime, seamless input tax credit will be available on interstate transactions, thereby dispensing with the requirement of maintaining warehouses in every state. Multi-state organizations would now have the option to replace many of their small warehouses in multiple states with larger and strategically located mother warehouses in selected states. This is expected to reduce distribution costs, which can be expected to be passed on to the end consumer.

Information Technology

One of the most crucial areas in the transition process will be the technology and enterprise resource planning ("E.R.P.") alignment from the current regime to the G.S.T. regime. Accounting software will need to be aligned to the provisions of the G.S.T. law. Computer systems will have to be updated to include the new tax codes. In addition to this, new modules will need to be developed to enable generation of G.S.T.-compliant output reports and invoices.

Business Realignment

Under the G.S.T. regime, the prices of goods and services are expected to change. As mentioned above, there will be a tax credit at each level in the supply chain. Businesses may need to realign their current business models under the G.S.T. regime in order to stay competitive in the market. To this end, procurement, logistics, distribution, and pricing policies may need to be revisited. Further, businesses may also re-negotiate contracts with vendors, and, *inter alia*, decide the extent to which G.S.T. levies are to be absorbed or passed on to the consumer.

POTENTIAL HURDLES

Like all significant changes in law, G.S.T. is expected to have its set of teething issues during the transition process before the benefits, to their fullest extent, can be enjoyed by industry and consumers.

Technology Infrastructure

At present, the technology infrastructure prevalent across states operate on different platforms and differ in technical complexity. G.S.T. will require a single seamless integrated platform that can efficiently manage the requirements of tax payers across 29 states and seven union territories. The government will have to ensure that this infrastructure is in place before G.S.T. goes live.

Non-G.S.T. Items

At present, alcoholic liquor for human consumption and petroleum products are excluded from the G.S.T. basket. The government will have to be careful that frequent changes are not made to the G.S.T. basket, so as to ensure that G.S.T. will remain the tax of convenience it is desired to be rather than becoming a tax of validation.

Administrative Realignment

The G.S.T. regime contemplates the integration of and information-sharing between the C.G.S.T. and the S.G.S.T. arms. If history is any yardstick, implementation of systems which could enable harmonization and seamless flow of data between inter-governmental bodies could be both time-consuming and arduous.

Division of Tax Collections Between States

The G.S.T. regime will result in states losing their individual identities, as they will only partake in a share of the total levies collected. In order for G.S.T. to succeed, it is essential that a just and equitable formula be sought for distribution of the receipts between the states and the central government.

Different Taxing Powers

The key taxing powers are not merged under the G.S.T. regime and therefore continue to remain either with the central or state government. As a consequence, the non-G.S.T. central and state levies will continue as they are.

CONCLUSION

While the government's initiative to make G.S.T. a reality has been received with overwhelming support and favor, the roadmap to its success is not straightforward and cannot be taken for granted.

In general, G.S.T. is expected to be a boon for commerce and industry due to the expected cost reductions and lower tax rates. The ripple effect of these benefits is also expected to reach the end consumer. Further, G.S.T. will also provide an opportunity to less developed states to compete in the national market on an equal footing, thereby boosting their individual economies and the Indian economy at large. Lastly, the uniform tax rate will also improve the ease of doing business in India, which has been the mantra of the Indian prime minister.

That said, the G.S.T. regime may not be tax-favorable for all industries. For example, the cost of insurance products is expected to rise, which, if passed on to the end consumer, will negatively impact insurance penetration in the country. Further, with the dual charging components, the compliance burden on businesses is expected to increase.

Despite the setbacks, industry is optimistic that G.S.T. will live up to the expectations. The National Council of Applied Economic Research projects that the introduction of G.S.T. would lead to a G.D.P. growth in the range of 0.9% to 1.7%, and export growth between 3.2% and 6.3%.[2] Thus, G.S.T. will not just restructure indirect taxation in India, but will seminally influence the way businesses function.

While the government has its work cut out to ensure that G.S.T. is the game changer it is touted to be, its successful implementation could be a major step towards making India the economic powerhouse it is destined to become.

"G.S.T. is expected to be a boon for commerce and industry due to the expected cost reductions and lower tax rates. The ripple effect of these benefits is also expected to reach the end consumer."

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2 Report of the Select Committee on the Constitution 122nd Amendment Bill, 2014, dated July 22, 2015.

SPANISH TAX IMPLICATIONS OF NONRESIDENT PRIVATE INVESTMENT IN SPANISH REAL ESTATE

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Tags
Foreign Investment
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INTRODUCTION

As global stock markets remain erratic and interest rates stay low, the Spanish real estate market has become an attractive investment opportunity for those in search of high-quality real property at reasonable prices. Major cities, such as Madrid and Barcelona, and some coastal areas have experienced growing demand translating into rising prices. While price levels remain below those in comparable cities in other countries, institutional and private investors are taking notice.

For an investor planning an intricate structure to invest in Spanish real property, it is important to recognize that Spanish tax law adopts a substance-over-form approach when it comes to taxation. Tax plans devoid of sound commercial basis and adequate substance are at risk to challenge. To illustrate, corporate structures used in Spanish real estate investments may be challenged where a corporate entity that owns the real property or that finances its acquisition

- has entered into arrangements that keep it from being tax resident for income tax treaty purposes in the country where it is formed, or
- lacks sufficient economic substance, as it may be defined for this purpose.[1]

In any event, using a corporate structure to invest in real estate may be beneficial for certain taxes and not beneficial for other taxes. This is especially true for private investors acquiring residential properties. This article provides a brief summary of the main domestic tax consequences that arise during the investment cycle of nonresident private investment in Spain.

INDIRECT AND LOCAL TAXATION

The acquisition of new residential property is subject to V.A.T. at a rate of 10% and stamp duty at a rate ranging from around 0.5% to 2.0%, depending on the region where the property is located. If the property is acquired in a resale – *viz.*, the purchaser is not the first owner – the purchase will be exempt from V.A.T. but subject to real estate transfer tax ("R.E.T.T.") at a rate generally ranging from around 8% to 10%, again depending on the region and market value of the property; a lower tax rate may apply in some circumstances.

Property tax (*Impuesto sobre Bienes Inmuebles* or "I.B.I.") is calculated annually

[1] With respect to a private real estate structure held for personal use, no economic substance should be required. However, an arm's length rental payment should be made by the individual living in the property to a corporation that owns it.

on the property's cadastral value, which is assigned by the local authority and is generally lower than the acquisition or market value. I.B.I. is generally nominal and is paid to the local town.

INCOME AND CAPITAL GAINS TAX

For periods when the property is not leased out, nonresident individuals are subject to an annual nonresident income tax at a rate of 24% on imputed income, which is generally equivalent to 1.1% (or 2.0% in some cases) of the cadastral value. If the property is leased out, nonresident income tax will apply on the gross rental income. The 24% rate is reduced to 19% for residents of other E.U. Member States, as well as residents of Iceland and Norway. Residents of these countries can also deduct expenses so as to be taxed on a net income basis.

Entities that are resident in a tax haven[2] and that hold Spanish real estate are subject to a special 3% annual tax on the cadastral value of the property (or the value established for wealth tax purposes, if cadastral value is unavailable).

When properties are sold or transferred by nonresidents, a 19% tax is applied on any capital gains. In such cases, the buyer withholds 3% of the total consideration as payment on behalf of the nonresident seller. If this withholding exceeds the final tax amount owed, the nonresident can request a refund.

The withholding tax also applies to transfers of shares in companies located in a tax haven whose assets are mainly composed of Spanish real estate, whether directly or indirectly.

If the property being sold qualifies as the habitual abode of the taxpayer, the capital gain may be exempt from tax if he or she is a tax resident of Spain, another E.U. Member State, Iceland, or Norway, and if other specific requirements are satisfied. For the property to be considered the seller's habitual abode, the seller must generally have lived there for at least three years, except when marriage, divorce, or employment reasons required a change of domicile.

When urban property is sold or transferred, the increase in value of the land is subject to a tax known as *plusvalía municipal*. The amount payable depends on criteria such as the cadastral value and the number of years the property has been held. The tax is paid by the seller to the local town.

WEALTH AND INHERITANCE TAXES

Wealth tax is payable on the value of assets located in Spain, less Spanish liabilities. Nonresidents are subject to general tax rules, while residents of Spain or another E.U. Member State may be subject to the rules applicable in the region where the property is located. Madrid, for example, grants a complete rebate on wealth tax to its residents.

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[2] See the list of tax haven countries or territories as established by Royal Decree 1080/1991, as amended. The list of tax haven countries in relation to Spain is published in a special edition of *Insights*, "Outbound Acquisitions: Holding Companies of Europe – A Guide for Tax Planning or a Road Map for Difficulty?" at page 114.

Wealth tax applies annually at progressive rates ranging from 0.20% to 2.75%, which is the marginal rate for net wealth exceeding €10.7 million. For E.U. residents, the applicable rules and tax rates may differ slightly depending on the region in which the property is located. The first €700,000 of net wealth (€500,000 in some regions) are generally tax exempt. Also exempt is the first €300,000 of the taxpayer's habitual abode. This amount varies depending on the region.

For wealth tax purposes, the tax base for real estate will be the greater of

- the consideration paid for the property,
- the cadastral value, and
- the value assigned by the authorities for other tax purposes.

Debt financing can reduce the net wealth base, resulting in lower effective taxation. This will be the case only if the loan proceeds are used to acquire or improve the property and not to finance other investments.

For inheritance tax purposes, the fair market value of real property on the transfer date is taxed at progressive rates of up to 34%. Effective taxation depends on several factors, including an E.U. resident's ability to apply the rules of the region where the property is located or where the deceased was resident. Again, the tax base can be reduced if a loan has been used to acquire or improve the property.

CORPORATE STRUCTURES

Aside from the benefits of increased privacy and limited liability, property ownership through a corporate structure can offer tax advantages. Those advantages are available only if the structure has appropriate substance and was established mainly for commercial purposes, not merely for tax reasons related to holding the real estate.

In terms of indirect taxation, if the property is acquired by a Spanish company during the course of conducting an appropriate business – *e.g.*, the company owning the property is engaged in real estate development activities and meets other criteria – R.E.T.T. may apply at a low rate. Alternatively, R.E.T.T. may not apply at all if the V.A.T. exemption on second or subsequent acquisitions is waived and the seller is registered for V.A.T. purposes. Such purchases would be subject to stamp duty and V.A.T. through a self-assessment mechanism, and V.A.T. may be fully or partially relieved. In comparison, R.E.T.T. leads to higher acquisition costs.

The acquisition of more than 50% of the shares in a Spanish or foreign company could be subject to indirect taxation in the form of R.E.T.T. or V.A.T., if Spanish real estate directly or indirectly comprises at least 50% of the fair market value of the target company's assets.

In relation to capital gains taxation, several double tax treaties concluded by Spain grant exclusive taxing rights to the investor's country of residence. Most of Spain's treaties follow paragraph 4 of Article 13 (Capital Gains) of the O.E.C.D. model tax convention,[3] meaning that taxation rights are generally granted to the country in

[3] O.E.C.D., *Model Tax Convention on Income and on Capital: Condensed Version 2014*, (Paris: O.E.C.D. Publishing, 2014).

which the underlying real estate is located. In relation to wealth taxation, nonresident individuals may not be shielded from Spanish wealth tax even if the Spanish real estate is held through a Spanish or foreign corporate structure. For example, Spanish wealth tax is applicable to individuals who reside in Russia, France, Germany, or the U.K. that directly or indirectly own Spanish real property.

Entities resident in a tax haven or other low-tax jurisdiction whose assets are mostly comprised of Spanish property can be deemed tax resident in Spain. Likewise, the right to tax capital gains arising from sales of shares in real-estate-rich companies is rarely granted to the country of residence of the ultimate investor or the transferor of the Spanish or foreign shares.

"Property ownership through a corporate structure can offer tax advantages . . . if the structure has appropriate substance and was established mainly for commercial purposes."

If the property is owned through a corporate structure, and Spain retains the right to imposed wealth tax on the shares in a company that holds mainly real property, the tax basis for wealth tax purposes will either be the net equity value of the company reported on financial statements reviewed by a statutory auditor or the highest of the following three values:

- The net equity value
- The nominal value of the shares
- The value derived when the average profits or losses of the previous three years are multiplied by a factor of five

Debt obligations incurred to finance the investment typically reduce the equity amount and interest on those obligations reduce the profit and losses during the three-year period. In either event, the effective taxation under the wealth tax regime would be lowered.

For income tax purposes, E.U. residents and residents of Iceland and Norway are entitled to deduct expenses directly linked to the income generated from the real property. As mentioned above, those residents may be subject to a 19% tax rate on net income. If the property is held through a Spanish entity, taxation on net income would be at a rate of 25% and withholding tax would likely apply to distributions. Conversely, if the property is not leased out and is held by a Spanish company, the imputed taxable income in relation to individuals – generally 1.1% of the cadastral value mentioned earlier – would not apply. The *plusvalía municipal* will only apply to gain derived from the direct sale of real property. This tax does not apply to gain on the sale of shares of the company.

As mentioned above, the transfer of Spanish shares to heirs would be subject to inheritance tax at progressive rates of up to 34% of their fair market value. Again, effective taxation could be reduced by a debt obligation incurred by the Spanish company, provided that the proceeds of the debt obligation were used to finance the real estate investment. In comparison, the transfer of shares in a foreign company may escape Spanish inheritance taxation under certain circumstances.

Regarding inheritance planning, trusts are not recognized under Spanish law and Spain does not adhere to the Hague Convention of July 1, 1985 on the Law Applicable to Trusts and on Their Recognition. Consequently, the use of a trust to hold real property may cause problems from a practical legal and tax standpoint. Relatively little jurisprudence and doctrine exist regarding the taxation of trusts, resulting in uncertainty. The Spanish Tax Authorities (*Dirección General de Tributos*) have issued rulings to taxpayers indicating that trusts generally should be disregarded for Spanish tax purposes and that transactions should be treated as if taking place directly between the settlor and the beneficiaries. In any event, trusts should be analyzed on a case-by-case basis.

CONCLUSION

In light of recent increases in the value of Spanish real property, acquisition tax planning is again of interest to potential investors from outside Spain. While income taxation of gains may not be reduced through structure planning, inheritance tax and wealth tax may be reduced through the use of a foreign corporation that is based in a tax treaty jurisdiction. The corporation must have economic substance. No matter how defined, if substance does not exist, expected tax benefits may be ephemeral.

FURTHER DEVELOPMENTS FOR U.K. NON-DOM INDIVIDUALS

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Summer is well and truly over, and as everyone started back at the office, H.M.R.C. published its latest consultation document (the "Current Consultation Document") on the proposed changes to be introduced for non-domiciled individuals ("Non-Doms") starting April 6, 2017.

ORIGINAL CONSULTATION DOCUMENT

Some aspects of the proposed changes, including a consultation document (the "Original Consultation Document") and draft legislation, were published in September 2015 as a consequence of announcements made by the U.K. government in the Summer Budget of 2015. The writer commented upon these in a previous edition of *Insights*.[1]

Those proposed changes were as follows:

- Any individual who is a Non-Dom who was born in the U.K. and has a U.K. domicile of origin will be deemed to be domiciled whenever they are resident in the U.K.
- Any individual who is a Non-Dom who has been resident in the U.K. for 15 out of the previous 20 tax years will be deemed to be domiciled in the U.K. from that point on.

At the time of the original announcements, H.M.R.C. also proposed the introduction of relief from the effect of the changes for Non-Doms who would become deemed domicile as of April 6, 2017. For example, one suggestion was to allow Non-Doms to settle assets into a trust in advance of the changes coming into effect.

The Original Consultation Document also stated that H.M.R.C. would take steps to change the rules regarding the holding of U.K. property in overseas corporate structures. Currently, the rules provide certain opportunities to reduce or extinguish stamp duty charges, and to treat both the shares of the company and, as a consequence, the underlying property as excluded from an estate for the purposes of U.K. inheritance tax ("I.H.T.").

SECOND & CURRENT CONSULTATION DOCUMENT

The Current Consultation Document sets out further details and draft legislation regarding the proposals, including protections against the deemed domicile measures and changes to the treatment of property held in overseas corporate structures.

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[1] Gary Ashford, "U.K. Non-Dom Taxation – Where It Is and Where It Is Going," *Insights* 10 (2015).

Some measures are not yet fully covered, such as the Anti-Avoidance Transfer of Assets Abroad rules. It is anticipated that further documents will arrive before April 6, 2017, but the Current Consultation Document provides considerable assistance and guidance on what can be done in anticipation of the April 6, 2017 deadline.

SPECIFIC ISSUES COVERED

Inheritance Tax on U.K. Individual Property

H.M.R.C. previously advised that starting on April 6, 2017, it plans to bring U.K. residential property that is held in an overseas corporate structure under the I.H.T. net. It will do this by introducing legislation that will prevent property held in an overseas corporate structure from being treated as excluded property (and therefore outside the I.H.T. net) if the value of the shares is derived from an interest in a dwelling in the U.K. This rule will apply to both Non-Doms and trusts with settlors or beneficiaries who are Non-Doms.

Background

Many U.K. residential or investment properties are held via corporate structures, and many of those companies are located overseas. In the case of a U.K.-resident Non-Dom, the shares of an overseas company would be non-U.K. situs property. As a result, the underlying property could potentially be treated as excluded property for I.H.T. purposes, so long as the Non-Dom is not yet deemed domiciled and has not settled the shares into an offshore trust.

H.M.R.C. is proposing that property held in overseas corporate structures where the underlying value relates to U.K. property shall no longer qualify as excluded property for I.H.T.

Properties Affected

H.M.R.C. is proposing the application of the new rules to any property which is a "dwelling." The definition of a dwelling was introduced in Finance Act 2015 for the purposes of capital gains tax on disposals by nonresidents of residential property in the U.K. This includes

- Any building which is used or suitable to be used as a dwelling,
- Any building which is in the process of being constructed or adapted for use as a dwelling, and
- The grounds on which such a building is situated.

The new I.H.T. rules will also apply to trustees. The rules will not have any minimum value threshold, nor does H.M.R.C. intend to provide an exclusion for residential properties that are transferred on arm's length terms to a third party or used as a main home.

Changes of Use

H.M.R.C. acknowledges that a residential property may have previously been used for a nonresidential purpose, and therefore, it proposes the introduction of a two-year rule similar to that which currently applies for the purposes of I.H.T. Business

Property Relief ("B.P.R."). This rule states that if the shares in an overseas corporate structure derive their value from a U.K. property I.H.T. will apply if the property was used for a residential purpose at any point in the two years before the I.H.T. event. There will be provisions to apportion I.H.T. charges on a property that has been used for both residential and other purposes at the same time (*e.g.*, property consisting of commercial premises with a flat above).

"H.M.R.C. proposed significant changes to the Non-Dom regime that would broadly limit the extent to which long-term, U.K.-resident Non-Doms could continue to benefit from the regime."

Debts

In Finance Act 2013, H.M.R.C. tightened the rules by which debt could be used to reduce a liability for I.H.T. purposes. H.M.R.C. has confirmed that it will continue to apply these rules in the new proposals.

As such, any debts which are not related to the property will not be taken into account when determining the value of the property subject to I.H.T., and H.M.R.C. intends to disregard any loans made between connected parties. Furthermore, where an offshore entity holds debts related to U.K. residential property alongside other assets, it will be necessary to take a *pro rata* approach with regard to that debt in calculating the amount of the I.H.T. base.

Administrative Matters

H.M.R.C. is proposing new reporting requirements so that a property cannot be sold until any outstanding I.H.T. charges are paid. Under this provision, a new liability may be imposed on any person who has legal ownership of a property, including the directors of a company that holds a property, to ensure that I.H.T. is paid. The relevant legislation will be published later in 2016. These rules will apply to all chargeable events that take place after April 6, 2017.

Deemed Domicile Rules for Long-Term U.K. Residents

Background

Prior to the release of the Current Consultation Document, H.M.R.C. proposed significant changes to the Non-Dom regime that would broadly limit the extent to which long-term, U.K.-resident Non-Doms could continue to benefit from the regime. A specific deemed domicile rule already exists for I.H.T. purposes, under which Non-Doms resident in the U.K. for 17 out of the previous 20 years are deemed to be domiciled in the U.K (the "17/20 Rule"). However, the new proposal would establish a general cap on the number of years that the Non-Dom regime could apply, after which any resident Non-Dom would be taxed on the arising basis[2] in the U.K. in the same manner as all other U.K.-resident and domiciled citizens.

H.M.R.C. has already issued draft legislation for this proposal. It will deem those individuals who were U.K. residents in 15 out of the previous 20 tax years as domiciled in the U.K. for both income tax and capital gains tax purposes (the "15/20 Rule"). The proposed new rule will essentially follow the same principles as the 17/20 Rule, albeit for a shorter threshold period, and will include any years in the U.K. under the age of 18. The new shorter deemed domicile period will also apply for I.H.T. and will replace the 17/20 Rule.

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2 Under the arising basis, income is taxed when and as it arises. Remittance to the U.K. is immaterial.

H.M.R.C. has confirmed that an individual can "lose" their U.K. domicile status if they become nonresident and spend at least six years overseas (four years for I.H.T. purposes).

Updates Within the Current Consultation Document

An interesting and significant point in the Current Consultation Document is that H.M.R.C. has confirmed that the residence tests will follow current law, which is a combination of the Statutory Residence Test for tax years 2012-2013 onwards and existing case law for prior years, as there was formerly no real legislation in this area. Given the historical problems that have arisen from uncertainties over residence under common law, one can see that application of the residence tests may not be as straightforward to apply as H.M.R.C. intends.

In the Current Consultation Document, H.M.R.C. clarified that split tax years will be counted towards one of the 15 years under the proposed deemed domicile rules.

Protections Proposed to Lessen the Impact of the Changes

Capital Gains Tax

H.M.R.C. proposes that individuals who will be deemed domiciled on April 6, 2017 under the 15/20 Rule shall be able to rebase directly-held foreign assets to the market value of the assets on April 5, 2017. Those individuals who become deemed domiciled after April 2017 and those who are deemed domiciled because they were born in the U.K. with a U.K. domicile of origin will not be able to rebase their foreign assets.

Mixed Funds Opportunity

A welcome development within the Current Consultation Document is that H.M.R.C. is introducing a window to clean up mixed funds.

Prior to arrival in the U.K., it is always advisable for a future Non-Dom to segregate his or her banking accounts into pre-arrival capital, income, and gains – in addition to a few other categories. The purpose of this is essentially to maintain the character of each component of the account so that any future remittance to the U.K. will be taxed at the appropriate rate, *i.e.*, 45% income tax, 28% capital gains tax (recently reduced to 20%), and to distinguish capital, which can potentially be brought into the U.K. without any tax charge.

Where segregation has not taken place, mixed funds arise and any future remittance will therefore contain a mixture of the various parts. There are specific rules for mixed funds that essentially tax any part of the funds at the highest rate first (*e.g.*, as income). Without a significant amount of work, H.M.R.C. might well contend that the whole remittance should be taxed at 45%.

Under the latest proposals, Non-Doms with mixed funds will have the opportunity to review the funds and separate out the different parts into clean capital, foreign income, and foreign gains. They will then be able to remit from the newly-segregated accounts as they wish. There will be no requirement for Non-Doms to make remittances from their newly-segregated accounts in any particular order or within any particular period of time.

This special treatment will apply only to mixed funds that consist of amounts deposited in banking and similar accounts. Where the mixed funds take the form of assets, an individual will have to sell any overseas assets during the transitional window and separate the sale proceeds in the same way as any other money.

To benefit from mixed fund cleansing, the remittance basis user will have to be able to show an audit trail for the offshore funds. This opportunity will be available to any Non-Dom, including those born in the U.K. without a U.K. domicile of origin and individuals who will be deemed domiciled under the new rules. An individual need not be resident in the U.K. in April 2017. This window for this benefit will last for one tax year from April 6, 2017.

The matter of whether a trust, treated as a relevant person under the remittance rules, will also be able to clean up its mixed funds is currently not clear. It would appear logical to allow this, but we will have to wait and see.

> ***"To benefit from mixed fund cleansing, the remittance basis user will have to be able to show an audit trail for the offshore funds."***

Nonresident Trusts

Nonresident trusts have always been very useful to Non-Dom clients, as they allow for non-U.K. situs assets to remain outside the U.K. estate for I.H.T. purposes, even beyond the point that the 17/20 Rule starts to apply, when settled before that point. Additionally, Non-Dom settlors and/or beneficiaries claiming the remittance basis are only taxed on income or gains to the extent they are remitted to the U.K.

H.M.R.C.'s proposal to deem those who fall under the 15/20 Rule as U.K. domiciled for all taxes potentially has significant effects for Non-Doms holding assets in non-resident trusts. Whilst the proposed rule simply reduces the threshold of the current I.H.T. deemed domicile rule by two years, any Non-Dom individual who is deemed domiciled would not be able to use the remittance basis. As a result, where these individuals receive distributions or have an interest in income and gains from a trust, they would then be liable for tax on any resulting income or gains.

To limit the burden of the proposed changes, H.M.R.C. has again proposed certain protections. One proposed protection is that Non-Doms who set up offshore trusts before they are deemed domiciled under the 15/20 Rule will not be taxed on trust income and gains that are retained in the trust or its underlying entities. Another proposed protection is that excluded property trusts will have the same I.H.T. treatment as at present (except where there is U.K. property, as discussed below).

Proposed Changes for Specific Taxation Areas for Nonresident Trusts

Attribution of Gains to Settlors (§86 T.C.G.A. 1992)

Section 86 taxes chargeable gains on any individual who is resident and domiciled in the U.K. and who has an interest in settled assets that are held in a nonresident trust or which are attributable to the trustees via an underlying company. The current §86 rules do not apply to Non-Doms, meaning that Non-Doms with an interest in an offshore trust will only be taxed on gains that are distributed to them and, even then, only when those gains are remitted to the U.K.

Under the proposed changes, §86 will be extended to include Non-Doms who are deemed domiciled. In order to mitigate the effects of this new application, H.M.R.C. is proposing to tax the Non-Dom only on any gains in relation to a trust established prior to becoming deemed domiciled when any distribution is made to the Non-Dom or a member of the Non-Dom's family. In this context, a family member is defined as the settlor, the spouse, or children under the age of 18. Additions made to a trust after the changes come into force will also potentially take away the protections.

The protections above will not be afforded to any person who is deemed domiciled as a result of having been born in the U.K. with a U.K. domicile of origin. Furthermore, any gains being taxed on the settlor under these proposals will be matched to the underlying gains in the nonresident trust.

Attribution of Gains to Beneficiaries (§87 T.C.G.A. 1992)

Section 87 taxes any U.K.-resident individual on capital payments they receive from a nonresident trust to the extent that there are chargeable gains arising in that trust. The legislation applies regardless of the individual's domicile status and includes, *inter alia*, the settlor of the trust. However, those currently taxed under §87 can elect to apply the remittance basis.

Following the introduction of the new deemed domicile rule and the proposed changes to §86 mentioned above, settlors of trusts will no longer be taxed under this clause. It is proposed that U.K.-resident individual beneficiaries who receive capital payments or benefits from a nonresident trust or underlying entity and who are deemed to be domiciled in the U.K. will be subject to capital gains tax under §87, regardless of where the benefits are received. The current rules of matching underlying gains in the nonresident trust to distributions will continue.

Settlements Legislation (§624 I.T.T.O.I.A. 2005)

The settlements legislation is an income tax provision which taxes any income of an individual settlor who has retained an interest in a settlement, including a non-resident trust. The legislation also taxes the settlor on any income arising to the settlor's unmarried minor children, on capital payments from a nonresident trust, on loans, and on capital payments made by bodies associated with a nonresident trust. Currently, where U.K.-resident Non-Doms are potentially taxed under this provision, those who claim the remittance basis are taxed only on foreign-source income remitted to the U.K.

The new deemed domicile rules will potentially tax U.K.-resident deemed domiciled individuals on a worldwide arising basis, and where the legislation applies, they may be liable for tax on all income arising in the nonresident trust. H.M.R.C. is proposing additional protections so that deemed-domiciled individuals will be taxed on income of a nonresident trust set up before they were deemed domiciled only to the extent that a "family benefit" is conferred. A family benefit is conferred where any of the protected income is applied for the benefit of or paid to any of the following:

- The settlor
- The spouse
- A minor child or grandchild
- A closely-held company in which a participator falls within the scope of the settlements legislation
- The trustees of a settlement of which a beneficiary falls within the scope of the settlements legislation

• A body connected with such a settlement

Anti-Avoidance for Transfers of Assets Abroad (Chapter 2, Part 13 I.T.A. 2007)

The Transfer of Assets Abroad legislation ("T.o.A.A.") is anti-avoidance legislation designed to prevent U.K.-resident individuals from avoiding U.K. income tax by transferring the ownership of assets to persons abroad while still being able to enjoy the benefit of the income generated by those assets. Essentially, T.o.A.A. exists to catch transactions or funds that would potentially escape income tax due to overseas arrangements. H.M.R.C. taxes transferors on the underlying income, or transferees (including beneficiaries) on the amounts they receive. Currently, T.o.A.A. allows for any individual claiming the remittance basis to be liable for income tax only on U.K.-source income and foreign income that it is remitted to the U.K.

The new deemed domicile rules will potentially tax U.K.-resident, deemed-domiciled individuals on any foreign income arising in or paid by a structure, wherever it is received. However, H.M.R.C. is proposing changes that partially remove the application of the provisions of the T.o.A.A. legislation that would affect deemed-domiciled settlors who set up a nonresident trust before they become deemed domiciled. This is to prevent them from being taxed on the foreign income of the trust or any underlying entity paying out dividends to the trust.

Under the proposed new rules, H.M.R.C.'s intention is that, rather than being taxed on the arising basis, foreign-source income will be taxed at the time any benefits received. If the settlor, the spouse, a minor child, or other relevant person receives any actual benefits from the trust – *e.g.*, by way of an income or capital distribution or enjoyment of trust assets – the distribution will trigger the imposition of tax on the settlor to the extent that it can be matched against relevant foreign income arising in that year.

"T.o.A.A. exists to catch transactions or funds that would potentially escape income tax due to overseas arrangements."

The full details of the proposed changes to the T.o.A.A. provisions have yet to be released. However, the details provided to date appear to suggest that some of the same principles under which beneficiaries are currently taxed on gains under §87 T.C.G.A. (see above) will be applied to the underlying income of the trust (*i.e.*, the distribution will be matched and taxed accordingly). H.M.R.C. has advised that it will publish further details on these proposed changes later in the year.

Born in the U.K. with a U.K. Domicile of Origin

H.M.R.C. has already stated that it proposes to treat any individual born in the U.K. with a U.K. domicile of origin as U.K.-domiciled while they are resident in the U.K.

Many, if not all, of the protections being proposed by H.M.R.C. to lessen the impact of the April 6, 2017 changes will be denied to those caught under this provision. This includes the opportunity to make settlements into nonresident trusts prior to arrival in the U.K. The resulting nonresident trusts would be treated as relevant property trusts once the individual becomes resident in the U.K.

However, H.M.R.C. is offering some relief from these provisions. For the purposes of I.H.T., the individual will not be treated as being domiciled in the U.K. until they have been resident for at least one of the two tax years prior to the year in question.

This would apparently provide some opportunity to settle matters in trust before becoming resident in the U.K. Whilst the resulting trust would be a relevant property trust when the individual is resident, the assets may still effectively sit outside the U.K. estate for I.H.T. purposes. However, it is understood that these individuals will be taxed on a worldwide basis for income tax and capital gains from the point they become U.K. residents.

Business Investment Relief

Building on the government's 2015 Autumn Statement, H.M.R.C. has also set its interest on ways business investment relief ("B.I.R.") may be modified to encourage foreign investment in U.K. business by remittance basis users. Clearly, given June's Brexit referendum result, one may suggest that this issue has risen to even greater prominence than when the 2015 Autumn Statement was first issued.

For those unfamiliar with B.I.R., it provides an exemption to the remittance basis rules that was introduced on April 6, 2012. B.I.R. helps U.K. businesses to attract inbound investment by allowing individuals who use the remittance basis to bring overseas income and gains to the U.K. without any tax liability if it is done for commercial investment purposes. The scheme effectively treats funding for qualified investments as if not remitted to the U.K. and therefore not liable to tax.

The range of companies in which a qualifying investment can be made under the scheme is quite wide. The definition includes an investment in:

- A company carrying on a commercial trade or preparing to do so, including one whose activities consist of generating income from land,
- A company carrying out research and development activities,
- A company making commercial investments in trading companies, and
- A holding company of a group of trading companies.

There are no restrictions preventing the scheme from being used for investments in a company with which an investor has a separate involvement, such as holding a director's position and receiving arm's length compensation for services provided in the ordinary course of business. Any investment must be made within 45 days of the date on which the funds are brought into the U.K.

Unlike other government schemes designed to encourage investments, there is no monetary limit on an individual's investments under B.I.R. However, the scheme is not available for investments to acquire existing shares nor is it available for investments in companies that are listed on a recognized stock exchange.

H.M.R.C. has indicated that any changes to B.I.R. would feature in Finance Bill 2017 and therefore be introduced on April 6, 2017.

CONCLUSION

Despite the Brexit vote, the U.K. government appears to be committed to limiting some of the benefits of the Non-Dom rules. However, for the newly arrived non-U.K.-born Non-Dom, there are still great opportunities and potentially 15 years of full benefits under the Non-Dom regime.

Even when the 15-year threshold has been reached, the individual in question has choices. The individual might, for example, settle assets into a trust. Provided that there are no distributions to family members, the assets could potentially sit within that trust without encountering taxable consequences. Various trust-related options will likely be considered between now and April 6, 2017, along with various other options that may provide for income tax deferment, such as an offshore life insurance bond.

Alternatively, some Non-Doms may actually decide to leave the U.K. – at least for a sufficient amount of time to reset the 15-year clock. For those who choose to do this, it is worth remembering that, depending on the circumstances, they may still have quite a generous allowance of days, which grants them continued access to the U.K. Departure need not amount to an all-or-nothing solution.

THE END OF THE NEGOTIATION: PROTOCOL TO INDIA-MAURITIUS TAX TREATY FINALLY RELEASED

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The Mauritius government has released the text of a protocol seeking to amend the India-Mauritius tax treaty (the "Protocol" and "Mauritius Tax Treaty," respectively). While a press release[1] issued by the Indian government on May 10, 2016 details some of the key amendments,[2] the Protocol itself provides for significant additional amendments, which are addressed in this article. The Protocol will come into force once each governments has notified the other that it has completed the procedures required by its respective laws.

ARTICLE 1 – SERVICE P.E. CLAUSE

Article 1 of the Protocol amends Article 5 of the Mauritius Tax Treaty. Article 5 provides that only business profits attributable to a Permanent Establishment ("P.E.") located in the other contracting state can be taxed by that other state. The amendment pursuant to the Protocol provides that services furnished through employees or other personnel would also constitute a P.E. in the source state of the enterprise rendering services, where activities of that nature continue (for the same or connected project) for an aggregate of more than 90 days within any 12-month period.

This is commonly referred to as a service P.E. clause. A service P.E. clause is not included in the O.E.C.D. Model Tax Convention on Income and on Capital (the "O.E.C.D. Model Treaty"). However, it is expressly promoted by the U.N. Model Double Taxation Convention (the "U.N. Model Treaty"). The service P.E. caluse was included in a number of tax treaties concluded by India, including the treaties with the U.S., the U.K., and Singapore. While some of India's tax treaties (*e.g.*, the foregoing treaties) specifically carve out certain technical services from the service P.E. clause, no such exception was provided under the Protocol. In that sense, the service P.E. clause added to the Mauritius Tax Treaty is similar to the service P.E. clause included in tax treaties by India with Iceland, Georgia, Mexico, and Nepal.

With increasing mobility of employees in multinational organizations, the service P.E. clause has been a matter of dispute in a number of cases where employees are sent on secondment or deputation.

It is important to note that the language added in the Protocol does not explicitly limit the application of the service P.E. clause to services provided "within a contracting state." The potential implication is that the source state could assert the existence

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1 See "India-Mauritius Tax Treaty Re-negotiated – Indian Government Issues Press Release," *BMR Edge*, 5.2 (2016).

2 *E.g.*, the amendment to the source-based taxation of capital gains on disposition of shares, including the transitional benefits and the applicability of the Limitation of Benefits ("L.O.B.") article.

of a service P.E., even if services are rendered entirely outside that state, if they are performed by the relevant employees or personnel and meet the time threshold.

In 2008, the O.E.C.D. added paragraphs 42.11 to 42.48 to the commentary on Article 5 of the O.E.C.D. Model Treaty. These paragraphs discuss the taxation of services performed in the territory of a contracting state and provide that these services will not be taxed in that state if they are not attributable to a P.E. situated therein. Simultaneously, India expressed its position that it reserves a right to treat an enterprise as having a service P.E. without specifically including the words “within a contracting state.” Hence, this omission seems to be in line with the position taken by India on the O.E.C.D. commentary and could even expose taxpayers without any physical presence to net income taxation in the source state and the resultant challenges.

ARTICLE 2 – TREATMENT OF INTEREST INCOME

Article 2 of the Protocol amends Article 11 of the Mauritius Tax Treaty, pertaining to taxability of interest income. The relevant changes are summarized below:[3]

Existing Provisions	Amended Provisions
• Interest arising in India and paid to a Mauritius resident could be taxed in India, according to its domestic tax law, without any ceiling on the tax rate. • Interest derived and beneficially owned by a Mauritius bank that carries on a *bona fide* banking business is exempt from tax in India.	• Interest arising in India and paid to a Mauritius resident can be taxed in India, according to its domestic tax law. However, if the Mauritius-resident payee is the beneficial owner of the interest, Indian tax shall not exceed 7.5% of the gross interest. • The exemption available to Mauritius banks is only available with respect to loans outstanding on or before March 31, 2017.

Limiting the tax rate applicable in the state of source, and the requirement that interest be “beneficially owned” by a resident of the other state, is in line with O.E.C.D. Model Treaty and the U.N. Model Treaty. Further, most tax treaties entered into by India provide similar benefits.

Under the current Mauritius Tax Treaty, interest income on instruments such as mandatory convertible debentures, non-convertible debentures, or loans issued by a Mauritius entity to a resident of India is subject to tax, with no limitation, at 40% in many cases, and a beneficial rate of 20% or 5%, in specific cases. Therefore, this amendment is certainly a welcome change, which provides the Mauritius Tax Treaty an edge above other treaties to which India is a party. This includes the treaties with Singapore, Cyprus, and the U.S., where the applicable tax is limited to 10% or 15%, as the case may be.

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3 The current Mauritius Tax Treaty (and the amended version pursuant to the Protocol) includes corresponding provisions for interest arising in Mauritius and paid to an Indian resident. However, for the sake of simplicity, this table refers to interest arising in India and paid to a Mauritius resident.

ARTICLE 3 – FEES FOR TECHNICAL SERVICES

While Article 12 of the Mauritius Tax Treaty provides for the treatment of royalties, unlike many other treaties to which India is a party, the Mauritius Tax Treaty did not include a provision discussing the tax treatment of Fees for Technical Services ("F.T.S."). Article 3 of the Protocol amends the Mauritius Tax Treaty and adds a new article, 12A, which provides for the tax treatment of F.T.S. Generally, Article 12A provides the following:

- Both the country of residence and the country of source have the right to tax F.T.S.
- The rate of tax in the source country is limited to 10% of the gross amount of the F.T.S., if the beneficial owner of the payment is a resident of the other contracting state.
- The definition of F.T.S. generally covers consideration paid for managerial, technical, or consultancy services, including the provision of services of technical or other personnel.

"In the event that income is paid with respect to managerial, technical, or consultancy services rendered by a Mauritius entity for a period of less than 90 days, the income would be taxed pursuant to the provisions of Article 12A."

The provisions of Article 12A are similar to the F.T.S. article included in other treaties to which India is a party. It is pertinent to note that neither the O.E.C.D. Model Treaty nor the U.N. Model Treaty provide a separate article discussing the treatment of F.T.S. In the absence of a separate article dealing with F.T.S., such income would typically not be taxed in the source state, unless the payee has a P.E. in that state. Pursuant to this change, F.T.S. income paid by an Indian resident to a resident of Mauritius would now be subject to tax in India.

Note that Article 12A does not include "make available" criteria in the definition of "included services," as is found in the treaties between India and the U.S., the U.K., and Singapore. This effectively expands the scope of taxable F.T.S. income to be on par with domestic Indian tax law.

To summarize, in the event that income is paid with respect to managerial, technical, or consultancy services rendered by a Mauritius entity for a period of less than 90 days, the income would be taxed pursuant to the provisions of Article 12A. Income arising from the rendering of all types of services for a period exceeding 90 days would be taxable under Article 7 of the Mauritius Tax Treaty, provided the services are for the same or connected projects.

ARTICLES 4 AND 8 – CAPITAL GAINS TAX EXEMPTION AND THE L.O.B. CLAUSE

With respect to the sale of shares of an Indian company by a Mauritius resident, Article 4 of the Protocol makes the following changes to Article 13 (Capital Gains) of the Mauritius Tax Treaty, effective as of April 1, 2017:

- Gains from the transfer of shares of a company resident in India, which are acquired on or after April 1, 2017, would be subject to tax in India.
- However, the tax rate applicable to gains arising from a sale of shares acquired after April 1, 2017 and sold between April 1, 2017 and March 31, 2019

shall not exceed 50% of the domestic tax rate otherwise applicable to such gains (see also below relating to Article 8 of the Protocol).

Article 8 of the Protocol adds new Article 27A (Limitation on Benefits) to the Mauritius Tax Treaty. The L.O.B. provision limits the availability of benefits under the Mauritius Tax Treaty to avoid treaty shopping and prevent conduit companies from obtaining benefits. The addition of this clause affects the transitional reduction of tax with respect to capital gains.

The new L.O.B. provision includes the following stipulations:

- An entity shall not be entitled to the benefits of the Mauritius Tax Treaty (including the newly inserted concessional capital gains taxation) if the entity's affairs are arranged in the country of residence primarily for the purpose of taking advantage of treaty benefits. This would include entities not having *bona fide* business activities.
- A shell or conduit company shall not be entitled to benefits under the Mauritius Tax Treaty. An entity will be treated as a shell or conduit company if, in the immediately preceding 12 months, it did not incur expenditures on operations in its country of residence of at least 1,500,000 Mauritian rupees or 2,700,000 Indian rupees, as the case may be. However, an entity is deemed not to be a shell or conduit company if it is listed on a recognized stock exchange in its country of residence.

According to Article 9 of the Protocol, Article 8 will be effective in India, for fiscal years beginning on or after April 1 of the year following the date on which the Protocol enters into force. In Mauritius, it will be effective for fiscal years beginning on or after July 1 of the same year. Article 4 of the Protocol (Capital Gains) shall be effective for assessment year 2018-19 and any subsequent assessment years.

The articles dealing with taxation of capital gains arising on sale of shares of an Indian company are in line with what has been stated in theMay 10, 2016 i press release.[4]

There are some open questions regarding the potential interplay between the General Anti-Avoidance Rule ("G.A.A.R.") and tax treaties, as well as the grandfathering of certain treaty benefits with regard to shares acquired after April 1, 2017 as a result of conversion of other instruments. Additionally, it seems that an indirect transfer of shares of a foreign (non-Indian) company whose value is derived substantially from Indian assets may not be subject to tax in India despite the changes made in the Protocol.

ARTICLE 5 – SOURCE RULE FOR TAXATION OF OTHER INCOME

Article 5 of the Protocol amends Article 22 (Other Income) of the Mauritius Tax Treaty to enable taxation in the source country of any "other income" arising in the country.

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[4] For a detailed analysis, see "India-Mauritius Tax Treaty Re-negotiated – Indian Government Issues Press Release."

According to Article 9 of the Protocol, Article 5 will be effective in India for fiscal years beginning on or after April 1 of the year following the date on which the Protocol enters into force. In Mauritius, it will be effective for fiscal years beginning on or after July 1 of the same year.

The amendment to Article 22 changes the rule for taxation of other income, and specifically ushers in "source-based" taxation. This seems to be an all-encompassing provision, which removes a preexisting safe harbor from Indian taxation for all other income derived in India by a Mauritius resident and vice-versa.

ARTICLE 6 – EXCHANGE OF INFORMATION

Article 26 (Exchange of Information) has been replaced to expand its scope. Significant provisions included in the new Article 26 vis-à-vis the existing exchange of information ("E.O.I") provisions are described below:

- In addition to the taxes covered under the treaty, the scope of E.O.I. has been enhanced to include "taxes of every kind and description," insofar as these taxes are not contrary to the provisions of the tax treaty.
- The information exchanged must no longer be "necessary," but it will be sufficient for the information to be "foreseeably relevant" for the purpose of carrying out the provisions of the tax treaty or the enforcement of a domestic law concerning tax.
- Information or documents received under the tax treaty, can also be shared with authorities or persons having "oversight" over the assessment, collection, and enforcement of taxes or prosecution with respect to these taxes or appeals thereof. Information so disclosed can also be used for "other" purposes if permitted by the laws of both states and authorized by the disclosing state. The provision enabling disclosure of information to the person to whom it relates has been deleted.
- The requested state cannot deny collection or disclosure of information on the ground that it does not need such information for its own tax purposes. Further, a requested state cannot decline to supply information solely because the information is held by a bank, other financial institution, nominee, or person acting in an agency or a fiduciary capacity; or because it relates to ownership interests in a person.

Efforts to increase tax transparency and E.O.I. have been gaining global momentum recently. Both Mauritius and India have been actively participating in global forums for E.O.I., are participating in the O.E.C.D.'s Common Reporting Standard ("C.R.S."), and are complying with the U.S. Foreign Account Tax Compliance Act ("F.A.T.C.A.").

Currently, Article 26 of the Mauritius Tax Treaty is being significantly revamped to widen the scope of E.O.I. and bring it on par with the provisions of the O.E.C.D. Model Treaty.

Further, information can also be disclosed to oversight bodies. Oversight bodies include authorities that supervise tax administration and enforcement authorities, as part of the general administration of the government. Neither having a purpose of carrying out the provisions of the tax treaty nor applicability of taxes covered in the tax treaty is a prerequisite for E.O.I. Instead, the Protocol states that E.O.I. shall not be restricted by Article 1 and 2 of the Mauritius Tax Treaty. This has the following potential ramifications:

- Information regarding an individual may be sought from a country, irrespective of whether the person is a resident of the requested country.
- E.O.I. may not be limited to taxpayer-specific information. Countries may also exchange other sensitive information related to tax administration and compliance improvement, *e.g.*, risk analysis techniques or tax avoidance or evasion schemes.

Moreover, under the existing E.O.I. provision, "persons with respect to whom the information or document relates" are specifically entitled to receive the information and documents that are obtained under Article 27. Under the new Article 27, such persons are not expressly mentioned. However, pursuant to the commentary to the O.E.C.D. Model Treaty, information obtained under this article may also be shared with the taxpayer, his/her proxy, or a witness deposed because such person is connected with the assessment or collection of taxes. It will be interesting to see how the Indian Revenue Authorities deal with information they obtain, either by sharing the information with taxpayers under the new Article 27 or refraining from doing so.

ARTICLE 7 – ASSISTANCE IN COLLECTION OF TAXES

In line with the O.E.C.D. Model Treaty and the U.N. Model Treaty, Article 26A (Assistance in the Collection of Taxes) has been added to the Mauritius Tax Treaty. Some of the notable features of the provision are as follows:

- Both countries shall lend assistance to each other in the collection of "revenue claims" arising out of any taxes.
- The term revenue claims refers to the amount owed with respect to taxes of every kind and description (including interest, administrative penalties, and costs of collection or conservancy related to such taxes), insofar as this taxation is not contrary to the provisions of the tax treaty or any other instrument signed by both countries.
- Both countries will be obliged to accept and collect revenue claims of the other country and take measures for conservancy, subject to the fulfillment of certain conditions.
- Revenue claims accepted by a country shall not be subject to time limits or accorded any priority applicable to a revenue claim under the laws of that country or accorded any priority applicable in the other country. No proceedings with respect to the existence, validity, or the amount of a revenue claim can be brought before the courts in the country accepting the revenue claim.

In an era of globalization, traditional approaches towards assistance in the collection of taxes have changed. This change was to some extent influenced by the development of electronic commerce and the concerns about the ability to collect V.A.T. (Value Added Tax) on such activities. The 1998 O.E.C.D. report *Harmful Tax*

Competition: an Emerging Global Issue also highlighted concerns about increased tax evasion, if one country will not enforce the revenue claims of another country. The report thus recommended that:

> Countries be encouraged to review the current rules applying to the enforcement of tax claims of other countries and that the Committee on Fiscal Affairs pursue its work in this area with a view to drafting provisions that could be included in tax conventions for that purpose.

As a result of these concerns, the O.E.C.D. Council approved the inclusion of a new Article 27 on assistance in tax collection in the 2003 update of the O.E.C.D. Model Treaty. The new Article 26A is in *pari materia* with Article 27 of the O.E.C.D. Model, and thus, it may help the Indian government to recover tax dues from willful defaulters. India has also inserted a similar provision for assistance in collection of taxes in recent tax treaties with Sri Lanka, Fiji, Bhutan, Albania, Croatia, Latvia, Malta, Romania, and Indonesia. Further, the tax treaties with the U.K. and Poland have been amended to insert an article of this nature.

"This is a landmark move by the Modi-led government, which finally claims victory over long-drawn treaty negotiations that have lasted several years."

Both India and Mauritius have also signed the Convention on Mutual Administrative Assistance in Tax Matters. Moreover, similar to the new Article 26, assistance in collection of taxes is not restricted by Article 1 and 2 of the tax treaty.

CONCLUSION

This is a landmark move by the Modi-led government, which finally claims victory over long-drawn treaty negotiations that have lasted several years. Taking a myopic view, as a result of the Protocol and the additional tax cost for Mauritian investors, Mauritius may lose its sheen as a preferred jurisdiction for investments into India. However, a broader view reveals that foreign investors are likely to welcome the certainty of the new tax regime and the lack of retroactive taxing provisions with respect to capital gains, as evidenced by the grandfathering rules.

The Indian government has been wise to grandfather investments made before April 1, 2017 and to align this date with the proposed introduction of G.A.A.R. Albeit, the interplay of the L.O.B. clause and G.A.A.R. is still unclear. The addition of two-year transitional provisions with respect to the taxation of capital gains is another welcome step. Other major changes provided in the Protocol are in line with the O.E.C.D. Model Treaty and with recent tax treaties entered into by India. This, therefore, makes the existing Mauritius Tax Treaty more robust while re-emphasizing the importance of Mauritius as a source of investments into India.

The only loose thread seems to be the fate of the capital gains exemption under the India-Singapore tax treaty (the "Singapore Tax Treaty"). From media reports, it appears that the Indian government may soon initiate negotiations with its Singaporese counterparts. With Singapore overtaking Mauritius as the largest source of foreign direct investment in 2015,[5] the Indian government would be well-advised to bilaterally negotiate the Singapore Tax Treaty well in time, in order to provide a level playing field for investments made from Singapore and those made from Mauritius.

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5 Department of Industrial Policy & Promotion, "Fact Sheet on Fact Sheet on Foreign Direct Investment (FDI), from April, 2000 to December, 2015."

ITALY MODERNIZES TAX TREATMENT OF L.B.O. TRANSACTIONS

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Tags
Investment Banking Fees
Italy
Leveraged Buyout
Management Buyout
Shareholder Loans

On March 30 2016, the Italian Revenue Agency issued the Circular Letter No. 6/E (the "Circular Letter"), which confirms the characterization of a Leveraged Buyout ("L.B.O.") from a tax perspective and addresses certain tax issues that typically arise from this type of transaction. The Circular Letter was designed to create a favorable environment for foreign investment in Italy and to reverse negative publicity arising from interpretative uncertainty over tax consequences.

In this respect, the Circular Letter provides important clarifications concerning

- the deductibility, for corporate income tax ("C.I.T.") purposes, of interest expense incurred in connection with acquisition loans and shareholder loans;
- the appropriate tax treatment, for C.I.T. and V.A.T. purposes, of transaction costs and other fees charged by private equity firms to a target company ("Target") and/or acquisition company ("Bidco"); and
- the taxation of capital gains realized at exit and the reduction of withholding tax on outbound dividends under an applicable Double Tax Convention ("D.T.C."), E.U. directive, or provision of domestic law.

INTEREST DEDUCTIBILITY

Over the past few years, the deductibility of interest incurred in connection with mergers of L.B.O. acquisitions has been challenged by the Italian tax authorities. The typical argument in these matters may be summarized as follows:

- The interest expense was not linked to borrowings incurred in the course of the business activities of Target.
- The L.B.O. transaction was simply a tax-driven transaction involving the pushdown of debt in order to obtain a tax advantage from the resulting interest expense, thereby reducing Italian tax on Target's cash flows.
- In transactions involving foreign investors mainly, the borrowing was not made for business reasons in Italy. Rather, it was incurred at the direction of the ultimate controlling shareholder. This leads to a contention that the borrowing is a form of service rendered by the acquired company for the benefit of the controlling foreign shareholder. The service must be compensated with an arm's length fee, which happens to be equal to the interest deduction.

Breaking with the past, the Circular Letter clarifies that, as a general principle, deductibility of interest on the acquisition loan should be allowed, subject only to ordinary limitations, which include a cap that is approximately 30% of earnings before interest, taxes, depreciation, and amortization ("E.B.I.T.D.A."). In addition, a more

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reasonable transfer pricing rule is applied by Italian Revenue Agency. On the basis of the Circular Letter, the revised treatment is as follows:

- Interest expense borne by a company set up to accomplish the acquisition (either a special purpose vehicle ("S.P.V.") or an existing Bidco) is recognized as being functionally connected to the purchase of Target. Therefore, the deduction of interest expense on third-party debt should be allowed either in the case that the transaction is concluded with (i) the merger of S.P.V./Bidco and Target or (ii) the creation of a fiscal unity between S.P.V./Bidco and Target.
- L.B.O. transactions are recognized as being grounded on sound economic reasons, as they are aimed at acquiring control over Target and this structure (including the debt push down) is usually requested by third-party lenders. Therefore, the leveraged transaction should not be regarded *per se* as abusive. The transaction should only be viewed as abusive when the operation is intended to obtain an undue tax benefit that is contrary to the spirit and objective of the law. An example would be a re-leveraged transaction without a change of control.
- The contention that S.P.V./Bidco acts for the benefit of its ultimate foreign controlling company has been abandoned. On the contrary, following the O.E.C.D. Transfer Pricing Guidelines, if the foreign parent company raises funds on behalf of the subsidiary that uses those funds to acquire a new company, the parent company would generally be regarded as providing a service to the subsidiary for which remuneration would be requested. This could justify the deduction of a service fee (in addition to interest) at the level of the subsidiary.

"Based on the new guidelines, the Italian Tax Authorities may decide to reconsider earlier tax assessments and pending litigation that are based on legal claims that debt pushdowns are generally abusive."

Based on the new guidelines, the Italian Tax Authorities may decide to reconsider earlier tax assessments and pending litigation that are based on legal claims that debt pushdowns are generally abusive. This reassessment would not include instances in which the transaction was specifically aimed at creating an artificial interest expense deduction, which may be the case with re-leveraged transactions within the same group.

SHAREHOLDER LOANS

The Circular Letter explains that interest expense incurred by S.P.V./Bidco on loans granted by foreign shareholders is subject to transfer pricing rules that apply the arm's length principle. Under exceptional circumstances, shareholder loans may be recharacterized as capital contributions where the facts so indicate. For example, an abusive transaction may be presumed to exist if one or more of the following situations occur:

- The reimbursement of the shareholder loan and the payment of the interest are subordinate to payment of loans/interests to third-party lenders.
- The ratios provided under the financial covenants do not consider the shareholder loan as debt and interest accrual as an expense (as opposed to equity).
- The payment of the interest and principal are subject to the same restrictions imposed on dividends distributions and capital reductions.

- In general terms, the shareholder loan and the accompanying interest expense are characterized by lenders as if they are equity capital and dividends.

If recharacterized, the following consequences arise:

- Interest expense accruals on shareholder loans are not deductible.
- Interest payments made in respect of shareholder loans may be subject to withholding tax as dividends.
- The Allowance for Corporate Equity ("A.C.E.") benefit – *i.e.*, a deduction of a notional return equal to 4.5% of the increase in equity – should increase (but specific anti-abuse rules should be considered in order to quantify the benefit).

The Circular Letter states that, in respect of past situations, administrative penalties should be waived since taxpayers have been misled by the interpretative uncertainty of the relevant law.

CORPORATE TAX TREATMENT OF FEES

The Circular Letter states that advisory fees (such as transaction or monitoring fees) charged by a private equity firm may be deducted by Target as long as an economic benefit is derived from the services received. In comparison, fees for services that are provided for the benefit of the investors but paid for by Target are not deductible by Target. Identifying the benefitting party is a factual exercise and all facts and circumstances surrounding the payment must be examined.

The following factors may indicate that advisory fees are paid for services that do not benefit Target:

- Fees paid by Target offset some or all of the management fees due by the fund.
- The amount of the fees paid to the private equity firm or advisory firm exceeds an arm's length amount that is customary for the types of services rendered.
- Payment of the fees is tied to the same limitations provided for dividend distributions to the private equity firm.
- Where the portfolio company is acquired by a consortium of private equity funds, fees charged by the various advisory firms are in proportion to the shareholdings of each private equity firm.

V.A.T. TREATMENT OF FEES

The Circular Letter states that, if S.P.V./Bidco is a passive investor that does not participate in the management of Target, input V.A.T. on various transaction costs may not be recovered by the S.P.V./Bidco used to effect the transaction or a successor company created through a merger with Target ("Mergerco"). In addition, Target is not entitled to recover V.A.T. on services provided for the benefit of the investor group.

EXIT TAX TREATMENT OF CAPITAL GAINS AND DIVIDENDS

Capital gains realized by a foreign S.P.V. that directly holds the shareholdings in the Italian Mergerco or Bidco are taxed at exit as follows:

- Under domestic rules, capital gains realized by non-Italian resident entities are taxable at an effective tax rate of approximately 14%.
- Capital gains realized by white-listed resident entities upon the disposal of a non-substantial shareholding (capped at 20% of voting rights or 25% of share capital) of an unlisted company are exempt from tax.
- Capital gains realized by foreign entities upon the disposal of a non-substantial shareholding (capped at 2% of voting rights or 5% of share capital) of a listed company are exempt from tax.
- Pursuant to Article 13 of a D.T.C. based on the O.E.C.D. Model Tax Convention, capital gains derived from the sale of shareholdings are taxable only in the state of residence of the shareholder.

EXIT TAX TREATMENT OF DIVIDENDS

Dividend distributions from an intermediary Italian holding company that owns shares of Target are taxed at exist as follows:

- Dividends are subject to ordinary withholding tax (currently 26%), which may be reduced pursuant to an applicable D.T.C.
- Dividends distributed to an E.U. parent company may benefit from full exemption from Italian withholding tax under the E.U. Parent-Subsidiary Directive (the "P.S.D."), as implemented in Italy.
- If outbound dividends do not qualify for full exemption under the P.S.D., the E.U. parent company may, in principle, claim the benefit of a reduced withholding tax rate of 1.375%.[1]

"The limitation on benefits deals only with investments made by funds established in blacklisted countries through an E.U. holding company."

LIMITATION ON EXIT TAX BENEFITS

According to the Circular Letter, where the fund is established in a country that does not allow for adequate exchange of information, the intermediary E.U. holding company will not be entitled to tax relief when it does not have sufficient economic substance. In the absence of substance, the intermediary holding company is viewed as having been artificially created to take undue advantage of the benefit provided for in the P.S.D. and/or D.T.C.'s as well as domestic rules that reduce the tax burden on exit.

In the absence of economic substance, an intermediary entity is deemed to have been artificially set up as mere a conduit to its beneficial owner. A non-Italian entity may be viewed as lacking economic substance where the following conditions are met:

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[1] D.P.R. 600/1973, art. 27, para. 3-ter.

- It has a light organization. For example, it does not have full-time employees on its staff and does not have offices and equipment other than those made available by third-party companies through management service agreements. It does not carry out real economic activity, or it has little or no discretion in the decision-making process of its business.

- It does not carry out real economic activity, or it has little or no discretion in the decision-making process of its business.

- It acts as a mere financial conduit in the context of a specific arrangement involving receipts and disbursements that are symmetrical in terms of amount and timing and are not subject to further withholding tax in the state of residence.

If the fund is established in a blacklisted country and the intermediary holding company would be disregarded based on the above arguments, capital gains realized upon the disposal of Target's shares would be subject to tax in Italy and outbound dividends from Italy would be subject to ordinary withholding tax, as if the fund invested directly. Nonetheless, when the fund is set up as a transparent entity, treaty benefits may be claimed directly by the ultimate parent fund's investors under certain circumstances.

WHITE LIST

The above-mentioned limitation deals only with investments made by funds established in blacklisted countries through an E.U. holding company. It should not apply when the fund is located in a country allowing for an adequate exchange of information (a so-called whitelist country) that is also in compliance with E.U. principles.

Countries allowing for adequate exchange of information are currently listed in Ministerial Decree 4 September 1996. This legislation was issued pursuant to Legislative Decree No. 239/1996, which sets the rules for taxation of interest on bonds and similar notes from Italian issuers. Legislative Decree No. 147/2015 introduced recent changes and stated that the white list should be rewritten and updated by ministerial decree every six months, so as to include all the (new) countries that meet the requirements in the intervening time and are therefore considered whitelisted.

In 2015, a number of Tax Information Exchange Agreements ("T.I.E.A.'s") were ratified by the Italian government, including an agreement with the Cayman Islands, Guernsey, and Jersey. Following these developments, and considering the level of actual cooperation attained with regard to exchange of information, there is no longer justification for countries having T.I.E.A.'s with Italy to be excluded from the white list. Therefore, even before a new list is formally issued, it is reasonable to treat these countries as whitelisted.

CANADA ADOPTS CHANGES TO TRUST & ESTATE TAXATION RULES

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Tags
Canada
Charitable Giving
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Trusts

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INTRODUCTION

On January 1, 2016, new income tax rules came into effect regarding the Canadian taxation of trusts, particularly testamentary trusts, and estates (the "New Rules"). These rules were first proposed in the 2013 Federal Budget under measures intended to address concerns over abusive tax planning. Draft legislation, proposing a series of amendments to Canada's *Income Tax Act* (the "Act"), was released in early 2014 and revised during the summer of 2014.

Organizations representing the Canadian tax, trust, and estate industries have expressed serious concern with the New Rules. In particular, industry representatives took issue with the amendments to the taxation of spousal and similar trusts and questioned the practicality of the New Rules with regard to the use and application of charitable tax credits by Canadian estates. In spite of these concerns, the New Rules received royal assent at the end of 2014, to take effect at the start of 2016.

Following discussions with industry representatives – which have been ongoing from the time the New Rules received royal assent – Canada's Department of Finance ultimately addressed the most pressing concerns by proposing further amendments to the Act. These proposed amendments were released on January 15, 2016.

This article provides a general overview of the New Rules and the problems they present with regard to the taxation of spousal and similar trusts and the use of charitable donation tax credits by Canadian estates. The article also discusses the manner in which the Department of Finance has proposed to remedy these problems.

BACKGROUND TO THE NEW RULES

As indicated above, Canada's 2013 Federal Budget included a surprise for tax and estate practitioners. Previously, Canadian testamentary trusts and estates were subject to taxation at graduated rates similar to the graduated rates for individuals. This contrasted with the single tax rate for *inter vivos* trusts, which was the highest marginal tax rate applicable to individuals in the province of the trust's residence. In the 2013 Federal Budget, the Canadian government announced that it was considering the elimination of graduated tax rates for testamentary trusts. This announcement was followed by a consultation paper, released on June 3, 2013, that proposed, *inter alia*, the application of the highest marginal tax rate to all trusts created by will and all income earned by estates for tax years ending more than 36 months after the death of the relevant individual.

The Federal government's primary concern was that testamentary trusts were being used in an abusive manner to avoid the payment of tax. In certain cases, the Federal government noted that multiple testamentary trusts were formed in order to benefit from graduated rates multiple times. Estates were taxed in the same manner as testamentary trusts under the law then in effect, and the Federal government expressed the view that the administration of certain estates was being unduly delayed for tax-motivated reasons.

The Federal government also expressed concern with deferral of tax on transfers of property to spousal or similar trusts, which are commonly used as part of Canadian tax and estate planning. Under prior law, the tax imposed on an inherent gain at the time of the transfer was deferred until the death of the beneficiary spouse. In general, all of the net income of a spousal or similar trust was payable to a surviving spouse during his or her lifetime, and discretionary payments of capital could also be made to the surviving spouse during that period. Spousal and similar trusts have become particularly attractive in circumstances involving multiple marriages or blended families.

To a lesser extent, the Federal government was concerned with inter-provincial tax planning involving opportunities that could be derived from manipulating the domicile of trusts. Prior to the New Rules, planning opportunities existed to access lower provincial tax rates based on the tax residence of a trust's trustee.

GRADUATED RATE ESTATES

Based on the Federal government's view that the time required to administer most Canadian estates is 36 months, the New Rules provide that graduated tax rates will apply only to taxation years ending within the first 36 months after the individual's death. During this period, estates are referred to as "graduated rate estates" ("G.R.E.'s") under the New Rules. After the 36-month period, G.R.E. status terminates and a continuing estate will be taxed only at the highest marginal tax rate applicable to individuals in its province of residence. Any testamentary trusts established under the terms of an individual's will are also taxed at the highest applicable marginal tax rate from the time of inception.

SPOUSAL AND SIMILAR TRUSTS

The New Rules introduce changes to Canadian income tax consequences upon the death of a surviving spouse. The new paragraph 104(13.4)(b) of the Act (which forms part of the New Rules) provides that, upon the death of a surviving spouse who is a beneficiary of a spousal trust, the capital gains arising from the deemed disposition are to be taxed in the surviving spouse's estate and not in the trust. Many industry leaders raised concerns regarding the fairness of this provision. It results in considerable inequity when the beneficiaries of a surviving spouse's estate are different from the residuary beneficiaries of the trust. In blended family situations, the capital gains tax liability triggered by the surviving spouse's death was typically borne by the estate. This diminished the overall property available for distribution to the beneficiaries of the estate. At the same time, the capital property of the trust could be distributed to the residuary beneficiaries of the trust and the recipients would take a cost base equal to fair market value of the property received.

A second major concern with the treatment of spousal and similar trusts under the New Rules is the risk of "stranding" charitable donation tax credits ("C.D.T.C.'s,") in a trust that gifts property to a charity after the death of the surviving spouse.

Because the tax liability associated with the surviving spouse's death will be borne by the estate and not by the trust, the trust may not have sufficient income tax payable to obtain a benefit from the donation tax credit. In the one-year period between the adoption and the effective date of the New Rules, practitioners had time to review estate plans in order to identify those involving spousal trusts that would be adversely affected. Typically, estate plans involving blended family situations and residual beneficiaries that differed from the beneficiaries of the surviving spouse's estate were most at risk.

CHARITABLE DONATION TAX CREDITS

Under the New Rules, an estate that is a G.R.E. for the purposes of the Act is generally permitted to allocate C.D.T.C.'s to any of the following taxation years:

- The taxation year of the estate in which the donation was made
- An earlier taxation year of the estate
- The two taxation years of the individual preceding his or her death

"The Federal government's primary concern was that testamentary trusts were being used in an abusive manner to avoid the payment of tax. In certain cases, the government noted that multiple testamentary trusts were formed in order to benefit from graduated rates multiple times."

In general, publicly listed securities and units of mutual funds are exempt from capital gains tax, which arises on an individual's death, if the property is donated to a charity by the individual's estate following his or her passing. The capital gains tax exemption is only applicable to the taxation year of the individual's death.

Industry representatives raised concerns over the feasibility of completing all charitable gifting within the 36-month G.R.E. period in complex estate situations.

PROPOSED CHANGES TO THE NEW RULES

In response to a submission made by the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada, the Department of Finance indicated in November 2015 that it was seeking to understand the concerns raised in respect of the New Rules. On January 15, 2016, the Canadian Department of Finance released legislative proposals to amend certain portions of the New Rules.

The amendments proposed by the Department Finance are aimed principally at the apparent inequity caused by new paragraph 104(13.4)(b) of the Act. The proposed amendments introduce a new paragraph 104(13.4)(b.1), which limits the application of paragraph 104(13.4)(b) to circumstances involving a surviving spouse who meets the following criteria:

- Immediately prior to his or her death, the surviving spouse was resident in Canada.
- The surviving spouse was a beneficiary of a post-1971 spousal or common law testamentary trust that was created by the will of a taxpayer who died before 2017.

If these conditions are met, the trustee or administrator of the surviving spouse's estate may jointly elect with the trustee of the spousal or common law partner testamentary trust to have paragraph 104(13.4)(b) of the Act apply, with the result that the capital gains arising as a result of the surviving spouse's death will be taxed in the estate and not in the spousal or common law partner trust.

For deaths occurring before 2017, there may be compelling tax reasons to make this election. For example, it may be beneficial to make use of the election if there is a capital gain in a spousal trust and, at the time of the surviving spouse's death, he or she had personal capital losses that otherwise could not be used.

"In the coming months, individuals with estate plans developed in contemplation of the New Rules should revisit planning done prior to the proposed amendments."

As previously noted, the joint election in proposed paragraph 104(13.4)(b.1) of the Act will only be available for spousal trusts created by the will of a taxpayer who died before 2017. Otherwise, the capital gains tax deemed to be recognized in a spousal or similar trust upon the death of a surviving spouse will continue to be taxed in the trust (at the highest marginal tax rate applicable to the trust) and not in the estate of the surviving spouse, as under prior law.

The Department of Finance's proposed amendments to the New Rules also extend the time during which testamentary trusts may allocate C.D.T.C.'s. While the existing legislation allows for the allocation to be made only within a 36-month period following an individual's death, the proposed changes would extend this period to 60 months. According to a Department of Finance release regarding the proposed amendments, it appears that any C.D.T.C.'s arising from donations made after the estate ceased to be a G.R.E. would be allocable among either (i) the taxation year in which the donation was made or (ii) the last two taxation years of the individual.

CONCLUSION

In general, the Department of Finance's proposed amendments to the New Rules would apply from the 2016 tax year. If implemented in the proposed form, the amendments will be welcomed by many individuals, families, and industry members. As drafted, the proposals provide more flexibility with respect to the taxation of capital gains and the period for claiming C.D.T.C.'s. They also restore a perceived sense of fairness to the taxation of spousal and similar trusts.

In the coming months, individuals with estate plans developed in contemplation of the New Rules should revisit planning done prior to the proposed amendments. Others should evaluate how the Department of Finance's proposed amendments will affect their estates and planned charitable giving.

U.K. ADOPTS PUBLIC REGISTER OF PEOPLE WITH SIGNIFICANT CONTROL OVER U.K. CORPORATIONS

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Tags
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INTRODUCTION

With effect from April 6, 2016, U.K. companies and L.L.P.'s are required to maintain a statutory register setting out the individuals who are considered "persons with significant control" ("P.S.C.'s"). The requirement was introduced by the Small Business, Enterprise and Employment Act 2015 and is designed to create more transparency around the ownership of companies.[1]

With effect from June 30, 2016, U.K. companies and L.L.P.'s will be subject to a further requirement to register that information with Companies House. The P.S.C. information will be available to the public.

POLITICAL CONTEXT

International pressure for transparency has been a recurring theme in recent years, as transparency has become increasingly high on many political agendas. Its proponents have included the G-20, the Financial Action Task Form ("F.A.T.F."), and the International Monetary Fund ("I.M.F."), and it was also the focus of E.U. anti-money laundering directives.

The immediate genesis of this particular measure began life in 2013, as a personal commitment by the U.K.'s prime minister, David Cameron, to introduce a public register of beneficial ownership. It was certainly a brave move, and businesses were alarmed. It was also unexpected, given that Prime Minister Cameron had previously decided to withdraw a proposal for public registers from the Lough Erne G-8 agenda – in part on the basis that other G-8 countries were unlikely to endorse the proposal.

As part of the consultation process that followed, a number of bodies, including the Law Society, voiced concerns. Inevitably, many of the concerns were based on issues of personal privacy. Policy initiatives preserving personal privacy are increasingly maligned, but few would suggest that public policy requires us to make available on Google the contents of our bank accounts or other statements of personal wealth. Yet, as significant wealth is held through the medium of companies, commentators have argued that this is exactly the effect of a public register of beneficial ownership of shares. The U.K. takes for granted its (relative) political stability and assurance of personal security. However, this position is not mirrored in all jurisdictions.

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1 The authors would like to acknowledge the contribution of Alice Foster, trainee solicitor at Memery Crystal LLP. Ms. Foster will qualify into the corporate department of the Firm in September 2016.

There was also particular concern that the U.K. would be the first jurisdiction to create and maintain a central public register of beneficial ownership. Investment might therefore be diverted from the U.K. to other jurisdictions. Although many jurisdictions have paid lip service to the concept of transparency and there are a number of supranational efforts to introduce further disclosure, this is generally limited to disclosure between government agencies (in particular, tax collection agencies). Although a number of jurisdictions offer information to the public in relation to the share registers of companies, the U.K. is the first to extend the breadth of transparency to include ultimate beneficial ownership, as opposed to nominee ownership.

PERSON OF SIGNIFICANT OF CONTROL DEFINED

The legislation is complex, but essentially, a P.S.C. is someone who meets one or more of the following conditions:

- Directly or indirectly owns more than 25% of the share capital
- Directly or indirectly controls more than 25% of the voting rights
- Directly or indirectly holds the right to appoint or remove a majority of the board of company directors
- Exercises, or holds the right to exercise, significant influence or control over a company
- Exercises, or holds the right to exercise, significant influence or control over activities of a trust or firm which itself meets one or more of the first four conditions

The legislation contains detailed provisions relating to the interpretation of these conditions and includes anti-avoidance provisions.

In the vast majority of cases, it will be easy to determine whether any particular individual is a P.S.C. – it will be a straightforward binary analysis. However, in the context of more complex structures, the determination will be much more difficult. For example, convoluted cross-border investment structures comprising share capital of different classes, shareholder agreements, and investment agreements will require a lengthy, cumbersome, and undoubtedly expensive analysis. The legislation is designed to identify ultimate beneficial ownership – these are individuals, not companies or other legal entitles. Therefore, there are provisions to "look-through" intermediate entities.

The government has recognized that the exercise will be difficult in certain circumstances, and has published extensive draft guidance. Nonetheless, it advises also that it is likely that companies will require expert advice in difficult cases, particularly given that failure to comply with the legislation can result in fines and imprisonment.

EXEMPTIONS TO MANDATORY DISCLOSURE

Given that the obligations created by the legislation are onerous, the availability of exemptions was fiercely debated at the consultation stage.

Listed companies

A significant number of companies will benefit from the exemption available to listed companies. Broadly, and on the basis that their significant shareholdings are already in the public domain, the following companies are not required to complete and maintain a P.S.C. register:

- Companies that are subject to D.T.R. 5 (Disclosure and Transparency Rules), which includes companies on the Main Market, A.I.M., and I.S.D.X. Growth Market
- Companies that are admitted to trading on a regulated market in an E.E.A. state (other than the U.K.)
- Companies listed on certain markets in Israel, Japan, Switzerland, and the United States

However, these exemptions do not simply flow through to any U.K. subsidiaries. Further, the exemption from these rules for A.I.M. and I.S.D.X. Growth Market companies is likely to fall away in July 2017, when the fourth E.U. anti-money laundering directive comes into force.

Protection Regime

The legislation also provides for a "protection regime," which allows a company to apply to Companies House on behalf of the P.S.C., requesting that Companies House refrain from publicly disclosing information about the P.S.C. if the company reasonably believes that the disclosure will expose the P.S.C. to the risk of violence or intimidation. Thus, there is still a requirement to disclose *vis a vis* Companies House; however, there is no further obligation on the company to make this information publicly available. The draft guidance states that applications will be assessed on a case-by-case basis, and there is no set list of circumstances in which protection will be granted.

INFORMATION THAT MUST BE DISCLOSED ON THE P.S.C. REGISTER

For individuals on the P.S.C. register, certain personal information will need to be disclosed, including name, service address, nationality, date of birth, and usual residential address. The P.S.C. register will also include details of the nature of the control exercised by the P.S.C.

U.K. companies and L.L.P.'s will have to file the information on their P.S.C. registers with an Annual Return (to be renamed as a Compliance Statement). The information must be filed with Companies House at least once every 12 months, from June 30, 2016, and the P.S.C. register must also be made available for inspection at the entity's registered office from April 6, 2016.

TERRITORIAL AMBIT AND ENFORCEMENT

The legislation applies to companies and other bodies corporate incorporated under the U.K. Companies Act and to L.L.P.'s formed under the Limited Liability

Partnerships Act 2000. It does not apply to the overseas subsidiaries of U.K. companies, for example.

The legislation requires an affected company to take reasonable steps to find out if it has any registrable P.S.C.'s and, if so, to identify them. The company must then record the requisite details in its P.S.C. register. Failure to maintain a register or take reasonable steps to find and identify P.S.C.'s will make the company liable to a fine and its director(s) liable to a fine and imprisonment. However, many individuals may be P.S.C.'s in relation to U.K. companies without having ever set foot in the U.K. This raises the following questions of fairness:

- How can a company elicit the required information?
- What are reasonable steps in these circumstances?

The legislation contemplates that the company will submit a notice to the potential P.S.C. requesting the information. It is a criminal offense for a person to fail to comply with a notice sent by a company. Further, the legislation allows the company to impose restrictions on shares or rights held by an individual if he or she does not comply with the terms of a notice.

"Effectively, the register relies on self-reporting only. There are no procedures in place for systematic and objective verification."

But, what if the company receives plainly inaccurate information? Is it under an obligation to investigate further? What steps are "reasonable" steps? And, more importantly, what steps are *not* "reasonable" steps? If a shareholder sent back a return stating that his full name was Mickey Mouse and his address was on Pluto, presumably it would be difficult for the company to claim that it had taken reasonable steps. But where does the boundary lie? What degree of investigation is required?

The government's draft guidance states the following:

> 2.3.1 You must take reasonable steps to determine whether any individual or any legal entity meets the conditions for being a P.S.C. or registrable [relevant legal entity] in relation to your company, and if so, who that person or registrable [relevant legal entity] is. It may be that, having taken these steps, you cannot identify the person or confirm their details, but failure to take reasonable steps is a criminal offence.

The draft guidance does therefore anticipate the possibility that it may not be feasible to identify the control by the company. However, it offers little else by way of guidance.

Further, there is no system for the verification of information. This was one of the objections voiced by a number of commentators during the consultation process. Effectively, the register relies on self-reporting only. There are no procedures in place for systematic and objective verification, which leads to the following two questions:

- Are there enough regulations to ensure that the data reported is reliable?
- Is a system that elicits and stores inaccurate information worse than no system at all?

When this objection was raised during consultation, the response was that if an entry was incorrect, public scrutiny would identify and report it. This seems weak at best and, given that the consequent penalties are criminal in nature, arguably wholly inadequate. Commentators have questioned the propriety of having the accuracy and verification of U.K. government regulation dependent on the N.G.O. community's agenda – a largely unregulated but politically powerful sector.

RECENT (IRONIC) DEVELOPMENTS

Transparency has moved further up the current political agenda with the recent unprecedented leak from Panamanian law firm Mossack Fonseca. The sheer scale of the leak has been dramatic, as has the number of high-ranking government officials that have been implicated. Ironically, given that he has been the prime protagonist in the development of the world's first publicly-available register of beneficial ownership of companies, Prime Minister Cameron has suffered in particular as a result of disclosures about the nature and background of his family's wealth.

As a result of the leak, tax and law enforcement agencies in the U.K., Germany, France, Italy, and Spain have agreed to additional data-sharing arrangements and are now seeking to establish cross-border company register information. However, although this is demonstrative of the continued drive for transparency, this information sharing is still at government level only and, therefore, can be clearly distinguished from the substantive content of the U.K.'s P.S.C. register. The U.K. remains the only jurisdiction to have implemented this type of legislation.

Some will be irritated by the continued assumption by the media (the good and the bad) that "offshore" jurisdictions are all created equal. For a start, the term "offshore" means different things to different people. In this context, "offshore" is widely used as a pejorative shorthand to suggest tax evasion, organized crime, terrorism, arms trade, or drug dealing.

The evidence suggests otherwise. A recent academic study, "Global Shell Games,"[2] looked at compliance with F.A.T.F. guidelines. In summary, the authors posed as consultants wishing to form a shell company. They sent emails asking over 3,500 different incorporation agents in 182 jurisdictions to form companies for them. Overall, 48% of the agents who replied failed to ask for proper identification. Almost half of these did not want any documentation at all.

The authors compiled a table of compliance, ranking jurisdictions in terms of their compliance. It makes for interesting reading. The following is an extract from the authors' conclusions:

> One of the biggest surprises of the project was the relative performance of rich, developed states compared with poorer, developing countries and tax havens.… The overwhelming policy consensus, strongly articulated in G20 communiqués and by many NGOs, is that tax havens provide strict secrecy and lax regulation, especially when it comes to shell companies. This consensus is wrong. The Dodgy Shopping Count for tax havens is 25.2, which is in fact much higher than the score for rich, developed countries at 7.8 – meaning

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[2] Michael G Findley, Daniel L Nielson and JC Sharman, *Global Shell Games: Experiments in Transnational Relations, Crime and Terrorism*, (Cambridge: Cambridge University Press: 2014).

it is more than three times harder to obtain an untraceable shell company in tax havens than in developed countries. Some of the top-ranked countries in the world are tax havens such as Jersey, the Cayman Islands and the Bahamas, while some developed countries like the United Kingdom, Australia, Canada and the United States rank near the bottom of the list. It is easier to obtain an untraceable shell company from incorporation services (though not law firms) in the United States than in any other country save Kenya.

THE ROAD AHEAD

Perhaps the most controversial aspect of the new provisions has been the requirement not just to collate information on the ultimate beneficial ownership of companies, but to make it publicly accessible. Recent developments notwithstanding, no other jurisdictions have made firm commitments to introduce equivalent measures.

No doubt the rest of the world will be watching the U.K. with interest over the coming months. The measures will undoubtedly add to the burden of doing business through a U.K. company – in some cases, considerably. Whether the benefits of that burden will be worthwhile remains to be seen. If the data is inaccurate, what will have been achieved but another layer of costly administration and a deterrent to doing business through U.K. entities? Anecdotal evidence suggests that reputable tax advisers try not to associate with criminals, and it seems likely that criminals are not much interested in accurate self-certification for government authorities.

As a final point, the lack of certainty surrounding a company's "reasonable" attempts to obtain information is of particular concern, particularly given that failure to make such efforts carries criminal penalties. In a sense, the requirement to maintain the P.S.C. register is simply an expansion of F.A.T.C.A. and the C.R.S. from financial institutions to everyday companies with an added twist: a failure to comply with an undefined standard of reasonableness elicits criminal penalties for non-performance. In the world of F.A.T.C.A., noncompliance is burdened only with withholding tax.

"Transparency has moved further up the current political agenda with the recent unprecedented leak from Panamanian law firm Mossack Fonseca. . . . Cameron has suffered in particular as a result of disclosures about the nature and background of his family's wealth."

EXCHANGE OF INFORMATION: ISRAEL INCHES TOWARD INTERNATIONAL NORMS

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INTRODUCTION

The State of Israel has always invested a large amount of effort to attract people from around the world to immigrate to Israel and to invest their funds in Israel.

As part of these efforts, Section 14 of the Israeli Income Tax Ordinance stipulates that when a person becomes a new Israeli resident, Israel grants the individual a ten-year exemption from disclosing to the Israeli tax authorities any information regarding non-Israeli assets, sources of income, and capital gains. This tax holiday also applies to senior returning residents who resume Israeli residency after residing overseas for at least ten years.

Some global tax policy officials claim that Israel has blindly accepted the source of funds that were invested in Israel by new immigrants and that it disregarded the possibility that the investments were made with the proceeds of tax evasion in other countries. For this reason, it is claimed that Israel has not been eager to disclose information regarding these funds and assets to other states.

PERSPECTIVE

The lack of willingness to disclose fiscal information between states has been a standard practice among nations, as evidenced in early multilateral conventions. One of the first conventions to deal with legal assistance between countries was the European Convention on Mutual Assistance in Criminal Matters 1959 (the "Strasbourg Convention").[1] The Strasbourg Convention specifically stipulated in Article 2 that any legal assistance may be refused in regard to fiscal offences.

Israel has adopted and ratified the Strasbourg Convention. However, in parallel to this convention, Israel, like many other states, has signed numerous double taxation treaties that call for exchange of information ("E.O.I.") regarding tax matters. In most double taxation treaties, the E.O.I. clause allows each Member State the sovereignty to decide whether or not it wishes to disclose information. Israel generally has preferred to maintain its sovereignty rather than willingly promote E.O.I. regarding assets and income located in Israel.

RECENT DEVELOPMENTS

Recently, Israel has reversed its prior position and has moved to establish an active E.O.I. policy. This is partly due to Israel's desire to obtain information regarding

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1 European Convention on Mutual Assistance in Criminal Matters, CETS No.030, Strasbourg, April 20, 1959.

financial activities of Israeli residents abroad and partly due to the worldwide trend toward breaking all secrecy barriers between tax authorities and financial institutions. As a result, effective January 2016, Israel has instituted new laws that will enable it to join international conventions and treaties relating to the disclosure and exchange of information regarding income and assets in Israel. Consequently, Israel will provide financial information to other foreign tax authorities. In turn, Israel will receive financial information relating to its residents.

The new laws enable Israel to join the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (the "M.L.A.T. Convention").[2] As we will show, joining the O.E.C.D. Convention does not necessarily mean that Israel will in fact abandon its historical position of preferring sovereignty over disclosure.

Israel Joins the M.L.A.T. Convention

As mentioned above, on November 24, 2015, Israel joined the M.L.A.T. Convention, making it the 91st jurisdiction to join.[3]

The M.L.A.T. Convention obligates the Member States to exchange information with each other concerning income and assets of residents of the Member States. The information can be used by the receiving state only for income tax purposes. Information is made available on a reciprocal basis between each of two states under existing Tax Information Exchange Agreements.

The M.L.A.T. Convention applies to a wide range of taxes, including taxes on income; capital gains; net wealth; compulsory social security; estates, inheritances, or gifts; immovable property; and consumption, such as value added tax ("V.A.T."), or sales; etc.[4]

The Israeli State Revenue Administration in the Ministry of Finance has stated that Israel will enforce the M.L.A.T. Convention on direct taxes only, not including social security payments.[5] This means that the Israeli law regarding E.O.I. will not be imposed on indirect taxes, especially V.A.T. Another interesting question is with regard to real estate tax. Israel may claim, that real estate tax is not covered by the M.L.A.T. Convention. This means that Israel may decide not to transfer information regarding the purchase and sale of real estate in Israel. Furthermore, Israel will not enforce the M.L.A.T. Convention's provisions on assistance in tax examinations abroad or on tax collection and service of documents, a decision which will not be addressed in this article.

Under the M.L.A.T. Convention there are five methods of exchanging information: E.O.I. on request, automatic exchange of information ("A.E.O.I."), spontaneous E.O.I., simultaneous tax examinations, and tax examinations abroad. Each Mem

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2 O.E.C.D. and Council of Europe, *Multilateral Convention on Mutual Administrative Assistance in Tax Matters: Amended by the 2010 Protocol*, (Paris: O.E.C.D. Publishing, 2011), last modified February 2016 (the "*O.E.C.D. Convention*").

3 O.E.C.D., "Israel Joins International Efforts to Boost Transparency and End Tax Evasion," news release, Nov. 24, 2015; Ministry of Finance, "Israel Signed the Multilateral Convention on Mutual Administrative Assistance in Tax Matters," news release, Nov. 25, 2015.

4 *O.E.C.D. Convention*, art. 2.

5 "Israel Signed the Multilateral Convention."

ber State can decide at its sole discretion whether or not to transfer information to other Member States by using one or more of these methods.

E.O.I. on Request

Upon the request of a Member State (the "Applicant State"), the Member State receiving the request (the "Requested State") must provide the Applicant State with any relevant information that concerns particular taxpayers or transactions. In order to comply with the request for information, the Requested State must provide information available in its tax files. It must also take all relevant measures to provide the Applicant State with the information requested.[6]

> ***"Under the M.L.A.T. Convention there are five methods of exchanging information: E.O.I. on request, A.E.O.I., spontaneous E.O.I., simultaneous tax examinations, and tax examinations abroad."***

A.E.O.I.

The M.L.A.T. Convention does not specify the way to conduct A.E.O.I., and in this respect, the O.E.C.D. published the Standard for Automatic Exchange of Financial Account Information in Tax Matters (the "Standard") on July 21, 2014.[7]

The Standard calls for Member States to obtain information from domestic financial institutions and automatically exchange that information with other Member States on an annual basis. The Standard also determines the type of financial information to be reported and exchanged, the different types of accounts and taxpayers covered, and the common due diligence procedures to be followed by domestic financial institutions.

According to the Standard, financial institutions (*e.g.*, banks and insurance companies) will determine a process for identifying account owners that are residents of foreign countries. The financial institutions will then collect information with respect to such account holders and transfer that information to the relevant tax authorities in the other Member State. This information will include balances and financial revenues of foreign account holders.[8]

Given the importance of implementing A.E.O.I., competent authorities from over 79 jurisdictions have signed the Common Reporting Standard Multilateral Competent Authority Agreement (the "C.R.S. M.C.A.A."), which implements the Standard and specifies the details of what information will be exchanged and when. While the C.R.S. M.C.A.A. is multilateral, the actual A.E.O.I. will be implemented bilaterally.[9]

Israel has yet to join the C.R.S. M.C.A.A. However, on October 27, 2014, the Israeli Ministry of Finance notified the O.E.C.D. that it will adopt the procedure for the automatic exchange of financial account information for tax purposes (referred to as the "Common Reporting Standard" or the "C.R.S.") by the end of 2018. The procedure will be implemented via an agreement between the relevant authorities in countries complying with the procedure.[10]

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6 *O.E.C.D. Convention*, art. 5.

7 *Id.*, art. 6; O.E.C.D., *Standard for Automatic Exchange of Financial Account Information in Tax Matters*, (Paris: O.E.C.D. Publishing, July 21, 2014) ("*The Standard*").

8 *The Standard*.

9 *O.E.C.D. Convention*; O.E.C.D., "The CRS Multilateral Competent Authority Agreement (MCAA),"

10 Ministry of Finance, "Israel to Adopt OECD Procedure for the Automatic Exchange of Financial Account Information," news release, Oct. 27, 2015.

Spontaneous E.O.I.

A party can spontaneously forward information to another party in the following circumstances:[11]

- A party concludes that there may be a loss of tax in the other party jurisdiction.
- A taxpayer obtains a reduction or exemption from tax in a party jurisdiction, which may result in an increase in tax or liability to tax in the other party jurisdiction.
- Business dealings between two taxpayers from different party jurisdictions are conducted through one or more countries in a way that may result in tax savings in one of the party jurisdictions, or in both.
- A party concludes that tax savings may result from artificial transfers of profits within a group of enterprises.
- Information forwarded to a party by the other party may be relevant in assessing the tax liability in the latter party jurisdiction.

Simultaneous Tax Examinations

Two or more parties shall consult with each other and determine cases and procedures for simultaneous tax examinations. During these examinations, two or more parties are each conducting domestic investigations into the tax affairs of a taxpayer or taxpayers in which they have common or related interest. The purpose of these examinations is that each state will exchange any relevant information it obtains during the examinations.[12]

Tax Examinations Abroad

The competent authority of the Applicant State can request to be present in tax examinations conducted by the competent authority of the Requested State. The Requested State can refuse to include the Applicant State in its examination, and even if it decides to allow the request, all decisions with respect to the conduct of the tax examination shall only be made by the Requested State.[13]

Israel Amends Tax Laws Regarding E.O.I. with Certain Reservations

On November 19, 2015, a week before joining the M.L.A.T. Convention, the Israeli parliament, the Knesset, approved a bill to increase enforcement of the M.L.A.T. Convention against tax evaders (the "Bill").[14] As of January 1, 2016, the Bill enables the director of Israeli Tax Authority (the "I.T.A.") to transfer information to a foreign country according to an international treaty for enforcement under the tax laws of that country.[15]

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11 *O.E.C.D. Convention*, art. 7.

12 *Id.*, art. 8.

13 *Id.*, art. 9.

14 The Law of Amending the Income Tax Ordinance (No. 207) - 2015.

15 Ministry of Finance, "The State of Israel Increases Enforcement Ability Against Tax Evaders," news release, Nov. 22, 2015.

The main goal of the Bill was to enable Israel to join the M.L.A.T. Convention. However, the Bill stipulates additional conditions that allow Israel to disregard provisions of the M.L.A.T. Convention. These additional conditions give precedence to the sovereignty of the I.T.A. (which may decide whether or not to transfer information) over the promotion of E.O.I. with other Member States.

"The Bill stipulates additional conditions that allow Israel to disregard provisions of the M.L.A.T. Convention. These additional conditions give precedence to the sovereignty of the I.T.A."

According to the Bill, the director of the I.T.A. (the "Director") may transfer information to a "Foreign Tax Authority" according to an international agreement, subject to the following conditions:

1. If the information is transferred at the initiative of the Director, it should be verified that the requested information is needed for the enforcement of the domestic tax law of the foreign Member State.[16]

2. If the information is transferred at the request of the Foreign Tax Authority, the Director should be convinced that the foreign requesting country requires the requested information in order to enforce its domestic tax law.[17]

3. The I.T.A. is allowed to use the requested information in order to enforce its domestic tax law.[18]

4. The foreign country is committed to the confidentiality and safekeeping of the requested information, as determined by an international agreement.

5. The Foreign Tax Authority uses the information solely for the purpose of enforcement of its domestic tax law.

6. The Foreign Tax Authority will transfer the information to other institutions in the foreign country solely for the purpose of enforcing its domestic tax law.

7. The Foreign Tax Authority will not transfer the information to other countries.[19]

8. The I.T.A. is allowed (under current Israeli tax law) to decide to withhold information from a country that does not keep up with international standards of E.O.I.

9. The I.T.A. will notify an Israeli resident, in the case of a request for information, at least 14 days before transferring the information, unless the requesting country has asked for secrecy.

10. No information will be transferred to a Foreign Tax Authority according to an international agreement if such transfer of information could harm Israel's national security, public safety, pending investigations, public policy, or any other matters that are vital to the State of Israel.[20]

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16 It remains to be seen how Israel will interpret this provision.

17 This provision may also be widely interpreted by Israel and may result in the refusal of an information disclosure to another country.

18 "Tax law" is defined as a law that deals with the imposition of tax or with a mandatory payment that it is the responsibility of the Finance Minister to execute.

19 It is interesting to see that sections 5, 6, and 7 only apply to Foreign Tax Authorities and the I.T.A. is not subject to these provisions at all.

20 This provision may also be widely interpreted and may lead to the refusal to transfer information to other countries.

CONCLUSION

Today, even after Israel has amended its domestic law and joined the M.L.A.T. Convention, Israel's intention seems to remain the same – to obtain information with respect to its residents but not to allow for disclosure of any information to other countries where such disclosure fails to meet protective provisions under Israeli domestic law. It seems that both the new law and the provisions of the M.L.A.T. Convention do not damage the sovereignty of Israel to deny any disclosure of information.

There is no question that as long as Israel does not amend the provisions of the tax holiday given to new immigrants and senior returning residents, these individuals will be allowed to deny the I.T.A. any information regarding their foreign assets and income, and Israel will thus be unable to disclose information it does not possess.

The one exception that may have a crucial effect on the balance between sovereignty and disclosure relating to Israeli-based assets and income is the A.E.O.I. procedure, under which a Member State truly loses its ability to decide what information is disclosed to other Foreign Tax Authorities. Israel has not established a plan to implement A.E.O.I. procedures and so far has not changed its laws in this respect. According to the current Israeli law, the I.T.A. is not entitled to receive any kind of information from Israeli banks and such information can only be obtained from individual taxpayers or by a court order in connection with an on-going criminal investigation. However, it is expected that Israel will adopt A.E.O.I. procedures by the end of 2018.

Although A.E.O.I. has yet to be implemented in Israeli law, this procedure has definitely changed the way Israeli banks operate – and did so long before Israel even joined the M.L.A.T. Convention. Today, all domestic Israeli banks require that information regarding the tax residency of the account owner must be provided at the time of account opening. In addition, each account owner must sign a waiver in order to protect the bank in the event it discloses information relating to the account to the I.T.A. or to any Foreign Tax Authority.

The interesting question remains whether Israel will truly agree to relinquish its sovereignty and its historical objective of promoting immigration from around the world and allowing immigrants to bring funds with them under assurance of confidentiality.

INDIA BUDGET 2016-17

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Dividend Declaration Tax
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Jairaj Purandare is the Founder Chairman of JPM Advisors Pvt Ltd, a consulting and tax firm based in Mumbai, India. He has over three decades of experience in tax and business advisory matters, having served as Regional Managing Partner and Country Leader – Markets & Industries for PwC India, Chairman of EY India, and Country Head of Andersen India's Tax & Business Advisory practice.

INTRODUCTION

The Indian Finance Minister presented the Union Budget for 2016-17 ("Budget 2016-17") and Finance Bill, 2016 in Parliament on February 29, 2016. Along with proposed amendments to the tax law, key economic figures (as per the annual economic survey) and policy proposals were also announced.

The proposals indicate that India is poised to experience sustainable growth, owing to favorable macro-economic factors and demographics, rising income, greater urbanization, and increasing focus on manufacturing activities. The positive domestic outlook is offset by turmoil in the global economic climate, characterized by uncertainty, low growth, and turbulent financial markets. For financial year ("F.Y.") 2016-17, the International Monetary Fund ("I.M.F.") projects 7.5% growth in India, while the estimates for global economic growth plummeted from 3.4% for 2014 to 3.1% for 2015. The negative Wholesale Price Index ("W.P.I.") of -2.8% and a reduction in the Consumer Price Index ("C.P.I.") from 5.9% in F.Y. 2014-15 to 4.95% in F.Y. 2015-16 highlight the stability of the Indian economy. Adherence to the fiscal deficit target of 3.5% is a sign of the Indian government's commitment to fiscal discipline.

Budget 2016-17 places an emphasis on infrastructure development, financial sector reforms, ease of doing business, education and skill development, and job creation.

This article focuses on key proposals of Finance Bill, 2016.

POLICY ANNOUNCEMENTS

Infrastructure and Investment

- Total outlay of I.N.R. 2.18 trillion (approximately $32.5 billion) is proposed for roads and railways.
- A bill is to be introduced regarding resolution of disputes in infrastructure-related construction contracts and Public Private Partnership ("P.P.P.") and public utility contracts. Guidelines will be issued for renegotiation of P.P.P. Concession Agreements.
- A dedicated fund is to be set up by the Life Insurance Corporation of India ("L.I.C.") to provide credit enhancement to infrastructure projects.
- A new credit rating system is to be set up for infrastructure projects.

Fiscal Discipline

- The fiscal deficit will be set as a target range rather than a fixed number, by way of an amendment to the Fiscal Responsibility and Budget Management Act, 2003 ("F.R.B.M. Act").

Relaxation of Foreign Direct Investment ("F.D.I.") Policy

- 100% F.D.I. will be allowed in marketing of food products produced and manufactured in India under the Foreign Investment Promotion Board ("F.I.P.B.") approval route.
- Investment in insurance and pension sectors will be allowed up to 49% under the automatic route for government approval.
- 100% investment in asset reconstruction companies will be permitted under the automatic route for government approval.
- The investment limit by foreign entities in Indian financial exchanges will be increased from 5% to 15%, which is on par with domestic institutions.
- The investment limit for Foreign Portfolio Investors ("F.P.I.'s") investing in listed central public sector enterprises (other than banks) will be increased to 49%.
- F.D.I. will be allowed in additional activities beyond the 18 Non-Banking Financial Company activities specified under the automatic route for governmental approval.
- Hybrid instruments will be included among eligible F.D.I. instruments.

Financial Sector

- A comprehensive code on the resolution of bankruptcy situations of financial firms will be introduced.
- New derivative products are to be developed by the Securities and Exchange Board of India ("S.E.B.I.") in the commodity derivatives market.
- A proposed I.N.R. 2.50 billion (approximately $37.5 million) will be devoted to recapitalization of public sector banks.

Governance and Ease of Doing Business

- Amendments will be made to the Companies Act, 2013 to improve ease of doing business and to enable the registration of companies in a single day.

INCOME TAX PROPOSALS

Most direct tax proposals in Finance Bill, 2016 are effective from F.Y. 2016-17, *i.e.*, from April 1, 2016 unless otherwise specifically stated.

Tax Rates

The basic tax rates for domestic and foreign companies will remain unchanged, at

30% and 40%, respectively. Separately, for companies having turnover or gross receipts not exceeding I.N.R. 50 million (approximately $750,000) in F.Y. 2014-15, the basic rate of tax will be reduced to 29%.

> ***"Newly-established domestic companies engaged in the business of manufacturing will have an option to pay tax at a reduced basic rate of 25%."***

Newly-established[1] domestic companies engaged in the business of manufacturing will have an option to pay tax at a reduced basic rate of 25%. Companies that exercise this option will not be eligible for deductions and reliefs that are otherwise allowable, except for the deduction for compensation paid to additional workmen employed.

The basic rate of tax for individuals will remain unchanged. However, the rate of surcharge that is levied on the amount of income tax will be increased to 15% for individuals earning income in excess of I.N.R. 10 million (approximately $150,000) in any financial year.

The basic rates of tax for Minimum Alternate Tax ("M.A.T.") and Dividend Distribution Tax ("D.D.T.") will remain unchanged, at 18.5% and 15%, respectively.

Taxation of Dividend Income Exceeding I.N.R. 1 Million

Under existing domestic tax law, where a dividend is paid by an Indian company, the Indian company is required to pay 15% D.D.T. on the amount of the dividend, plus a surcharge and education cess.[2] Once these amounts are paid, the dividend is exempt from further tax in the hands of the recipient, whether resident or nonresident ("N.R.").

It is now proposed that dividends received by resident individuals and firms in excess of I.N.R. 1 million (approximately $15,000) will be taxed at 10%, on a gross basis. If implemented, this proposal will have numerous adverse consequences. Most notably, it will amount to the same income being taxed three separate times:

- Corporate tax imposed on the corporation
- D.D.T. imposed on the corporation
- Proposed tax of 10% on the shareholder

This provision also has the effect of discriminating between residents and N.R.'s. Further, it will adversely affect promoters holding shares directly and may lead to disputes over the taxability of dividends in the case of taxable non-business trusts that receive dividends exceeding I.N.R. 1 million, even if the shares of individual beneficiaries are less than I.N.R. 1 million.

Provisions Relating to N.R.'s

Equalization Levy to Tax B2B E-commerce Transactions

It is proposed that a 6% "equalization levy" will be charged on the gross amount of consideration for specified services received or receivable by an N.R. that does not have a permanent establishment ("P.E.") in India when the consideration is received from residents carrying on a business or profession in India or N.R.'s having a P.E. in India.

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[1] *I.e.*, incorporated on or after March 1, 2016.

[2] A cess is a type of tax levied by the Indian Tax Authorities, which must be used for a particular purpose, here education.

No levy will be charged in any of the following fact patterns:

- The N.R. providing the specified service has a P.E. in India and the specified service is connected with the P.E.
- The total consideration received/receivable by the N.R. does not exceed I.N.R. 100,000 (approximately $1,500) in any F.Y.
- The services are not provided for the purpose of carrying on a business or profession.

Income on which the equalization levy is charged will be exempt from income tax.

The payer of a consideration that is subject to the equalization levy will be required to deduct the levy from the amount payable to an N.R. If no deduction is made by the payer, a deduction for the entire consideration will be disallowed in computing the income of the payer.

Procedures for collection of the levy, interest, penalties, and prosecution are in *pari materia* with withholding tax provisions under the domestic tax law.

This provision has been introduced to extend the scope of taxation to transactions relating to the digital economy and is based on the recommendations of the O.E.C.D. committee on base erosion and profit shifting ("B.E.P.S."). At present, income from digital economy transactions is not taxable in India, in accordance with India's Double Taxation Avoidance Agreements ("D.T.A.A.'s"), since the relevant foreign entities do not maintain a P.E. in India. However, these transactions are intended to be brought under the ambit of taxation by way of introduction of the equalization levy.

"It may be noted that the amount of equalization levy paid in India may not be available as a credit in the home country of the N.R., as this amount is per se not a 'tax' under the domestic tax law."

However, it may be noted that the amount of equalization levy paid in India may not be available as a credit in the home country of the N.R., as this amount is *per se* not a "tax" under the domestic tax law. For U.S. companies that provide services to Indian clients from locations in the U.S., the income is domestic-source income. Consequently, even if the tax is an income tax under U.S. concepts, it cannot be used to offset U.S. income tax on the consideration received.

The proposed amendment will be effective from a date to be stipulated by the Indian government.

Tax Incentives for International Financial Services Centers ("I.F.S.C.'s")

Various incentives are proposed with regard to entities set up in an I.F.S.C. to enable the I.F.S.C.'s to become international financial hubs.

Securities Transaction Tax ("S.T.T.") will not be payable on transactions in securities undertaken on a recognized stock exchange located in an I.F.S.C. In addition, the existing exemption from Long Term Capital Gains ("L.T.C.G.'s") will be extended to transactions undertaken in foreign currency on a recognized stock exchange by an entity located in an I.F.S.C., even if no S.T.T. is paid on such transactions.

Companies located in an I.F.S.C. will be entitled to pay M.A.T. at a reduced rate of 9%, if the income of such companies is derived solely in foreign exchange.

Further, no tax will be levied on distributions of profits by a company located in an I.F.S.C. that derives income solely in foreign exchange, and such dividend income will also not be taxable in the hands of the recipient.

These are welcome measures to promote the growth of I.F.S.C.'s.

Application of M.A.T. to Foreign Companies for the Period Prior to April 1, 2015

The issue of the application of M.A.T. on foreign companies has been a matter of long-standing debate.

It has been now clarified that M.A.T. will not be applicable to foreign companies with effect from F.Y. 2000-01, if

- the foreign company is a resident of a country or specified territory with which India has a D.T.A.A. and such company does not have a P.E. in India, or
- the foreign company is a resident of a country with which India does not have a D.T.A.A. and such company is not required to seek registration under the Companies Act in India.

This clarification will be greatly appreciated by foreign companies.

Rationalization of Withholding Tax Provisions for Categories I and II Alternative Investment Funds ("A.I.F.'s")

Income of the fund that is not business income will be exempt in the hands of the fund. In addition, income received by the investor from the investment fund, other than specified income that is taxed at the fund level, will be taxable in the hands of investor in the same manner as if the investment were made directly by investor.

The person responsible for making the payment to the investor will be required to withhold tax at 10% where the payee is a tax resident. If the payee is an N.R., the rate will be specified and may change from time to time. A certificate for deduction of tax at a lower rate may also be obtained from a tax officer.

This proposed amendment will be effective from June 1, 2016.

Country-by-Country ("CbC") Reporting

It is proposed that a three-tier structure will be implemented for transfer pricing documentation and CbC reporting, in accordance with the recommendations of the O.E.C.D. committee on B.E.P.S. Specified information will be required to be reported in the prescribed formats, if the consolidated revenue of the multinational enterprise ("M.N.E.") group exceeds the specified threshold.

- CbC reporting would involve the following:
- Local file – containing material transactions of the local taxpayer
- Master file – containing standardized information relevant to all M.N.E.'s in the group
- CbC reporting – containing information about global allocation of the M.N.E. group's income and taxes along with the location of economic activity within the M.N.E. group

Exemption of Income of a Foreign Company Accruing from the Storage and Sale of Crude Oil

Income accruing or arising to a foreign company from the storage of crude oil in a facility in India and the sale of the stored crude oil to any person resident in India will be exempt, provided that such storage and sale by the foreign company is made pursuant to an agreement entered into and/or approved and notified by the Indian government.

The proposed amendment will be effective retrospectively from F.Y. 2015-16.

Relaxation of the Conditions of the Special Taxation Regime for Offshore Funds

The provision dealing with certain activities that are not considered to constitute a business connection in India has been relaxed to include funds established, incorporated, or registered in a country or a specified territory that is identified by the Indian government. Also, the existing requirement preventing funds from controlling and managing any business in or from India has been diluted so that only activities carried on in India are subject to the prohibition.

"Certain incentives will be provided to eligible, certified, start-up companies to promote the growth of entrepreneurship and start-ups."

Place of Effective Management ("P.O.E.M.") and the General Anti-Avoidance Rule ("G.A.A.R.")

Implementation of a P.O.E.M.-based residency test for foreign companies will be deferred to April 1, 2016. Under these rules, a foreign company is treated as being resident in India if its P.O.E.M. is in India; this means that key management and commercial decisions that are necessary for the conduct of its business, as a whole, are made in substance in India.

For G.A.A.R., the scheduled effective date of April 1, 2017, remains unchanged.

Exemption from the Requirement to Furnish a Permanent Account Number ("P.A.N.")

The higher rate of withholding tax in the absence of a P.A.N. will not apply to N.R. or foreign companies for payments of interest on long-term bonds or any other payments, subject to prescribed conditions.

Tax Incentives for Start-ups

Certain incentives will be provided to eligible, certified, start-up companies to promote the growth of entrepreneurship and start-ups. A 100% deduction of profits will be available to an eligible, certified, start-up company that is

- incorporated after March 31, 2016 but before April 1, 2019, and
- engaged in the business of innovation, development, deployment, or commercialization of new products, processes, or services driven by technology or intellectual property.

The deduction will be available for any consecutive three-out-of-five F.Y.'s after the date of incorporation of the start-up.

L.T.C.G. will be exempt if it is invested after March 31, 2016 in units of a fund that is identified by the Indian government as a qualified fund. The exemption is capped at

I.N.R. 5 million (approximately $75,000). Further, exemption will be provided if the L.T.C.G. is invested in the subscription of shares of a company that qualifies as an eligible start-up, subject to certain conditions.

Taxation of Income from Patents

A new section will be introduced to tax gross royalty income, at a concessional rate of 10%, arising from a patent developed and registered in India. However, M.A.T. provisions will be applicable to such companies. This provision will apply to a person resident in India, who is the true and first inventor.

D.D.T. on Distributions Made by a Special Purpose Vehicle ("S.P.V.") to a Business Trust

D.D.T. will not be imposed on distributions made by an S.P.V. to Real Estate Investment Trusts ("R.E.I.T.'s") or Infrastructure Investment Trusts ("Inv.I.T.'s") holding prescribed shareholdings. In addition, dividends received by R.E.I.T.'s or Inv.I.T.'s and their investors will be exempt from tax. The exemption is allowed only in respect of dividends paid out of current income generated after the date of purchase of shares of the S.P.V. by a R.E.I.T. or Inv.I.T. This proposal is expected to have a positive impact on the establishment of R.E.I.T.'s and Inv.I.T.'s. These collective investment vehicles have not been widely utilized by investors since their enactment.

Amortization of Spectrum Fees

A new provision is announced to provide for amortization of the amount actually paid to acquire rights to use radio frequency spectrum for telecommunication services. The amortization will be allowed in equal installments over the license period.

Disallowance of Expenditures Incurred in Connection with Exempt Income

Currently, under the domestic tax law, no deduction is allowed for expenses incurred in connection with earning income that is exempt from tax. In the absence of a one-to-one correlation between exempt income and the expenditure specifically incurred to earn such income, tax officers generally disallow a part of the total expenses claimed as a deduction by the taxpayer based upon a formula for computing the disallowance. In certain fact patterns, the amount of the disallowance can be greater than the actual expenditure incurred. This has been a long standing topic of dispute between taxpayers and tax examiners in India.

The budget announces provisions redressing the problem. The disallowance will be computed at 1% of average monthly value of investments yielding exempt income and will be capped at the amount of the actual expenditure. Implementation rules will be announced in coming months.

Phasing out of Deductions and Incentives

Certain profit-linked deductions and exemptions, included weighted deductions, will be phased out under the budget. In addition, the highest rate of depreciation will be restricted to 40% with effect from April 1, 2017.

Tax Dispute Resolution Scheme

In order to reduce the huge backlog of pending appeal matters, a new scheme for resolution of disputes will be introduced. The scheme relates to "tax arrears" in respect of matters pending before the first level appellate authority and "specified taxes" in respect of pending matters relating to retrospective amendments, as of February 29, 2016, and provides as follows:

Tax Arrears

- If the declarant pays the entire disputed tax demand plus interest up to the date of the scrutiny order, it will be deemed that the appeal has been withdrawn, and the taxpayer will be granted immunity from penalty and prosecution, subject to exceptions in the following paragraphs.
- If the disputed tax liability exceeds I.N.R. 1 million (approximately $15,000), a 25% minimum penalty will be due in addition to tax and interest.
- In the case of pending appeals against a penalty order, a 25% minimum penalty will be due in addition to tax and interest payable.

Specified Taxes

- The taxpayer will be required to pay the amount of disputed tax and will be granted immunity from interest, penalty, and prosecution.
- The taxpayer will be required to withdraw the relevant appeals, notices, or claims filed with an authority.

The proposed dispute resolution scheme will be effective from June 1, 2016.

Income Declaration Scheme, 2016

A new scheme will be introduced to provide an opportunity for taxpayers to disclose previously undisclosed domestic income, pertaining to the period up to F.Y. 2015-16. Tax will be payable at 30% on such income along with a 7.5% surcharge and a 7.5% penalty, resulting in an effective tax rate of 45%.

The proposed amendment will be effective from June 1, 2016, and the scheme will remain open till a date that will be notified subsequently.

Various other measures are proposed with a view to rationalize and simplify the taxation system and to transition toward a non-adversarial tax regime.

INDIRECT TAX PROPOSALS

Service Tax

- The 0.5% *Krishi Kalyan* cess has been introduced with effect from June 1, 2016 on all taxable services. Thus, the effective tax rate on services will be 15% considering the basic rate of service tax as well as the *Swachh Bharat* cess of 0.5%, which was introduced from November 15, 2015.
- Service tax exemptions in respect of the following services are withdrawn:
    - Construction services in respect of monorail and metro projects, to be taxed at a basic rate of 5.6% after abatement

- Air conditioned stage carriages, to be taxed at a basic rate of 5.6% (in line with service tax on contract carriages)
  - Transport by cable car, ropeway, and tramway, to be taxed at 14%[3]
- Exemptions are given to the following services:
  - Housing projects under affordable housing schemes (*i.e.*, 30m² in four metropolitan areas and 60m² in other areas) are exempt as of March 1, 2016.
  - Services rendered by Pension Fund Regulatory and Development Authority/Employees Provident Fund Organization/Insurance Regulatory and Development Authority of India and S.E.B.I. are exempt as of April 1, 2016.[4]
  - Government-sponsored cold chain, biotechnology, and vocational training and cultural projects are exempt as of April 1, 2016.

"The 0.5% Krishi Kalyan cess has been introduced with effect from June 1, 2016 on all taxable services. Thus, the effective tax rate on services will be 15% considering the basic rate of service tax as well as the Swachh Bharat cess of 0.5%."

- A single premium insurance policy will attract service tax at 1.4%, rather than the existing 3.5% rate, from April 1, 2016.
- Service tax is levied on Indian shipping lines along with the full input tax credit ("I.T.C.") available, so as to ensure parity with foreign shipping lines.
- Service tax is levied on a receipt basis and payment of service tax is made on a quarterly basis for One Person Companies ("O.P.C.'s") and Hindu Undivided Families ("H.U.F.'s").
- The C.E.N.V.A.T. credit rules have been amended to give an option to banks and financial institutions to either reverse 50% of I.T.C. or reverse only part of the credit in proportion to exempt service turnover *vis a vis* total turnover.
- A clarification had been made that the allocation of radio frequency spectrum by the Indian government will be a taxable service and not a sale of intangible goods.
- Further clarifications include mutual exclusivity of application of service tax and excise duty on one taxable event.
- Interest rates and abatements have been rationalized in line with those applicable to customs duty and excise duty payments, except when the taxpayer has collected and not paid the service tax, in which case the rate of interest is increased to 24% per annum.
- The limit for prosecution for wrongful withholding of service tax has been increased to I.N.R. 20 million (approximately $300,000), from I.N.R. 10 million (approximately $150,000) under prior law.
- The limitation period for under-collection or underpayment of service tax has been extended from 18 months to 30 months when not attributable to fraud, collusion, or misrepresentation.

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[3] This will increase costs for tourists and hence may be a retrograde step, in so far as promoting India as a tourism destination is concerned.

[4] Previously only services rendered by the R.B.I. were exempt.

Excise Duty

- An infrastructure cess in the range of 1% to 4% will be levied on all motor vehicles, depending on the length of the motor vehicle, engine capacity, etc.
- The clean environment cess will be increased from I.N.R. 200 (approximately $3) per ton to I.N.R. 400 (approximately $6) per ton.

SUMMARY

Budget 2016-17 demonstrates the government's intent to promote balanced, long-term growth in India through fiscal discipline, infrastructure development, job creation, and tax and financial sector reforms. In particular, the focus on infrastructure projects has been praised by IMF chief Christine Lagarde.[5] Although Budget 2016-17 does not contain broad provisions aimed at attracting large multinational enterprises, it offers a number of more modest proposals, such as tax incentives to encourage investment through R.E.I.T.'s and Inv.I.T.'s, easing of restrictions on foreign direct investment, and benefits for start-ups and manufacturing businesses, which will strengthen the private sector and position India for sustainable, high growth rates on par with major global economies such as the U.S. and China.

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5 "India's Fiscal Stance Sensible: IMF's Christine Lagarde," NDTV, March 13, 2016, where Ms. Lagarde is quoted as saying:

> We consider that the fiscal stance adopted by India is exactly appropriate and a very sensible objective that has been set. It's just the right one that has been set under the given circumstances.

B.E.P.S. INITIATIVE SPAWNS UNFAVORABLE PERMANENT ESTABLISHMENT COURT DECISIONS

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Tags
India
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INTRODUCTION

Over the past few months, two court decisions in different parts of the world found that a permanent establishment ("P.E.") existed in structures that appeared to be risk free. These decisions serve as warnings that reliance on the business profits and P.E. articles of an income tax treaty may have to be rethought. The provisions may not provide benefits when most needed: during the course of a tax examination abroad.

TOKYO DISTRICT COURT JUDGED PRODUCT SHIPPING FACILITY FOR ONLINE SHOPPING SERVICES AS A P.E.

Background

Sometimes, it is dangerous to anticipate that a standard provision of an income tax treaty will be applied in a straightforward way to achieve a desired goal. This was recently illustrated by a Tokyo district court case that was asked to apply one of the more prevalent provisions of an income tax treaty.

The case apparently ignored the plain meaning of the of the Japan-U.S. Income Tax Treaty ("the Treaty"), and expanded its interpretation to conclude that a storage facility for inventory could rise to the level of a P.E. The case involved the following fact pattern:

- A U.S. resident operated an online shopping service directed to Japanese customers. It rented an apartment and warehouse in Japan (hereinafter the "Japanese Facilities") in order to store products prior to their shipment to Japanese customers. All orders were placed through the internet.
- The Japanese tax authorities asserted that the U.S. resident was taxable on the resulting business income because the Japanese Facilities qualified as a P.E. under the Treaty.
- The taxpayer asserted that the Japanese Facilities used for storage and delivery purposes could not qualify as a P.E. because they were maintained for preparatory or auxiliary purposes.

The court affirmed the position of the Japanese tax authorities and held that the Japanese Facilities amounted to a P.E. under the Treaty.

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Treaty Provisions

Article 7 (Business Profits) of the Treaty addresses the threshold of contact with Japan that must exist before a U.S. tax resident may be taxed on its business profits. Paragraph 1 provides as follows:

> The profits of an enterprise of a Contracting State shall be taxable only in that Contracting State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in that other Contracting State but only so much of them as is attributable to the permanent establishment.
>
> Article 5 (Permanent Establishment) of the Treaty addresses facts that must exist in order for a U.S. resident to be considered to maintain a P.E. in Japan. The starting point is the general rule in paragraph 1: For the purposes of this Convention, the term 'permanent establishment' means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Paragraph 2 contains specific examples of facts that would be considered to comprise a P.E.:

> The term 'permanent establishment' includes especially
>
> a) a place of management;
>
> b) a branch;
>
> c) an office;
>
> d) a factory;
>
> e) a workshop; and
>
> f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

Paragraph 4 contains express exclusions from P.E. status for certain places of business that are used for preparatory and auxiliary purposes. It provides as follows in pertinent part:

> Notwithstanding the preceding provisions of this Article, the term 'permanent establishment' shall be deemed not to include
>
> a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
>
> b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
>
> * * *

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

The Technical Explanation prepared by the Treasury Department in connection with the approval process in the Senate explains the exception in the following way:

> This paragraph contains exceptions to the general rule of paragraph 1, listing specific activities that may be carried on through a fixed place of business, but which nevertheless do not create a permanent establishment. The use of facilities solely to store, display or deliver merchandise belonging to an enterprise does not constitute a permanent establishment of that enterprise. The maintenance of a stock of goods belonging to an enterprise solely for the purpose of storage, display or delivery, or solely for the purpose of processing by another enterprise does not give rise to a permanent establishment of the first-mentioned enterprise. * * * Subparagraph 4(f) provides that a combination of the activities described in the other subparagraphs of paragraph 4 will not give rise to a permanent establishment if the combination results in an overall activity that is of a preparatory or auxiliary character. This combination rule, derived from the OECD Model, differs from that in the U.S. Model. In the U.S. Model, any combination of otherwise excepted activities is deemed not to give rise to a permanent establishment, without the additional requirement that the combination, as distinct from each constituent activity, be preparatory or auxiliary. If preparatory or auxiliary activities are combined, the combination generally also will be of a character that is preparatory or auxiliary. If, however, this is not the case, a permanent establishment may result from a combination of such activities.

Issue Presented

The issue presented to the court was whether the Japanese Facilities have a "preparatory or auxiliary character." Presumably, that was because both a stock of goods and a storage facility were maintained. The court held that the Japanese Facilities were not of a "preparatory or auxiliary character" based on the following facts:

- The U.S. resident conducted sales activities in the Japanese Facilities as sales offices, even though all sales were placed on the U.S. entity's website.
- Employees actually performed important operations of the online shopping service in the Japanese Facilities, such as the storing, wrapping, and shipment of products and the receipt of returned products.[1]

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[1] Judged on May 28, 2015.

Analysis

Critical to the judge's ruling was the fact that the U.S. resident emphasized on its website, which was written entirely in Japanese, that the U.S. business could deliver goods imported from the U.S. soon after a purchase order was placed. The judge acknowledged that such quick delivery was possible because the Japanese Facilities stored goods imported from the U.S. beforehand. In order to fulfill one of the conditions of the service's contract with their customers, *i.e.*, that they would deliver goods quickly, the Japanese Facilities were playing an important role for the online shopping service provided by the U.S. resident, and as such, their character was beyond preparatory or auxiliary.

The logic of the court is somewhat unique. The Treaty does not limit the exclusion for storage facilities that are slow, or that ship goods in unwrapped condition, or only in packages with delivery addresses written in English. Yet the court seemed to distinguish storage facilities that are effective and that store inventory prior to sale to Japanese customers from other storage facilities. Presumably, efficiency is the enemy of preparatory or auxiliary activity. U.S. businesses are cautioned that neither the Japanese tax authorities nor the courts are willing to allow competition from businesses designed to be efficient, and nothing in the Treaty will be applied to the contrary.

BROADCASTER'S TAX LIABILITY IN INDIA BASED ON P.E. RULES

An Indian tax court, the Mumbai Bench of the Income Tax Appellate Tribunal ("I.T.A.T."), held that a U.S. broadcaster owes tax to India on the income generated from the independent sale of advertising airtime by its Indian network subsidiary because such subsidiary is considered a dependent agent and constitutes a P.E. of the broadcaster. Despite the existence of principal-principal contractual provisions and arm's length payments, the court in *NGC Network Asia LLC v. Joint Director of Income Tax*[2] found that the entities had a principal-agent relationship. The tax liability created by this principal-agent characterization is expected to impact how foreign broadcasters enter into contracts and advertise in India.

The case involved NGC Network Asia LLC Co. ("NGC Asia"), which is a Delaware subsidiary of U.S. Fox Entertainment Group, Inc., and the Indian tax authority. NGC Asia owns the television channels National Geographic and Fox International, which the company broadcasts in India as well as other countries. NGC Asia entered into an advertisement sales agreement with one of its subsidiaries, NGC Network (India) Private Limited ("NGC India"), in which NGC Asia sold to NGC India the rights to distribute its two television channels and to sell advertising airtime in exchange for a lump sum. Under the agreement, NGC India made arm's length payments to NGC Asia for the income derived from the distribution rights and from the advertising profits. The agreement provided that NGC India bear all the risks for the sale of advertising airtime as well as determine the terms of the airtime sales to advertisers. NGC Asia and NGC India intended to establish a principal-principal arrangement and viewed NGC India as an independent agent.[3]

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2 *NGC Network Asia LLC v. Joint Director of Income Tax*, ITA No. 7994/Mum/2011.

3 Amrit Dhillon, "Foreign Broadcasters Risk PE Findings After Indian Ruling," *BNA International Tax Monitor*, January 15, 2016.

“The tax liability created by this principal-agent characterization is expected to impact how foreign broadcasters enter into contracts and advertise in India.”

NGC Asia did not regard NGC India as a P.E. and therefore considered its income from the sale of distribution rights and airtime to NGC India to be excluded from tax. However, the Indian tax authority determined that NGC India is a dependent agent P.E. of NGC Asia and, as such, NGC Asia’s income from the sale of distribution rights and advertising airtime was taxable in India. The tax authority also determined that “advertisement airtime” does not constitute goods that can be sold because “time” cannot be stocked or delivered in advance, or in this case, cannot be separated from the channel airing the advertisement.[4] NGC Asia challenged the determination and the case went up to the I.T.A.T. in Mumbai.

The I.T.A.T. agreed with the Indian tax authority, and on December 16, 2015, it that since the agreements NGC India entered into in India were binding on NGC Asia, NGC India is a dependent agent P.E. of NGC Asia.[5]

The court affirmed that airtime is not capable of sale and that NGC India is an agent dependent on NGC Asia because NGC India cannot use the advertising airtime without NGC Asia’s transfer of rights.[6] Thus, the court held that NGC Asia and NGC India have a principal-agent relationship, despite the fact that the advertising sales agreement intended to establish a principal-principal relationship between the companies.

The I.T.A.T. further refuted NGC Asia’s reliance on *DIT v. Morgan Stanley & Co.*[7] and its argument that the arm’s length payments by NGC India did not trigger a tax obligation for NGC Asia, even if NGC India is a P.E. The I.T.A.T. stated that *DIT v. Morgan Stanley & Co.* is limited to the situation in which a foreign company makes payments to its associated entity or P.E. in India – it does not apply to an entity in India making payments to an associated entity abroad.[8]

NGC Asia will probably appeal the I.T.A.T.’s decision in the Mumbai High Court. In the meantime, however, the tax court’s decision creates uncertainty about tax liability for foreign broadcasters selling advertising airtime in India and concerns that a contractual principal-principal relationship will be viewed as principal-agent with an Indian P.E.

CONCLUSION

Emboldened by the O.E.C.D.’s attack on base erosion and profit shifting (“B.E.P.S.”), tax authorities are looking at new ways to assert the existence of a permanent establishment. In the Japanese case, it was web-based advertising in the Japanese language, combined with a local delivery service. In India, it was furnishing media content to a local subsidiary. Tax advisers who remember the world before the B.E.P.S. initiative are likely surprised by these cases. Nonetheless, in a post-B.E.P.S. world, they may represent the new normal.

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4 *Id.*

5 *Id.*

6 *Id.*

7 *DIT v. Morgan Stanley & Co.*, (2007) 292 ITR 416 (SC).

8 Dhillon, “Foreign Broadcasters Risk PE Findings After Indian Ruling.”

THE MEANDERINGS OF THE TAXATION OF U.K. REAL ESTATE: WHERE ARE WE GOING?

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Tags
Capital Gains
Real Estate
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INTRODUCTION

A striking feature of the U.K. tax landscape has been the recent introduction of significant changes to the taxation of real estate. Residential property in particular (as opposed to non-residential or "mixed" property – see further below) has borne the brunt of the attack.

Where governments make choices about who, what, and how much to tax, tax policy becomes an emotive issue, never more so than now. It is the area of a government's political strategy that has the most direct and immediate effect on a citizen's pockets. These decisions tend to have a rather focusing effect – an effect that is compounded in this case because the tax in question is on an Englishman's home (or a Welshman's, etc. – you get my drift), which is his castle, as the adage goes. It also affects the desirability of local real estate to foreign investors, whether considering it for personal use or as investment real property.

THE FISCAL SIGNIFICANCE OF PROPERTY

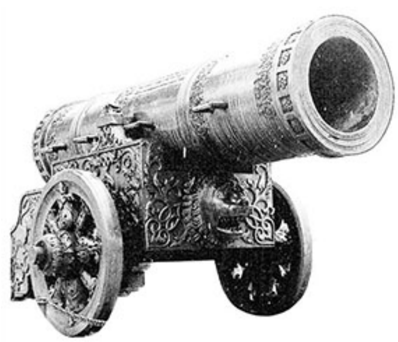
The U.K. housing market is one of the key barometers of the country's economic health. Over the long term, capital growth in real estate can be counted upon to outstrip many other forms of investment. Land is one of the few commodities that is genuinely finite in nature. We cannot produce more of it, and in the U.K., it is in relatively short supply. We Brits have enjoyed an enduring love affair with property ownership, in particular since the 1980's and the introduction of the "right to buy."

One feature that has become increasingly significant for governments seeking to raise funds in the current climate is that real estate is immoveable. This is hugely significant in a world that has seen exponential growth in international mobility, both in terms of persons and assets.

The global environment is increasingly mobile, yet taxing rights are fundamentally territorial in nature. Governments therefore compete with each other to attract mobile capital with occasionally aggressive competitive tax regimes and beneficial economic environments. The initiatives of supranational organizations, such as the E.U. and O.E.C.D., that look to provide for a fair allocation of taxing rights are increasingly important. However, the internal infrastructure and processes of these organizations are necessarily cumbersome, and the results, although astonishing under the circumstances, lag behind the changing economic landscape. In the interim, each government does what it can to tax what it perceives to be its fair share of the global tax base.

In this context, real estate is the dream asset – it is by its very nature immoveable. If an investor wants U.K. real estate, he or she will have to succumb to the U.K. tax authorities. It is perhaps not surprising that the U.K. government wants to cash in on gains arising from this immovable asset.

THE GROWING TAX ARSENAL



What follows in this section is a gallop through some of the recent changes to the taxation of U.K. property, in chronological order (according to the date of entry into force of each). Although not exhaustive, the discussion addresses some of the more significant measures.

March 2012: S.D.L.T. on Enveloped Dwellings

The first of the recent fiscal assaults began in March 2012 with the higher rate of stamp duty land tax ("S.D.L.T.") for "enveloped" dwellings. Very broadly, S.D.L.T. is the tax that is paid by a purchaser on the acquisition of interests in property. It is payable at various rates on the "chargeable consideration" (generally equal to the purchase price).

At the time of the reform, the U.K. Conservative-Liberal Democrat coalition government was (and it appears the Conservative Party government still is) concerned with dissuading the acquisition and holding of real property by non-natural persons. In significant part, this was because the stamp taxes attributable to a transfer of shares in a company holding property (for example) are likely to be considerably less than the S.D.L.T. attracted by a transfer of the underlying property itself.

The effect of the changes was to increase the rate of S.D.L.T. to a flat 15% on the acquisition of residential property by a non-natural person. By comparison, the rates of S.D.L.T. for residential property at the time ranged from 0% to 7%. In the context of commercial or "mixed" property, the rate was (and still is) a flat 4%.[1] At the time that the changes were introduced, the provisions applied only to purchases where the chargeable consideration exceeded £2 million. The government could therefore assure its public that the measure would affect only the very wealthy.

Inevitably, however, the enemy settled in and spread out – mission creep. The threshold has now been significantly reduced so that the inflated rate applies to non-natural persons acquiring residential property with a value of £500,000 and over. In many parts of the U.K., £500,000 is a depressingly insignificant trigger point. Although there are a series of exemptions to the increased S.D.L.T. charge for acquisitions by non-natural persons, they are often complex and in some cases produce anomalous results.

APRIL 2013: A.T.E.D. AND A.T.E.D.-RELATED CAPITAL GAINS

A further attack came in April 2013 with the introduction of the Annual Tax on

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1 These rates are quite high when compared to the acquisition of a comparable residential property in New York City. There, the city imposes a comparable tax of 1% of the value of the property (1.45% if the value exceeds $500,000), and the state imposes one tax on the seller of $2 for each $500 or fractional part thereof (essentially a tax of 0.4% of value) and a second tax on the purchaser of 1% when the value of the residential property exceeds $1 million.

Enveloped Dwellings ("A.T.E.D."). Again, the intention was to dissuade individuals from holding high-value residential property within a corporate structure. The effect of the A.T.E.D. is to impose an annual charge on enveloped dwellings, the quantum of which is linked to the value of the property. As above, although initially the charge applied only to properties worth in excess of £2 million, this threshold was soon reduced, and with effect from April 2016, it will be £500,000.

Although the introduction of the A.T.E.D. was intended to dissuade certain behaviors, the measure proved to be a far greater revenue generator than the government had anticipated. This seems extraordinary, given that the compelling but non-verified, anecdotal evidence indicates that the vast number of non-U.K. companies holding residential property knew nothing about the charge and non-deliberate non-compliance has been widespread. If government statistics are to be believed, the well of potential tax collections runs quite deep once the A.T.E.D. requirements are more widely known.

"The effect of the A.T.E.D. is to impose an annual charge on enveloped dwellings, the quantum of which is linked to the value of the property."

Alongside the A.T.E.D., its brother was introduced – the A.T.E.D.-related capital gains charge. This is an extended capital gains tax on disposals of high-value residential property made on or after April 6, 2013 where the property is held in a corporate wrapper and is within the A.T.E.D.

December 2014: Overhaul of S.D.L.T. for Residential Property

In December 2014, the government announced a further package of reforms to the S.D.L.T. for residential property. The measures included some welcome simplifications (the end of the "slab" system of taxation, which resulted in unnecessary market distortions, was to be replaced by a progressive "slice" system), but also some less-welcome and eye-watering tax hikes, including a new top rate of 12% for acquisitions by individuals (the rate applicable to acquisitions by companies remains 15%). Again, the measures applied (and continue to apply) only to residential property.

April 2015: Capital Gains Tax on Residential Property for Non-U.K. Residents

In April 2015, the U.K. government introduced capital gains tax ("C.G.T.") for non-residents in respect of gains realized on U.K. residential property. This measure in particular represented a very significant shift in U.K. tax policy. Until then it had been a significant (and relatively unusual) feature of the U.K. tax system that it did not seek to impose capital gains tax in respect of U.K. property on non-U.K. tax residents. This had undoubtedly contributed to the popularity of the U.K. real estate market with offshore investors. However, the prevailing political climate meant that the economic clout of foreign investors (inevitably also non-voters) was easily eclipsed by political expedience.

April 2016: Additional 3% S.D.L.T. Rate for Second Homes

The most recently announced development (November 2015) has been the rather extraordinary and generally unforeseen announcement that the U.K. government would introduce an additional 3% S.D.L.T. surcharge on the purchase of additional residential properties (such as second homes and buy-to-let properties) for considerations exceeding £40,000, with effect from April 2016.

The announcement has been met with predictable outrage from the long-suffering property industry, together with a series of specific criticisms (not least in relation to the very rushed nature of the consultation), which has required a significantly shortened consultation period and a delay in the usual timetable for publishing the draft legislation.

Clearly the intention of the measure is to curb the rise of holiday home and buy-to-let properties. The proliferation of these properties is perceived to have caused damage to the local communities of certain areas. However, the measure goes much farther and has some rather surprising consequences. In particular, the government has confirmed that it is intended that the surcharge will apply to purchases by non-U.K. residents of a first home in the U.K. where that nonresident owns other homes worldwide. This is a pretty bold move in terms of the territoriality of a domestic tax measure. How the government intends to police this provision is unclear.

The government has also stated that married couples will be treated as a "unit" for the purposes of the legislation. Commentators have argued that this effectively penalizes married couples over cohabiting couples, since married couples will be treated as acquiring a second home and taxed accordingly, while unmarried couples may simply acquire a property each. The measure may also deter parents co-purchasing property with their children. This is an odd result for a Conservative Party measure and one which has inflamed the suggestion that the ill-thought-out consequences of some of the recent measures demonstrates a lack of coherent policy in this area. Certainly, the piecemeal and fragmented approach of recent announcements is unfortunate. Many of the measures have been forward-looking in any event, and it is not clear why the measures could not have been announced together.

"Clearly the intention of the measure is to curb the rise of holiday home and buy-to-let properties. The proliferation of these properties is perceived to have caused damage to the local communities of certain areas."

Predictably, there is some vigorous lobbying underway. It remains to be seen what form the draft legislation will be in when it is published in due course.

April 2017: Extension of I.H.T. to Indirectly Held U.K. Residential Property

Finally, as part of the 2015 Summer Budget, the government announced a number of significant reforms to inheritance tax ("I.H.T.") and the concept of domicile. Broadly, I.H.T. is a charge to tax primarily on an individual's estate on death. The rate is 0% on the nil rate band, 20% for any taxable lifetime gifts, and 40% on death. An individual who is domiciled in the U.K. is subject to I.H.T. on his or her worldwide estate. An individual who is not domiciled in the U.K. is subject to I.H.T. only in respect of his or her U.K. estate. Under current rules, U.K. property does not include shares in a foreign registered company, even where that company's only asset is U.K. land. However, with effect from 2017, "U.K. property" will include U.K. residential property, even where it is indirectly held through a foreign-registered and -resident company.

As was true for the extension of C.G.T. to non-residents, the change represents a very fundamental policy shift in the U.K.'s approach to the taxation of certain foreign nationals. Historically, the U.K. has provided an extremely hospitable economic climate to the foreign investor. The sands now appear to be shifting but only in respect of residential property, at least for the current time.

Residential vs. Non-residential: Why?

As is abundantly clear, a key feature of a number of the more penal tax developments is that they apply only to "residential" property. The economic consequences of finding that a property is residential in nature are therefore very significant. Not only will it dramatically affect the rates of S.D.L.T., it can also affect the incidence of the A.T.E.D., C.G.T., and I.H.T. Clearly, this puts huge pressure on the distinction.

So what does the term "residential property" mean? The definition largely turns on whether or not the land includes buildings suitable for use as a "dwelling." Specifically, property is regarded as residential if it comprises land and/or buildings

- used as a dwelling,
- suitable for use as a dwelling, or
- in the process of being constructed or adapted for use as a dwelling.

Note that for S.D.L.T. purposes, the higher rates apply only where the land transaction is comprised "entirely" of residential property. Where the property is mixed use (that is, it includes residential and non-residential property), the lower non-residential S.D.L.T. rates will apply.

However, the fact that part of what is otherwise a dwelling is used for business purposes does not necessarily result in a finding that the property is not residential. The key question is whether the building is suitable for use as a dwelling. The distinction is not always an easy one to make. By way of example, a five-bedroom farm house with 20 acres used for commercial agricultural purposes would be mixed use and would qualify for the lower rates. On the other hand, the same house with 20 acres of parkland and the neighbor's chickens on the field at the bottom of the drive might not.

Inevitably, a number of so-called "tax planning" schemes (some more accurately described as fairytales) seek to exploit this distinction. Some of the schemes are eye-wateringly creative and undoubtedly ineffective. We can expect increasing H.M.R.C. scrutiny in this area.

What is not clear is why the U.K. government has chosen to impose such different fiscal treatment on the basis of a distinction that is in some cases both arbitrary and esoteric, and more importantly, difficult to predict. What is it about residential property that justifies this disadvantageous treatment? Many other jurisdictions do not make the distinction at all in terms of tax treatment.

THE LAFFER CURVE

Tax specialists are sometimes reputed to be inaccessible and nerdy. (I believe my U.S. friends refer to this as "dweeb-like.") This is plainly an absurd proposition, and one which I am loathe to promote by including abstract references to academic constructs without practical purpose. Instead, I will refer simply to the Laffer Curve.

The Laffer Curve demonstrates, in diagrammatic form, the behavioral economics principle that increasing the rate of tax does not continue to result in higher tax yield; indeed, the converse is true. Although increases in rates of tax at certain levels may increase total tax take, at some point, an increase in the rate will dis-incenti*vize* the activity producing the asset. At one end of the spectrum (the beginning of the curve), the tax rate is zero, as is tax take. There may be plenty of economic activity, but no tax is levied on it. On the other side of the curve (the end), the tax rate is 100%, and the tax take is also zero. The tax rate has extinguished economic activity. This is referred to, at times, as making others pay their "fair share" of tax.

The peak of the curve is the holy grail of good tax policy. It represents the maximum level at which a government can tax any particular activity before dis-incenti*vizi*ng it to levels at which tax yields decrease. In other words, it is important to tax (in this case) property investors until Lord Healy's pips squeak, but not to continue to do so to the point of a thermonuclear explosion.

Clearly, the U.K. government feels that the U.K. real estate sector is sufficiently robust to withstand the recent fiscal assaults. In other words, it believes that the Laffer Curve applicable to residential property is still in its ascendancy. However, at some point, the zenith will be reached. What then? And who will benefit at that time? Most likely, it will be the ultra, ultra-wealthy, as only they will be immune from the tax increase.

THE REAL, IMPRECISE, AND IMPERFECT WORLD

However, economics is not the only driving force behind tax policy. Tax policy does not operate in an academic vacuum. Rather, it is formed in a rather more real, imprecise, and imperfect world, in which rather more real, imprecise, and imperfect politicians (with varying degrees of intellect, personality, and competing motives) jostle for power and position, and the maximum length of fiscal foresight tends to be pretty much around the five-year mark.

In this rather more real, imprecise, and imperfect world, tax policy makers must make decisions about who, what, and how much to tax in response to any number of domestic and global economic, social, and natural events. They must then defend these positions to the media, the lobbyists, and the ever-powerful court of public opinion. Budget Day announcements undoubtedly often owe more to extravagant political posturing than to the Laffer Curve.

As mentioned above, one of the more frequent criticisms of the recent changes has been their fragmented and piecemeal development. Where is the reasoned and coherent tax policy? However, it may be that in this rather more real, imprecise, and imperfect world, it is unrealistic and even undesirable for governments to impose rigid long-term fiscal policies. Instead, it may be that an iterative approach is the ideal. It allows policymakers to respond to the changing economic and social factors and the vagaries of the tax take. Which is not to say that policymakers should abandon efforts to design and pursue a careful and coherent tax policy, but neither should they be restricted from reacting appropriately to necessity and expedience.

The U.K. enjoys a hugely successful property industry. Under the circumstances, perhaps it is not surprising that the U.K. government has sought to exploit that fact.

WHERE TO NOW?

How is the market to make sense of it all? Clearly, the taxation of real estate in the U.K. is a fast-moving and increasingly specialized area. The intricacies of many of the relevant taxes proliferate, and their interactions can be difficult to quantify in advance. Who should invest, in what form, from what jurisdiction, and in accordance with what terms? How should the property be used? The tax practitioner may find that it is best to be agile in planning, including flexibility in that investment structures so that they may be modified on the fly in response to changes of policy.

It remains to be seen whether some of recent residential property developments will be extended to commercial and mixed property. It is also possible – maybe even likely – that the government will seek to tinker with the definition of residential property or remove it entirely.

Meanwhile, it is perhaps not surprising that we are seeing an increased appetite for investment in commercial property.

THE COMMON REPORTING STANDARD – A GLOBAL F.A.T.C.A.?

Author
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Tags
Automatic Exchange of Information
Common Reporting Standard
Global Forum
O.E.C.D.
Transparency

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STANDARD FOR AUTOMATIC EXCHANGE OF FINANCIAL ACCOUNT INFORMATION IN TAX MATTERS

The Standard for Automatic Exchange of Financial Account Information in Tax Matters (also known as the "Common Reporting Standard" or "C.R.S.")[1] is a global system of automatic exchange of information for tax purposes ("A.E.O.I."). As of January 1, 2016, financial institutions ("F.I.'s") in jurisdictions that have signed up as members of the Early Adopters Group ("E.A.G.")[2] of the C.R.S. are obligated to gather identification and residence information from new account holders to pass it to their jurisdictions' reporting authority in order to enable reporting of the accounts. By 2018, the 96 jurisdictions[3] that have adopted the C.R.S. will be exchanging information on those account holders identified as reportable between their respective reporting authorities. F.I.'s and tax authorities still need to work through all the details, but below is a brief introduction to the system, how it is expected to work, and some potential pitfalls.

What Countries Does It Affect and When?

Those jurisdictions that have adopted the C.R.S. include most of the world's major economies and financial centers, with the notable exception of the U.S. The earliest date for information exchange under the C.R.S. will be 2017[4] (for information gathered in 2016) for the 56 jurisdictions that make up the E.A.G. The remaining 40 jurisdictions are committed to commence exchange by 2018. The process starts with F.I.'s collecting information on new account holders and then expands to include information on relevant existing account holders. The system was developed by the Organization for Economic Co-operation and Development ("O.E.C.D.") and the Global Forum on Transparency and Exchange of Information for Tax Purposes ("Global Forum") to combat tax evasion in response to a request by the G-20. The aim was to build on the systems and agreements put in place to comply with the Foreign Account Tax Compliance Act ("F.A.T.C.A.") and to create a comprehensive global standard for A.E.O.I.

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1 "Standard for Automatic Exchange of Financial Information in Tax Matters." O.E.C.D. Automatic Exchange Portal - Common Reporting Standard (C.R.S.). July 21, 2014.

2 "Joint Statement by the Early Adopters Group." O.E.C.D. October 1, 2014.; "CRS by Jurisdiction." O.E.C.D.: C.R.S. Implementation and Assistance.

3 "A.E.O.I.: Status of Commitments." O.E.C.D. Global Forum on Transparency and Exchange of Information for Tax Purposes.

4 "C.R.S. by Jurisdiction." O.E.C.D.: C.R.S. Implementation and Assistance.

The U.S. is already receiving information on U.S. persons ahead of these C.R.S. deadlines. The first information exchange under its own A.E.O.I. system took place at the end of September 2015.[5] Under the U.S. system – operating under F.A.T.C.A. – the U.S. Internal Revenue Service ("I.R.S.") is provided with information on financial accounts of U.S. persons, either from F.I.'s directly or from the relevant tax authority of those foreign tax jurisdictions that have appropriate Intergovernmental Agreements ("I.G.A.'s") with the U.S. The U.S. has committed to implement a level of reciprocity under the Model 1 I.G.A.'s rather than signing up to participate in the C.R.S., but political stalemate has prevented the legislative changes necessary to make that work in practice. Among other consequences, if a jurisdiction participating in the C.R.S. deems the U.S. as non-participating, then most U.S. trusts, as well as F.I.'s that are investment entities (*e.g.*, a managed investment entity like a mutual fund), with accounts in the participating jurisdiction will have to provide information on their controlling persons, which otherwise is only required for more limited types of F.I.'s in participating jurisdictions.

How Does It Work?

The C.R.S. sets out the information that reporting authorities in participating jurisdictions should gather from F.I.'s located in those jurisdictions and that should be automatically exchanged on an annual basis with other participating jurisdictions. This information broadly consists of details of financial assets that are held by the F.I.'s on behalf of taxpayers that are resident in other participating jurisdictions, provided that the reporting authority has in place an agreement for the exchange of tax information. F.I.'s report to the reporting authority in the participating jurisdiction in which they are located. The consequences of non-compliance are left to the participating jurisdictions to specify in domestic legislation.

The Documentation

The system is made up of components. First, there is the 'Model' Competent Authority Agreement ("C.A.A.")[6] (a bilateral and reciprocal agreement based on the F.A.T.C.A. Model 1 I.G.A.), which provides the international legal framework[7] for A.E.O.I. under the C.R.S. The Common Reporting and Due Diligence Standard[8] sets out the reporting and due diligence requirements, and is known as the Common Reporting Standard or "C.R.S." This can cause confusion because the acronym C.R.S. is also commonly used to refer to the Common Reporting Standard as a whole. Finally, there is a "User Guide"[9] for the C.R.S. XML Schema and Commentaries.[10] The Schema may need to change in the future as the system evolves. To overcome the potential legal difficulties this would create, in December 2015, the O.E.C.D. agreed on a plan to work out a system for adopting future changes (see below).

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5 The first information exchange under reciprocal I.G.A.'s, took place by the September 30, 2015 deadline.

6 "Commentaries on the Common Reporting Standard." O.E.C.D.

7 "The C.R.S. Multilateral Competent Authority Agreement." O.E.C.D.: International Framework for the CRS.

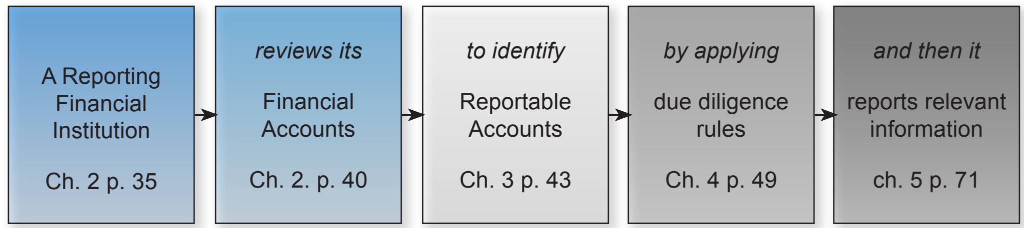
8 "Commentaries on the Common Reporting Standard." O.E.C.D.

9 "Common Reporting Standard User Guide and Schema." O.E.C.D.

10 "Commentaries on the Common Reporting Standard." O.E.C.D.

What Is Required of F.I.'s?

The A.E.O.I. process for the C.R.S. is set out in the component documents above, but the O.E.C.D. has also prepared the C.R.S. *Implementation Handbook*[11] (the "Handbook"), which explains the basics simply and clearly in "Part II: Overview of the C.R.S. and Due Diligence Rules."[12] Put simply, F.I.'s in jurisdictions that participate in the C.R.S. will need to follow the steps in the diagram below.



Guidance on exactly how to implement these steps may be found at each chapter of the Handbook referenced in the diagram above, with step-by-step flow charts on identifying Reporting Financial Institutions, Financial Accounts, and Reportable Accounts as well as the various due diligence rules to be applied depending on the nature of the account as new or pre-existing (open before January 1, 2016) and the nature of the holder as an entity or individual.

"F.I.'s should advise clients and account holders that they must provide their details to the F.I. and that data will be made available to tax authorities in the client's jurisdiction of residence."

F.I.'s should advise clients and account holders that they must provide their details to the F.I. and that data will be made available to tax authorities in the client's jurisdiction of residence. While there is considerable overlap between F.A.T.C.A. and the C.R.S., information, systems, and processes that F.I.'s have established to comply with F.A.T.C.A. will need to be adapted if they are to be used for the C.R.S. The C.R.S. covers more accounts and entities than F.A.T.C.A., and there is some flexibility on which accounts are included (*e.g.*, individual jurisdictions can define which accounts are low-risk) so there is a real possibility of jurisdictional variations for reporting. Also, jurisdictions are free to decide the format by which F.I.'s will report information. Although the Handbook suggests jurisdictions use the C.R.S. Schema (which is virtually identical to the F.A.T.C.A. XML Schema) to avoid the need for significant additional investment on the part of governments or F.I.'s, it is not mandatory and F.I.'s will need to confirm the approach taken by the appropriate jurisdiction.

Timetable

F.I.'s in E.A.G. countries will have prepared their I.T. and administrative systems to deal with the requirements for new account-opening procedures from January 1, 2016. For E.A.G. jurisdictions, the timetable is as follows:

1. F.I.'s will be required to have account-opening procedures in place to record tax residence for all new accounts opened from January 1, 2016.
2. Pre-existing accounts are those already open on December 31, 2015.
3. Due diligence identifying high-value, pre-existing individual accounts must be

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11 "The C.R.S. Implementation Handbook," O.E.C.D.

12 *Id.*, p. 34.

complete by December 31, 2016.

4. Due diligence for low-value, pre-existing individual accounts and entity accounts must be complete by December 31, 2017.

5. First reporting of information gathered in 2016 is expected in 2017.

As an example of the preparations being made in E.A.G. countries, in the author's jurisdiction of the Cayman Islands (which is a founding member of the E.A.G.) the Cayman Islands Department of International Tax Co-operation of the regulatory authority, the Cayman Islands Monetary Authority, has introduced regulations[13] and set up an A.E.O.I. Portal[14] to allow F.I.'s to monitor progress.

For jurisdictions that are not in the E.A.G., the timetable for collecting the same information is extended through 2017, with reporting scheduled to commence in 2018.

What Is the Domestic Legal Basis of the C.R.S.?

To create any global standard, the information gathering and exchange mechanisms need to be incorporated into the legal system of each participating country. This means that the jurisdictions that have signed up to participate in the C.R.S. have been bringing in new or adapting existing legislation to ensure that F.I.'s report the required information on the relevant financial assets that are held. The four core requirements for governments to implement the C.R.S. are as follows:

1. Translating the reporting and due diligence rules into domestic law, including rules to ensure their effective implementation (including penalties and sanctions)

2. Selecting a legal basis for the automatic exchange of information

3. Putting in place I.T. and administrative infrastructure and resources

4. Protecting confidentiality and safeguarding data

The approach to protecting the confidentiality and integrity of the data being exchanged may differ for each jurisdiction. There is non-mandatory guidance offered by the O.E.C.D. in its guide *Keeping it Safe*[15] from July 2012. In it, the O.E.C.D. sets out best practices and gives practical guidance (including a checklist) on what steps jurisdictions should take to protect the confidentiality of tax information. This protection is important, as jurisdictions can withhold information based on the fact that they consider it will not be safe in the destination jurisdiction.

What Is the International Legal Basis?

To reduce the number of F.I.'s providing information to the I.R.S. directly, the U.S.

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13 "The Tax Information Authority (International Tax Compliance) (Common Reporting Standard) Regulations, 2015." Cayman Islands Department for International Tax Cooperation. October 16, 2015.

14 "AEOI News & Updates." Cayman Islands Department for International Tax Cooperation.

15 "Keeping It Safe: The O.E.C.D. Guide on the Protection of Confidentiality of Information Exchanged for Tax Purposes." O.E.C.D.

developed Model I.G.A.'s, which allowed governments to collect information from the F.I.'s that is then provided to the U.S. in bulk. The C.R.S. provides for an alternative to multiple bilateral tax information exchange agreements. The O.E.C.D. and Global Forum drafted a Multilateral Convention on Mutual Administrative Assistance in Tax Matters ("M.A.C.") that jurisdictions may sign. This provides a legal gateway for the exchange of tax information between all countries and jurisdictions that have signed up for the C.R.S. As of October 29, 2014, 51 jurisdictions signed the Model C.A.A. for A.E.O.I. based on Article 6 of the M.A.C. – there are now 89 jurisdictions covered by the M.A.C. and 74 by the Model C.A.A.[16] To help F.I.'s understand how far along a jurisdiction is in the implementation of the C.R.S., the O.E.C.D.'s A.E.O.I. Portal has an overview of the current state of implementation for all committed G-20/O.E.C.D. member countries, which is contained in a single table.[17]

Future Changes to the C.R.S. XML Schema

On December 1, 2015, the O.E.C.D. agreed[18] to plan to consider, review, and adopt future changes to the C.R.S. XML Schema that would allow it to evolve over time. This came after the European Commission asked for the inclusion of three additional fields and a value in the C.R.S. XML Schema, which highlighted the potential legal issues involved in making such a change (*e.g.*, changes to the C.A.A.). The plan is for a substantive review of the experiences of tax authorities during the first exchange and use of the C.R.S. information in 2017 and 2018 (as well as the early exchanges of information under the F.A.T.C.A. I.G.A.'s) in order to see what other technical changes to the C.R.S. XML Schema might be needed.

"The C.R.S. asks for different data and will affect significantly more accounts than F.A.T.C.A., as it has no universal minimum level of pre-existing individual account holding below which due diligence by F.I.'s is not required."

So, Is It Really Any Different from F.A.T.C.A.?

The C.R.S. was designed to build on the agreements and systems put in place by governments and F.I.'s to comply with F.A.T.C.A. The goal was to create an effective new international standard at a minimal cost to F.I.'s and governments.

However, F.A.T.C.A. is U.S.-specific and its I.G.A.'s were unsuitable for a global standard, so changes were made.[19] The use of citizenship as an indication of tax residence and references to U.S. domestic law were changed, as were approaches that were more suited to the bilateral context of F.A.T.C.A. I.G.A.'s rather than the multilateral context of the C.R.S. The use of F.A.T.C.A. regulation definitions in the C.R.S. should help those working with both systems, but not all definitions are the same. This will create practical problems and operational challenges for F.I.'s. These include identifying which entities need further investigation for the C.R.S. and reporting entities with controlling persons that have a different tax residency than the entity.

The C.R.S. asks for different data and will affect significantly more accounts than F.A.T.C.A., as it has no universal minimum level of pre-existing individual account

16 "Statement of Outcomes." O.E.C.D.: Global Forum on Transparency and Exchange of Information for Tax Purposes. October 30, 2015.

17 "C.R.S. by Jurisdiction." O.E.C.D.: C.R.S. Implementation and Assistance.

18 "Statement of Outcomes by Working Party No. 10 on the EU Proposal on the Addition of Fields to the CRS XML Schema." O.E.C.D. December 1, 2015.

19 The Handbook offers detailed comparisons at p. 84, "Part III: The Standard compared with F.A.T.C.A. Model 1 I.G.A.," and p. 22, ¶36, "Differences to F.A.T.C.A."

holding below which due diligence by F.I.'s is not required. Regarding non-compliance, the F.A.T.C.A. threat of withholding from a non-compliant F.I.'s own money does not apply, but each participating jurisdiction will legislate its own non-compliance penalties.

The C.R.S. covers accounts held by individuals and entities, including trusts and foundations, and the information it covers includes balances, interest, dividends, and sales proceeds from financial assets. Some C.R.S. due diligence procedures will require manual checks to confirm information with paper-based documentary evidence. Without an agreed, standard form of self-certification, each jurisdiction is free to ask F.I.'s for more information than the minimum, causing duplication in the preparation of information on account holders in order to meet the information and presentation requirements of different jurisdictions.

Further Help from the O.E.C.D. and Global Forum

To back up the formal documentation of the C.R.S., the O.E.C.D. recently launched a new A.E.O.I. Portal[20] to give tax administrations and F.I.'s the information and legal, administrative, and I.T. tools that may be needed. It has published detailed F.A.Q.'s[21] and a second edition of its *Offshore Voluntary Disclosure Programmes*[22] with updated guidance on the design and implementation of voluntary disclosure programs based on the practical experience of 47 countries, including the views of private client advisers. The Global Forum has also been monitoring how jurisdictions that have signed up for the C.R.S. are implementing the commitments they have undertaken.

Beneficial Ownership Registers and the C.R.S.

There has been much discussion of beneficial ownership public registers, and it is significant that the Global Forum will include in its next round of peer reviews the examination of a jurisdiction's ability to provide beneficial ownership information.[23] This is not something that arises from the C.R.S. In fact, the C.R.S. does not actually refer at all to beneficial ownership, but rather to controlling persons. There is nothing in the C.R.S. that requires the setting up of a register, public or otherwise, for any of the information collected by F.I.'s and passed to the relevant reporting authority.

The driver for establishing beneficial ownership registers comes from the G-20 High-Level Principles on Beneficial Ownership Transparency,[24] which includes the provision that

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20 "A.E.O.I. Portal." O.E.C.D.

21 "C.R.S.-related F.A.Q.'s." O.E.C.D.

22 "Update on Voluntary Disclosure Programmes: A Pathway to Tax Compliance." O.E.C.D. August 1, 2015.

23 "Statement of Outcomes." O.E.C.D.: Global Forum on Transparency and Exchange of Information for Tax Purposes. October 30, 2015.; "Global Forum on Tax Transparency Pushes Forward International Co-operation against Tax Evasion." O.E.C.D. Newsroom. October 30, 2015.

24 "G20 High-Level Principles on Beneficial Ownership Transparency." G-20.: 2014.; "Update to Article 26 of the O.E.C.D. Model Tax Convention and Its Commentary." O.E.C.D. July 17, 2012.

> “A global system of A.E.O.I. to attempt to defeat tax evasion is an ambitious idea, which goes far beyond F.A.T.C.A.”

> [c]ountries should ensure that competent authorities (including law enforcement and prosecutorial authorities, supervisory authorities, tax authorities[,] and financial intelligence units) have timely access to adequate, accurate[,] and current information regarding the beneficial ownership of legal persons. Countries could implement this, for example, through central registries of beneficial ownership of legal persons or other appropriate mechanisms.

The Global Forum is the premier international body for ensuring the implementation of the internationally agreed upon standards of transparency and exchange of information in tax matters. Through an in-depth peer review process, it monitors its members to ensure that they fully comply with the standard of transparency and exchange of information to which they have committed. This monitoring covers C.R.S. compliance as well as other commitments, such as those under a Tax Information Exchange Agreement (“T.I.E.A.”). Under T.I.E.A.’s, there is an exchange of information on request (“E.O.I.R.”) mechanism. At a meeting[25] held at the end of October 2015, the Global Forum created a new framework for the second round of Phase 2 peer reviews on exchange of information. The new 2016 terms of reference[26] include a requirement that

> [j]urisdictions should ensure that ownership and identity information, including information on legal and beneficial owners, for all relevant entities and arrangements is available to their competent authorities.

The U.K. and the E.U. have chosen to meet their commitment to ensure “timely access to adequate, accurate[,] and current information regarding the beneficial ownership of legal persons” by implementing public registers. Other countries, such as the Cayman Islands, meet the same obligation by ensuring their regulatory bodies have the information available from the formation of the relevant entities, and valid requests for such information can be, and are, responded to in a timely fashion. The C.R.S. will not require any change to this commitment or the way it is met by participating jurisdictions. It will, in fact, require assessment of slightly different criteria to identify controlling persons for some entities.

CONCLUSION

A global system of A.E.O.I. to attempt to defeat tax evasion is an ambitious idea, which goes far beyond F.A.T.C.A. It remains to be seen whether, and how, the dual F.A.T.C.A. and C.R.S. systems for A.E.O.I. will continue on their parallel paths. It will be interesting to see whether or not the two systems will gradually converge, and how the fact that the U.S. is not a participating C.R.S. country and isn’t legally able to require U.S.-based F.I.’s to collect the relevant information on account holders will play out in practice.

With 96 jurisdictions committed to A.E.O.I. through the C.R.S. system, it is a certainty

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25 “Statement of Outcomes.” O.E.C.D.: Global Forum on Transparency and Exchange of Information for Tax Purposes. October 30, 2015.; “Global Forum on Tax Transparency Pushes Forward International Co-operation against Tax Evasion.” O.E.C.D. Newsroom. October 30, 2015.

26 “Tax Transparency 2015: Report on Progress.” O.E.C.D.: Global Forum on Transparency and Exchange of Information for Tax Purposes. 2015, p. 33.

that F.I.'s will be asking their clients for more information in order to establish the clients' residence and then report their account information to the tax authority of their residence (through the F.I.'s tax authority). This will happen in every jurisdiction where the client has a reportable account and, as what is asked may differ slightly from jurisdiction to jurisdiction, it will be difficult to apply a "one size fits all" approach to due diligence/"know your client" requirements. These are early days for the C.R.S., but like F.A.T.C.A., it is here to stay in one form or another, and it is already operating in E.A.G. jurisdictions. Even though the U.S. is not a participating jurisdiction, the C.R.S. will still have an impact on some F.I.'s located there and it must still be taken it into account.

THE 2016 MODEL INCOME TAX TREATY

U.S. TREASURY ANNOUNCES NEW U.S. MODEL INCOME TAX CONVENTION

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Tags
B.E.P.S.
Double Non-taxation
Expatriated Entity
Limitation on Benefits
Mandatory Arbitration
Special Tax Regimes
Tax Treaties
U.S. Model Income Tax Treaty

On February 17, 2016, the Treasury Department released a revised U.S. Model Income Tax Convention (the "2016 Model Treaty") – the baseline from which the U.S. initiates treaty negotiations.

Many of the revised provisions reflect current negotiating positions developed in actual tax treaty negotiation sessions, and on the whole, the 2016 Model Treaty should be seen as a natural progression, as taxpayers and treaty partner countries have also adapted to existing treaties. Other provisions are new and are designed to limit double non-taxation in addition to double taxation, reflecting the global attack on cross-border tax planning led by the O.E.C.D.

While a prudent planner will wish to review and compare the entire 2016 Model Treaty with its predecessor, several notable provisions are outlined below:

- The 2016 Model Treaty contains provisions designed to attack special tax regimes that provide attractive tax results for highly movable income such as interest, royalties, and guarantee fees. These regimes were created to eliminate the need for back-to-back payments after anti-conduit rules were adopted by the U.S. and other countries.
- The new Article 28 (Subsequent Changes in Law) is a provision that calls for notification and consultation with a view to amending a treaty when changes in the domestic law of a treaty partner draw into question the treaty's original balance of negotiated benefits and the need for the treaty to reduce double taxation. While the addition may be interpreted as a bold move in support of the O.E.C.D.'s B.E.P.S. initiative, it is unlikely to produce significant results, as long as the treaty partner's tax rate does not dip below 12.5%. The U.S. has income tax treaties in effect with Ireland and Cyprus, where the headline rate for each is 12.5%. It also has a treaty with Malta where the tax rate is 5% after a refund of corporate tax that is triggered by a dividend payment. The U.S. has not indicated that it would to initiate action against the U.K., where the headline rate of corporate tax is scheduled to be reduced to 17% in 2020. Comparatively, the U.S. corporate tax rate can be as high as 35% at the Federal level and around 40% when most state taxes are taken into account. The tax on distributed profits in the U.S. will add another 30% on the after-tax earnings that are distributed – about 12%, if the combined Federal and state rate is 40%.
- The 2016 Model Treaty adopts a series of highly technical provisions designed to tighten the tests under Article 22 (Limitation on Benefits) in an effort to curb cross-border tax planning that circumvents the Limitation on Benefits article in existing treaties. These provisions may be harmful to sophisticated multinational businesses. The provisions also contain an expansion of the derivative benefits provision, which applies principally to dividends when the

treaty resident is owned by an individual who would be an equivalent beneficiary but for the lower withholding tax rates or exemption for intercompany direct investment dividends. This is a beneficial provision. Whether the revisions are beneficial or harmful for taxpayers, added complexity is evident in Article 22, as the various tests for qualifying taxpayers or income streams have become multifaceted.

- The 2016 Model Treaty would reduce the benefits of corporate inversions by denying treaty benefits for U.S. withholding taxes on U.S.-source dividends, interest, royalties, and certain guarantee fees paid by U.S. companies that are "expatriated entities." An expatriated entity is an entity with a foreign charter, but because it or a predecessor in interest was at one time a U.S. corporation, it continues to be treated as a U.S. corporation when certain conditions are met regarding the composition of the shareholder group. For a period of ten years, treaty benefits are denied to payments by expatriated entities when the recipient is "connected" with the expatriated entity. Payments made to unconnected persons benefit from the treaty. While U.S. tax law defining an inversion may change from time to time, the definition under the 2016 Model Treaty relies upon U.S. law applicable on the date of signature of an income tax treaty. Subsequent modifications are to be ignored.
- The 2016 Model Treaty expands Article 25 (Mutual Agreement Procedure) to provide for mandatory binding arbitration. In doing so, it follows four treaties that have been submitted and await the advice and consent of the Senate. These treaties have been blocked at the level of the Senate Foreign Relations Committee for several years.
- The overall B.E.P.S. initiative policy of preventing double non-taxation is elevated to a principal purpose of the 2016 Model Treaty. However, not all of the recommended permanent establishment provisions have been adopted. In that regard, a speaker at a conference once commented on the O.E.C.D. obsession with double non-taxation in the following way: It is better that 100 taxpayers incur double taxation than that one aggressive taxpayer pays too little.[1]

This month, *Insights* explores these provisions of the 2016 Model Treaty in the articles that follow.

[1] Benjamin Franklin, letter to Benjamin Vaughan, March 14, 1785, in *The Writings of Benjamin Franklin, Volume 9*, ed. Albert H. Smyth, (1906), p. 293. Mr. Franklin was echoing Voltaire.

2016 MODEL TREATY – SPECIAL TAX REGIME PROVISIONS

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Tags
Double Non-taxation
Notional Interest Deduction
Special Tax Regimes
Tax Treaties
U.S. Model Income Tax Treaty

The U.S. Treasury Department issued a revised U.S. Model Income Tax Convention on February 17, 2016 ("2016 Model Treaty") that, among other things, implements new provisions to address special tax regime issues and prevent situations of double non-taxation. A special tax regime provides preferential tax treatment (usually in the form of a low or zero tax rate) for payments of interest, royalties, or other similar, highly-mobile income to taxpayers that reside in the relevant jurisdiction. The 2016 Model Treaty enumerates the circumstances in which a reduction in the U.S. statutory withholding rates on deductible payments to a treaty resident will be denied because the resident benefits from a particular special tax regime.

The Treasury Department has targeted the provision on special tax regimes to prevent erosion of the U.S. tax base without an offsetting tax in the country of residence. This is viewed to be unfair to existing U.S. corporations and incentive for U.S. businesses to undergo inversions to foreign corporations. The special tax regime provisions also reflect the concerns of the O.E.C.D. in connection with double non-taxation, a target of the B.E.P.S. initiative.[1]

The previous Model Treaty, which was issued in 2006 ("2006 Model Treaty"), did not have express provisions dealing with the problems of double tax avoidance caused by special tax regimes. In May 2015, the Treasury Department invited the public to comment on a draft of the revised Model Treaty (the "2015 Draft"), which added new special tax regime provisions that were not in the 2006 Model Treaty. Overall, the comments on the 2015 Draft conveyed that the term "special tax regime" was too expansive, the provisions were too ambiguous as to when treaty benefits and reductions of withholding taxes would be denied, and public notification should be required before implementing provisions of a particular special tax regime so that taxpayers may properly apply the treaty.[2] The 2016 Model Treaty addresses these comments and more carefully defines the application of special tax regime provisions.

SPECIAL TAX REGIME PROVISIONS

The 2016 Model Treaty's special tax regime provisions only apply to particular payments of interest, royalties, or guarantee fees from a related or connected party to a resident of a treaty country that benefits from a special tax regime. The special tax regime provisions are defined in Article 3 (General Definitions) and apply to Article 11 (Interest), Article 12 (Royalties), and Article 21 (Other Income) of the 2016 Model Treaty.

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1 U.S. Department of the Treasury, *Preamble to 2016 U.S. Model Income Tax Convention*, (Feb. 17, 2016), p. 2.

2 *Id.*

The term “special tax regime” is a new addition to the Model Treaty. A special tax regime means any statute, regulation, or administrative practice related to a tax covered by the treaty that meets all of the following conditions:[3]

- It results in one or more of the following benefits for a resident of the country:
  - Preferential taxation for interest, royalties, guarantee fees, or any combination of those items, as compared to income from sales of goods or services
  - A permanent reduction in the tax base with respect to the above categories of income by allowing
    - an exclusion from gross receipts,
    - a deduction without corresponding payment or obligation,
    - a deduction for dividends paid or accrued, or
    - taxation that is inconsistent with the principles of the business profits and permanent establishment articles in that a preferential tax rate or permanent reduction in the tax base is available to companies that do not engage in an active business in the resident treaty country.[4]
  - Other similar tax benefit applied to substantially all of a company’s income or substantially all of a company’s foreign source income for companies that do not engage in the active conduct of a trade or business in the country of residence
- For patent or innovation box regimes, the preferential rate of taxation or permanent reduction in the tax base does not condition the tax benefits on research and development activities within the state of residence.
- The special tax regime is generally expected to result in a rate of taxation that is less than lower of the following to rates:
  - 15%
  - 60% of the statutory rate of corporation tax that is generally applied

The 2016 Model Treaty’s special tax regime provisions expressly do not apply to pension funds, charitable organizations, or collective investment vehicles such as U.S. regulated investment companies and U.S. real estate investment trusts that are designed to achieve a single level of current tax at either the entity level or shareholder level.[5]

The 2016 Model Treaty requires that a written public notification be issued by a country that implements a special tax regime provision. The country must first consult with, then notify the other treaty country of its intention to implement such

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3 *Id.*; U.S. Department of the Treasury, *U.S. Model Income Tax Convention*, (Feb. 17, 2016), art. 3(1)(l).

4 *2016 Model Treaty*, art. 3(1)(l)(i).

5 *Id.*, art. 3(1)(l)(iv).

provision through a diplomatic note before issuing the public notice. Such provision cannot be treated as a special tax regime until 30 days after the public notification is issued.[6] The public notification requirement was added in response to comments on the 2015 Draft.

EFFECT OF THE SPECIAL TAX REGIME PROVISIONS

Articles 11, 12, and 21 pertaining to interest, royalties, or guarantee fees, respectively, limit treaty benefits when a special tax regime applies to the recipient of income. Thus, the 2016 Model Treaty provides that:

> Interest, royalties, or guarantee fees arising in a treaty country and beneficially owned by a resident of the other treaty country that is a connected person with respect to the payor of such interest, dividend, or guarantee fee, may be taxed in the first-mentioned country in accordance with domestic law if such resident benefits from a special tax regime with respect to such income.

"Special tax regime provisions will only apply when the payee is a 'connected person' with respect to the payor of the income of interest, royalties, or guarantee fees."

These special tax regime provisions will only apply when the payee is a "connected person" with respect to the payor of the income of interest, royalties, or guarantee fees. The term "connected person" is used instead of "related to the payor" (found in the 2015 Draft) in response to concerns about the special tax regime provisions being too expansive. The term "connected person" is defined as follows:

> [T]wo persons shall be 'connected persons' if one owns, directly or indirectly, at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent of the aggregate vote and value of the company's shares) or another person owns, directly or indirectly, at least 50 percent of the beneficial interest (or, in the case of a company, at least 50 percent of the aggregate vote and value of the company's shares) in each person. In any case, a person shall be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.[7]

EXCEPTIONS TO THE PROVISIONS

Notional Interest Deductions

Tax regimes that provide a notional interest deduction with respect to equity are not treated as special tax regimes. However, Article 11, which pertains to interest income, allows a treaty country to tax interest when the interest is beneficially owned by a connected person and the connected person benefits from a notional interest deduction based on equity. This change represents a more focused approach to addressing the policy concern that interest income that benefits from a notional interest regime is often subject to little or no tax because (i) at the level of the lender a notional interest deduction applies in the country of residence on equity,

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6 *2016 Model Treaty*, art. 3.

7 *Id.*, art. 3(1)(m).

and (ii) the parent of the investor benefits from a participation exemption with respect to dividends.[8]

Moreover, use of notional interest regimes has been a favorite way for certain planners to circumvent the anti-conduit financing rules of U.S. tax law.[9] Those rules attack back-to-back financing arrangements that are designed to reduce U.S. tax. Many income streams are caught by the anti-conduit rules, including interest-in/interest-out transactions, royalties-in/royalties-out transactions, and interest-in/fixed-dividends-on-preferred-stock-out transactions all looked at from the point of view of the entity receiving payments from the U.S. However, interest-in/ordinary-common-stock-dividends-out transactions are not among the listed transactions that are caught, presumably because common stock dividends paid by the recipient of U.S.-source interest income ordinarily is not viewed as abusive. However, when the dividend-out leg is accompanied by a notional interest deduction on equity capital, the tax base in the country where the recipient of U.S.-source interest is resident has been reduced in a way that violates the spirit of the anti-conduit rules.

Exempt and Fiscally Transparent Entities

The special tax regime provisions do not apply to pension funds, charitable organizations, collective investment vehicles that are tax transparent, or other entities that are tax transparent. An entity is not tax transparent if tax is deferred for more than one year.

CONCLUSION

The new provisions implemented in the 2016 Model Treaty combat the problem of double non-taxation by denying treaty benefits for payments of interest, royalties, and certain guarantee fees between connected parties if the beneficial owner of the payment benefits from a special tax regime with respect to the payment.

8 *Preamble to the 2016 Model Treaty*, p. 3.

9 Treas. Reg. §1.881-3.

2016 MODEL TREATY – L.O.B. REVISIONS

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IN GENERAL

While the U.S. Senate has not ratified a treaty since 2010, the Treasury Department released a revised U.S. Model Income Tax Convention on February 17, 2016 (the "2016 Model Treaty").[1] The 2016 Model Treaty is the baseline text used by the Treasury Department when negotiating tax treaties with other countries. The U.S. Model Income Tax Convention was last updated in 2006 (the "2006 Model Treaty").

The 2016 Model Treaty was not published with a technical explanation. However, the preamble, which accompanied the February release, provides that the Treasury Department plans to publish a technical explanation later this spring.

U.S. tax treaty negotiation policy is aimed at eliminating double taxation without creating opportunities for "treaty shopping." Treaty shopping arises when a person, or group of persons, who is not resident in the treaty country channels investments into the U.S. through a company that is resident in a treaty partner country but has no "real" nexus to that country. To prevent treaty shopping, the U.S. includes a limitation on benefits ("L.O.B.") provision in its income tax treaties. The L.O.B. provision provides that a resident of a foreign country cannot enjoy benefits under a treaty unless that resident is a "qualified person" or is otherwise entitled to claim benefits.

A draft version of the 2016 Model Treaty was released on May 20, 2015 (the "2015 Draft") for public comment. The 2015 Draft proposed changes to Article 22 (Limitation on Benefits) of the 2006 Model Treaty, and comments are reflected in the 2016 Model Treaty. In the 2016 Model Treaty, two new methods for satisfying the L.O.B. provision were added: a "derivative benefits" test and a "headquarters company" test. Additionally, a number of preexisting tests, from the 2006 Model Treaty, have been tightened to prevent abuse by third-country residence.

THE 2006 MODEL TREATY

Under the 2006 Model Treaty, there are four main categories under which a person (other than an individual, a non-for-profit organization, or a governmental body of one of the treaty countries) could qualify for treaty benefits. Generally, these categories include the following:

- A publicly traded company[2] – In order to meet this requirement, the company's principal class of stock must be traded regularly on a recognized exchange.

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1 U.S. Department of the Treasury, *U.S. Model Income Tax Convention*, (Feb. 17, 2016).

2 *Id.*, art. 22(2)(c)(i).

- A company that is a subsidiary or an affiliate of a publicly traded company[3] – In order to meet this requirement, 50% or more of the vote and value of the company's stock must be owned by five or fewer publicly traded companies that are qualified persons. Indirect ownership was allowed only through companies that are residents of either contracting state.

- A pension fund in which more than 50% of the beneficiaries, members, or participants are individuals resident in either the foreign country or the U.S.[4]

- A company that meets the "ownership/base erosion" test[5] – The ownership prong of this test requires that persons who are otherwise qualified persons under the treaty must own 50% or more of the vote and value of that company for at least half the year. The base erosion prong requires that disqualifying payments representing 50% or more of the company's gross income must not be made. Payments are disqualifying when they are (i) made to impermissible payees (*i.e.*, generally, payees other than individuals, governmental entities, tax-exempt entities, pension funds, and public companies that are residents of one of the contracting states and eligible for treaty benefits), (ii) tax deductible in the country of residence, and (iii) not arm's length payments made in the ordinary course of the company's business for services rendered or for the purchase of tangible property. Typically, payments that are caught in this base erosion prong are interest payments, royalty paymens, and fees for management services.

The 2006 Model Treaty also permits treaty benefits to be claimed by companies that are not qualified persons, but only for specific streams of income. Companies covered by this provision include

- a company that is actively engaged in a trade or business in its country of residence (generally, other than the business of making or managing investments for the resident's own account), but only with respect to income that is "derived in connection with" that trade or business or is incidental to that business;[6] and

- a company that is granted discretionary relief by the competent authority of the source country, based on a determination that the "establishment, acquisition or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under this Convention."[7]

REVISIONS MADE IN THE 2016 MODEL TREATY

Public Subsidiary Exception Modified

The 2016 Model Treaty modifies the regarding a subsidiary of a publicly traded company (i) to include a base erosion test and (ii) to allow for indirect ownership

3 *Id.*, art. 22(2)(c)(ii).

4 *Id.*, art. 22(2)(d).

5 *Id.*, art. 22(2)(e).

6 *Id.*, art. 22(3).

7 *Id.*, art. 22(4).

through a qualifying intermediate owner who is resident in a third state, but only if that state has a tax treaty with the country in which the income arises that includes provisions addressing special tax regimes ("S.T.R.'s") and notional interest deductions ("N.I.D.") similar to those in the 2016 Model Treaty (the "New Intermediate Ownership Rules"). Currently, no treaty includes such provisions.

The base erosion test in the 2016 Model Treaty is not applicable when the income for which treaty benefits are claimed is dividend income. Generally, a base erosion test provides that the company seeking treaty benefits may not, directly or indirectly, pay or accrue 50% or more of its gross income to impermissible payees in the form of payments that are deductible for tax purposes in the country of residence, not counting certain payments made in the ordinary course of business. The base erosion test in the 2016 Model Treaty expands the list of "bad payments" to include a payment made to a connected person that benefits from (i) an S.T.R. provision with respect to the payment or (ii) an N.I.D. provision in the residence state when the item of income is an interest payment. Additionally, the 2016 Model Treaty provides that, if the company seeking treaty benefits is a member with any other company in a tax consolidation, fiscal unity, or similar regime that requires members to share profits or losses or it shares losses with other companies pursuant to a group relief or other loss-sharing regime, the other company or companies must also meet the base erosion test. In other words, both the tested group of companies and the company receiving income must meet the base erosion standard.

"The base erosion test in the 2016 Model Treaty expands the list of 'bad payments' to include a payment made to a connected person."

The list of permissible payees under the base erosion prong of the 2016 Model Treaty is the same one that appears in the standalone ownership/base erosion test of the 2006 Model Treaty; it includes individuals, governmental entities, public companies, tax-exempt entities, and pension funds resident in one of the contracting states. Arm's length payments made in the ordinary course of business for services or tangible property and, in the case of a tested group, intra-group transactions are not taken into account when making the determination.

Active Trade or Business Test Modified

The active trade or business test in the 2016 Model Treaty requires a factual connection between an active trade or business in the residence country and the item of income for which benefits are sought. Specifically, the income benefiting from the treaty must meet a new standard – whereby the income "emanates from, or is incidental to," a trade or business actively conducted by the resident in the residence state – rather than the former "derived in connection with" test. Unlike the 2015 Draft, the 2016 Model Treaty allows activities to be attributed from connected persons.

Further guidance will be included in the technical explanation that is expected to be released this spring. The guidance will likely address whether an item of income, in particular an intra-group dividend or interest payment, will meet this new "emanates" test. The preamble also provides an example: Dividends and interest paid by a commodity-supplying subsidiary acquired by a parent whose business in the residence state depends on a reliable source for that commodity would meet the emanates test, whereas payments between two companies that are merely in similar lines of business would not be sufficient to meet this test.

The public is invited to send examples of income for potential inclusion in the technical explanation until April 18, 2016. Unless the provisions are changed after public comments, the mere expansion of a business on a lateral basis from the treaty partner to the U.S. may not be sufficient meet the active trade or business exception in the absence of active management by the parent.

Additionally, the 2016 Model Treaty specifies additional activities that are excluded from the active trade or business test: (i) operating as a holding company; (ii) providing overall supervision or administration of a group of companies; (iii) providing group financing (including cash pooling); and (iv) making or managing investments, unless carried on by a bank, insurance company, or registered securities dealer in the ordinary course of its business as such.

Derivative Benefits Test Added

While the 2006 Model Treaty did not provide for a derivative benefits test (only a standalone ownership/base erosion test, on which the derivative benefits test is based), a form of this test is included in existing U.S. tax treaties with most countries and Canada.[8] However, existing treaties limit third-country ownership to seven or fewer "equivalent beneficiaries," meaning residents of a member country of the E.U. or N.A.F.T.A. (the North American Free Trade Agreement).

The derivative benefits clause in existing U.S. treaties generally allows a company that cannot otherwise qualify for treaty benefits to obtain treaty relief if

- the company is at least 95% owned by shareholders that are residents of other countries having a comprehensive income tax treaty with the U.S. (a "Shareholder Treaty");
- the Shareholder Treaty would allow the shareholders to claim treaty benefits with respect to the underlying income if it was paid directly to them; and
- with respect to dividends, interest or royalties, the benefits accorded to the shareholders under the Shareholder Treaty are equal to, or better than, the benefits the company will obtain under the treaty in issue.

This posed a problem under the 2015 Draft for holding companies in one country owned by individuals resident in a second country having a treaty with the U.S. With regard to dividends, individuals are eligible only for a 15% withholding tax, not a 5% withholding tax or an exemption. A similar problem existed for corporations owning less than 10% of the holding company. This has now been eliminated.[9]

The 2016 Model Treaty adds a derivative benefits clause to the model L.O.B. article. This new provision accomplishes the following:

- It removes the geographic restriction found in the derivatives benefit provision of existing treaties.
- It allows a corporation owned by individuals and others to benefit from the withholding tax applicable to the shareholder if payments were made diretly to the shareholder.

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8 *E.g.*, a derivative benefits provision was added to the Germany-U.S. Income Tax Treaty in a 2006 protocol, which amended Article 28 (the L.O.B. provisions) to include a new Article 28(3).

9 *2016 Model Treaty*, art. 10(6).

- If a corporation is engaged in the active conduct of a trade or business in its country of residence that is substantial in relation, and similar or complementary, to the trade or business in the U.S., the individual is treated as if he or she were a company for purposes of the rate equivalency test.

In addition, the derivative benefits test includes a base erosion test, that is similar to the test applicable to a subsidiary of a publicly traded company. Consequently, the base erosion test must be met by the group as a whole and not just the company seeking benefits.

Headquarters Company Category Adopted

The 2016 Model Treaty adds a new test allowing a company that qualifies as a "headquarters company" to claim treaty benefits for dividends and interest paid by members of its multinational group. This test requires that the company's "primary place of management and control" must be in its country of residence. This is a heavier burden to meet than the existing test, which looks to the exercise of supervision and administration functions in the country of residence. According to the preamble, the presence in the treaty country of strategic, financial, and operational policy decision-making for a multinational group establishes sufficient nexus to that country with respect to dividends and interest.

"The 2016 Model Treaty adds a new test allowing a company that qualifies as a 'headquarters company.'"

To qualify as a headquarters company, the multinational group must consist of companies resident in at least four countries, all engaged in the active conduct of a trade or business and certain income tests must be met. A base erosion test must be met that is comparable to other provisions within the L.O.B. article.

It should be noted that treaty benefits for headquarters companies are capped in the 2016 Model Treaty. A headquarters company is entitled to benefits only with respect to dividends and interest paid by members of its multinational corporate group. In the case of interest, withholding tax is not eliminated; rather, it is capped at 10%.[10]

CONCLUSION: PLAN WITH THE 2016 MODEL TREATY IN MIND

The 2016 Model Treaty signals the latest view on treaty and protocol negotiation. Some of its changes are helpful, such as the addition of a derivative benefits clause and a headquarters exception. However, other changes will be problematic for certain taxpayers, such as adding a base erosion test in some cases and an active trade or business test that may be more difficult to meet. Moreover, reflecting the complexities of a post-B.E.P.S. world, provisions in the 2016 Model Treaty are drafted in a Byzantine manner to ensure prevention of abuse by aggressive planners.

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[10] *Id.*, art. 11(2)(f).

2016 MODEL TREATY – MANDATORY ARBITRATION

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Action 14
B.E.P.S.
Mandatory Arbitration
O.E.C.D. Model Treaty
Tax Treaties
U.S. Model Income Tax Treaty

In the newly released U.S. Model Income Tax Convention ("2016 Model Treaty"), a provision was made for "mandatory arbitration" to resolve disputes. The mandatory arbitration provision is designated in Article 25 (Mutual Agreement Procedure).

IN GENERAL

In general, competent authority provisions in most U.S. tax treaties require that parties attempt to resolve treaty disputes between themselves, but generally, they do not mandate an agreement. The 2016 Model Treaty, along with several newly-signed U.S. tax treaties, includes a mandatory arbitration provision. However, most existing treaties contain arbitration provisions that are non-binding.

The U.S. believes that a mandatory arbitration provision will incenti*vize* parties to resolve their disputes before the actual arbitration proceeding. Based on results from the U.S.-Canada Income Tax Treaty, the I.R.S. estimates that 80% of the cases that were scheduled for arbitration were settled in advance due to that treaty's mandatory arbitration provision. The U.S. estimates that mandatory arbitration will resolve disputes in six to nine months, a timeframe which is considerably faster than current alternative treaty dispute resolution options.

2016 MODEL TREATY HIGHLIGHTS

Local Law

The 2016 Model Treaty contains language that supersedes procedural limitations in domestic law. Additionally, collection procedures are suspended during the arbitration period.[1]

Mandatory Arbitration Process

The arbitration board is comprised of three members who may only consider resolutions presented by the parties. The board may not provide its own resolution to the dispute.

In order to submit a case to arbitration, the following conditions must be satisfied:

- Tax returns have been filed for the years in question with one of the treaty countries.
- Two years have passed since the commencement date of the case, unless

[1] U.S. Department of the Treasury, U.S. Model Income Tax Convention, (Feb. 17, 2016), art. 25(2).

the competent authorities agree to a different date.

- The taxpayer has submitted a written request to proceed to binding arbitration.
- A decision on the matter has not already been made by a tribunal or a court.[2]

Appeal Process

Should the taxpayer disagree with the arbitration panel's decision, the taxpayer will have 45 days to appeal the ruling.[3] The taxpayer may then proceed with other alternative dispute resolution procedures, such as court litigation or voluntary amnesty programs.

COMPARISON TO OTHER U.S. TAX TREATIES

Canada

The U.S.-Canada Income Tax Treaty contains many of the same elements of the 2016 Model Treaty, with some significant differences. First, both Canada and the U.S. must agree that the subject matter is suitable for arbitration. Subject matter suitable for arbitration is explicitly enumerated in the 2010 memorandum of understanding between the two countries.[4] Secondly, rules concerning the appeals process are not explicit in the U.S.-Canada treaty or its protocols, contrary to the 2016 Model Treaty, which specifically describes these matters.

Germany

The U.S.-Germany Income Tax Treaty has an arbitration clause similar to the one established in the Canadian treaty. However, the U.S.-German arbitration process is much more detailed than the one established under the Canadian treaty. While the German treaty provides for the composition of the arbitration board in a manner similar to the 2016 Model Treaty, it does not mention the appeals process in the same detailed manner.[5]

O.E.C.D. Model Treaty

The O.E.C.D. includes a mandatory arbitration article in its 2014 O.E.C.D. Model Tax Convention on Income and on Capital (the "O.E.C.D. Model Treaty").[6] Under the O.E.C.D. Model Treaty, a party is able to apply for mandatory arbitration if an issue has not been resolved within two years from the presentation of the matter

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2 *Id.*, art. 25(7).

3 *Id.*, art. 25(9)(k).

4 Memorandum of Understanding Between the Competent Authorities of Canada and the United States of America, art. 26(6)(b), Nov. 8, 2010.

5 U.S. Department of the Treasury, *Technical Explanation of the Convention and Protocol Between the United States of America and the Federal Republic Of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes On Income and Capital and to Certain Other Taxes*, (1989), art. 25.

6 O.E.C.D., *Model Tax Convention on Income and on Capital: Condensed Version 2014*, (Paris: O.E.C.D. Publishing, 2014), art. 25(5).

to the competent authority. Similar to the new U.S. provisions, the O.E.C.D. Model Treaty states that mandatory arbitration cannot occur if the matter is resolved by a court or tribunal in advance of arbitration. The decision is binding on both parties, notwithstanding procedural time limits in the domestic country of either state.

A key difference between the O.E.C.D. Model Treaty and the 2016 Model Treaty is the appeals process and the composition of the arbitration board. While these matters are explicitly described in the 2016 Model Treaty, the O.E.C.D. Model Treaty allots the actual process and structure to the competent authorities of each treaty country.

"A key difference between the O.E.C.D. Model Treaty and the 2016 Model Treaty is the appeals process and the composition of the arbitration board."

B.E.P.S. CONCERNS REGARDING MANDATORY ARBITRATION

Action 14 of the O.E.C.D.'s B.E.P.S. Action Plan acknowledges several concerns with regard to mandatory arbitration clauses. Firstly, mandatory arbitration removes national sovereignty through the superseding effect of treaties over domestic procedural limitations. Secondly, the power of mandatory arbitration boards may be too broad and some countries may wish to constrain an arbitrator's power over certain issues. Practitioners should note that the U.S. has demonstrated a similar concern, as evidenced by this exact limitation in the arbitration clause of the U.S.-Canada treaty.

CONCLUSION

Based on recently signed U.S. tax treaties, the mandatory arbitration clause will be an essential part of U.S. tax treaties going forward. Practitioners should focus on details relating to the composition of the arbitration panel and the appeals process. These two provisions often result in the biggest divergence between the 2016 Model Treaty and an actual effective treaty when signed.

2016 MODEL TREATY – B.E.P.S. & EXPATRIATED ENTITIES

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INTRODUCTION

The Treasury released a revised version of the U.S. Model Income Tax Convention (the "Model Treaty") on February 17, 2016 ("2016 Model Treaty"). The 2016 Model Treaty includes many technical improvements developed during tax treaty negotiations and implements efforts to eliminate double taxation while fighting base erosion and profit shifting ("B.E.P.S.").

TACKLING B.E.P.S.

In order to effectively tackle B.E.P.S. under the G-20/O.E.C.D. initiative (the "B.E.P.S. Project"), many of the deliverables call for legislative reform and incorporation into tax treaties. B.E.P.S. Action 6 specifically looks at treaty abuse and the role treaties have played in triggering non-taxation. The 2016 Model Treaty reflects the Treasury's preference for addressing B.E.P.S. through changes in objective rules applied prospectively. Although certain O.E.C.D. recommendations were already a part of the Model Treaty (such as, *e.g.*, comprehensive limitation on benefits provisions), the 2016 Model Treaty incorporates other recommendations for the first time.

The 2016 Model Treaty directly states that both treaty partners aim to eliminate double taxation of income without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance. Eliminating double taxation maintains a competitive global economy, but taxpayers have often taken advantage of these measures to ensure that no tax is paid in either of the contracting states. While eliminating double taxation has always been the objective of the bilateral tax conventions, expressing a clear intent to counteract non-taxation or reduced taxation through evasion or avoidance declares the need for balance in order to achieve broader fiscal policy goals.

The 2016 Model Treaty incorporates a rule to protect against contract-splitting abuses of the 12-month permanent establishment ("P.E.") threshold for building, construction, or installation projects. Contract splitting occurs when an enterprise divides a contract into several parts, each covering a period of less than 12 months and attributed to a different company, all of which are, however, owned by the same parent company. By so doing, the company avoids creating a P.E., and thus, paying tax as a resident.

The 2016 Model Treaty contains a 12-month ownership and residence requirement for companies to qualify for the 5% withholding rate for direct dividends. This addresses the practice of companies changing residence for the purpose of qualifying for the lower rate.

“Exceptions to the creation of a P.E. for certain activities . . . have changed the way business is conducted by limiting the core activities being performed in a country to those that can be deemed as preparatory or auxiliary.”

It is worth noting that the 2016 Model Treaty has not adopted the other B.E.P.S. Project recommendations with respect to P.E.'s, *e.g.*, the revised rules related to dependent and independent agents and the exemption for preparatory and auxiliary activities under B.E.P.S. Action 7 (“Action 7”). Action 7 stresses the need to update the definition of a P.E. in order to prevent artificial avoidance of P.E. status through the use of intermediary agents and the performance of preparatory and auxiliary activities.

Under the 2016 Model Treaty, a P.E. is established when a nonresident company has a fixed place of business or a dependent agent concluding contracts on its behalf in a foreign country. Companies may avoid creating a P.E. through their agents (without materially changing the functions performed in the country) by changing the terms of contracts, thus showing that these agents did not conclude and bind the principal. In addition, there is a carve-out rule for independent agents, whereby no P.E. is created if the agent is found to be legally and economically independent and acting in the ordinary course of business.

Action 7 proposes that where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a sufficient taxable nexus in that country unless the intermediary is performing these activities in the course of an independent business. Action 7 recommends that a P.E. should be deemed to be created when, on behalf of an enterprise, a person both (i) has and habitually exercises an authority to conclude contracts and (ii) habitually concludes contracts or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise. These may be contracts (i) in the name of the enterprise; (ii) for the transfer of ownership of, or the granting of the right to use, property that is owned by the enterprise, which the enterprise has the right to use; or (iii) for the provision of services by the enterprise. A P.E. would be created under these circumstances unless the activities of such person are exercised through a fixed place of business that would not be considered to establish a P.E. This proposal maintains the exclusion for independent agents, but the carve-out rule does not apply to exclusive independent agents that are closely related to the enterprise and are not considered independent agents by virtue their activities.

The O.E.C.D. Model Tax Convention on Income and on Capital (the “O.E.C.D. Model Treaty”) provides exceptions to the creation of a P.E. for certain activities – generally activities considered to be preparatory or auxiliary. These exceptions have changed the way business is conducted by limiting the core activities being performed in a country to those that can be deemed as preparatory or auxiliary, *i.e.*, not the types that create a P.E. These exceptions have often led to the fragmentation of cohesive operating businesses into smaller, separate operations so that each unit is merely engaged in preparatory or auxiliary activities that avoid creating a P.E.

Action 7 proposes limiting the exemption for preparatory and auxiliary activities. It provides a more selective test than the O.E.C.D. Model Treaty and excludes a number of fixed places of business, which should not be treated as P.E.'s because the business activities exercised through these places are merely preparatory or auxiliary. These provisions prevent the creation of a P.E. in a state if the enterprise only carries out activities that are purely preparatory or auxiliary in nature an ensure that preparatory or auxiliary activities carried on at a fixed place of business are viewed in the light of other complementary operations that are part of a cohesive business.

The Treasury has said it will continue to look at the P.E. recommendations under the B.E.P.S. Project and the concerns raised by the O.E.C.D.

EXPATRIATED ENTITIES

The Model Treaty aims to reduce the tax benefits of corporate inversions by denying treaty benefits for U.S. withholding taxes on U.S.-source dividends, interest, royalties, and certain guarantee fees paid by U.S. companies that are "expatriated entities," as defined under the Internal Revenue Code ("Code").

Under Code §7874(a)(2)(A) the term "expatriated entity" generally means (i) the domestic corporation or partnership with respect to which a foreign corporation is a surrogate foreign corporation, and (ii) any U.S. person who is related to a domestic corporation or partnership described in (i) above. A "surrogate foreign corporation" is an acquiring foreign corporation or foreign publicly traded partnership that has acquired a U.S. corporation or partnership under the rules described in Code §7874(a)(2)(B).

An expatriated entity is one that has been acquired by a foreign entity in a country where the business activities are not substantial when compared to those of the affiliated group. However, the shift of ownership residency may offer lower withholding taxes or certain other tax benefits.

Under the 2016 Model Treaty, the Model Treaty provisions (discussed above) will apply only when the beneficial owner of a dividend, interest payment, royalty, or guarantee fee is a connected person with respect to the expatriated entity.

Further, the definition of expatriated entity is fixed to the definition under Code §7874(a)(2)(A) as of the date a treaty is signed, in order to match the scope with any future changes to the Code.

Under certain circumstances, pre-existing U.S. subsidiaries of a foreign acquirer would not be considered expatriated entities.

POLICY IMPLICATIONS

As noted above, the Treasury has decided not to adopt the O.E.C.D. recommendations regarding dependent and independent agents and exemptions for preparatory and auxiliary activities at this point. It should be remembered that any changes to the Model Treaty should be globally understood and uniformly applied by the contracting states. Action 7 addresses the challenges that countries create for P.E.'s in the jurisdictions where they operate. However, the directive still leaves open a number of questions, such as the scope of the P.E. test. The Treasury is not willing to adopt these P.E. rules before creating a common global understanding and developing ways to ease the compliance burdens that Action 7 could create.

While the revisions regarding expatriated entities generally restrict treaty benefits, the 2016 Model Treaty also exempts previously existing U.S. subsidiaries under certain conditions. Pre-existing U.S. subsidiaries of the foreign acquirer would not be considered expatriated entities for purposes of denying treaty benefits unless the entities join in filing a U.S. consolidated return with the domestic entity, or another entity connected to the domestic entity, after the domestic entity has been acquired. This exemption recognizes that expatriated entities may be multinational corporations with genuine business reasons for having U.S. subsidiaries. By allowing for this concession, the 2016 Model Treaty attempts to balance measures taken to combat B.E.P.S. against the real business operations of multinational corporations.

EUROPEAN STATE AID

THE MAKINGS OF A GLOBAL TRADE WAR

E.U. STATE AID – THE SAGA CONTINUES

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Tags
European Commission
State Aid
T.F.E.U.

The drama continues with the E.U. State Aid[1] investigations by the European Commission for Competition (the "Commission"). In the past month, the competition commissioner, Margrethe Vestager, met with Luxembourg officials to discuss the outcome of the Amazon investigation, and the Commission ordered Fiat Chrysler Automobiles to pay about €30 million in back taxes to Luxembourg and released a public letter regarding the investigation of McDonald's alleged State Aid violations in Luxembourg. An even more bold attack on multinational tax practices came not from the Commission but from the French authorities, who raided the offices of Google and McDonald's in May.

As the Commission's probe expands, E.U. Member States are increasingly expressing objections to being forced to recoup back taxes from multinational enterprises ("M.N.E.'s") that allegedly received illegal State Aid. States, including the United States, question whether the Commission is acting beyond its authority and impeding Member States' sovereignty to directly tax persons within their jurisdictions.

The European Parliament has even formed a special tax committee to investigate the Commission's role, as well as Member States' roles, in failing to enforce laws that would have prevented entities and individuals from sheltering money in offshore havens to avoid paying taxes.[2] Although the Commission itself will be a subject of these investigations, a Commission spokesperson applauded the creation of a special tax committee to assist in combatting harmful tax practices.

The Commission has argued that it is acting within the authority granted by E.U. law and that it has not infringed on the jurisdiction of Member States, the U.S., or any other country. Since 2013, the Commission has been investigating various Member States' individual tax rulings with U.S. companies, including Starbucks in the Netherlands,[3] Apple in Ireland, Google in the U.K., Amazon in Luxembourg, and McDonald's in Luxembourg. The Commission has alleged that these companies' tax arrangements with different Member States amount to unjustifiable State Aid in violation of E.U. anti-competition laws. If the Commission determines that a Member State provided a selective tax advantage, and thus illegal State Aid, to an entity, the Member State is forced to retroactively, not prospectively, recoup taxes from the

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[1] For the definition of E.U. State Aid see Beate Erwin and Christine Long, "Apple in Europe – The Uphill Battle Continues," *Insights* 2 (2016), pp. 9-15; and Beate Erwin, "Tax Rulings in the European Union – State Aid as the European Commission's Sword Leading to Transparency on Rulings," Insights 6 (2015), pp. 13-14.

[2] Joe Kirwin, "EU Parliament to Probe Intermediaries, Members on Havens," *BNA International Tax Monitor*, June 2, 2016.

[3] Although the Commission's ruling was issued In October 2015, the text of its decision was first released in late June 2016.

entity over a ten-year period. Enforcement of this requirement to recoup back taxes is arguably beyond the Commission's regulatory power.

LATEST ON U.S. REACTIONS

The U.S. reaction to the Commission's State Aid investigations has also intensified. Several U.S. senators and Treasury Department officials continue to express concern and frustration with the Commission's probe into U.S. M.N.E.'s, arguing that the Commission has overstepped its bounds, as the retroactive imposition of tax "is improper and plainly undermines legal certainty and the rule of law."[4] In a May 23 letter to the Treasury Department, Senators Hatch, Wyden, Portman, and Schumer contended that the Commission "appears to be ignoring the national practice and law of its Member States and to be imposing its own new standard for transfer pricing determinations."[5] Furthermore, the Commission's actions confirm "our suspicion that these cases are about more than objectively enforcing existing competition policies."[6] The targeting of U.S. enterprises could potentially undermine U.S. rights in bilateral tax treaties with Member States and the retroactive payment for back taxes would likely prevent a U.S. M.N.E. from receiving a tax credit towards its U.S. income.

U.S. officials have been asserting that Commissioner Vestager is unfairly targeting U.S. M.N.E.'s and that the Commission has no right to claim the offshore profits of U.S. companies. Commissioner Vestager has repeatedly rejected such criticism, claiming that potential State Aid violations involving several non-U.S. companies are currently being examined. U.S. senators have been encouraging the U.S. Treasury Department to strike back by increasing taxes on European companies through enforcement of Internal Revenue Code (the "Code") §891.[7] Code §891 was implemented in U.S. tax law in1938, but it has never been invoked.[8] Under this rule, the tax rates for foreign citizens and corporations could be doubled in "retaliation" against unfair treatment of U.S. persons by these countries.

IS THE COMMISSION EXCEEDING ITS AUTHORITY?

In addition to the U.S., an increasing number of E.U. Member States are concerned that the Commission is overstepping its bounds by retroactively, rather than prospectively, imposing Member State taxation of M.N.E. earnings, particularly those of U.S. entities. Many states argue that the Commission is using the State Aid investigations as a disguise to impede on Member States' taxing power. Therein lies the difficulty with the E.U. system – balancing the right of Member States to directly tax, with the right of the Commission to protect the E.U. single market from anti-competitive tax practices.

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4 "Hatch, Wyden: EU State Aid Probe Violates Rule of Law," *BNA Daily Tax Report*, May 24, 2016.

5 Letter to Secretary Jacob Lew, U.S. Senate Committee on Finance, May 23, 2016.

6 *Id.*

7 Erwin and Long, "Apple in Europe," pp. 9-15.

8 It appears that this rule was intended rather as a tool in treaty negotiations to achieve reciprocal concessions than a weapon for unilateral use.

The Commission has since argued that it is acting within its authority. As if to justify this position, in May the Commission released "Commission Notice on the Notion of State Aid as Referred to in Article 107(1) TFEU" (the "Notice").[9] The Notice should provide guidance to clarify the definition of State Aid.

The Notice is allegedly a reaction to pleas made by the Netherlands in its appeal of the Starbucks outcome. The Netherlands has argued that the arm's length principle is not covered by E.U. law and, thus, could not be subject to State Aid infringement proceedings. To better understand the context of the Notice, the Commission's investigation of Starbucks's arrangement in the Netherlands is outlined below.

The Starbucks Case

In 2008, the Netherlands issued a tax ruling for Starbucks, approving the company's transfer pricing methods. The Commission alleged that the Dutch transfer pricing ruling provided a selective advantage to Starbucks in violation of E.U. anti-trust laws and began investigating the case in 2013. In October 2015, the Commission issued a final decision, finding that Starbucks received illegal State Aid because the Dutch transfer pricing ruling artificially lowered the company's tax burden in the Netherlands, thereby distorting competition. As a result, the Commission has ordered the Netherlands to recoup between €20 and €30 million in back taxes from Starbucks.[10]

The Dutch Finance Ministry appealed the Commission's decision in December 2015 and argued that Starbucks did not benefit from illegal State Aid. The Dutch appeal included five "pleas in law," alleging:

> (A) Incorrect application of Article 107(1) TFEU to the extent that the European Commission finds that the transfer pricing ruling (specifically, an APA) is selective in nature, as the Commission referenced the wrong Dutch tax legislation and failed to demonstrate that the selectivity criterion was fulfilled;
>
> (B) Incorrect application of Article 107(1) TFEU in relation to the European Commission's assessment of the existence of an advantage by reference to the arm's length principle under EU law, as no arm's length principle exists under E.U. law and is not part of the EU State aid assessment;
>
> (C) Incorrect application of Article 107(1) TFEU in relation to the European Commission's finding that the transfer pricing ruling confers an advantage on Starbucks due to the selection of the 'Transactional Net Margin Method' to establish pricing;
>
> (D) Incorrect application of Article 107(1) TFEU in relation to the European Commission's statement that the transfer pricing ruling confers an advantage on Starbucks as a result of the manner under which the 'Transactional Net Margin Method' was applied; and

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9 European Commission, "Commission Notice on the Notion of State Aid as Referred to in Article 107(1) TFEU," (Brussels: 2016)

10 "European Commission Reclarifies the Scope of EU State Aid Rules," *Checkpoint International Taxes Weekly* 21 (2016).

(E) Breach of the duty to exercise due care in so far as the European Commission did not assess and include all the relevant information in the decision and also uses as a basis anonymous information, or at least information that has never been shared with the Netherlands government.[11]

The pleas articulated by the Netherlands reflect the positions of other Member States, which argue that, through State Aid decisions, the Commission is acting beyond its capacity and forcing Member States to retroactively impose tax on multinationals. In particular, the fact that pricing methods and the arm's length principle are not doctrines of E.U. law puts them beyond on the scope of the Commission's assessment.

"The Notice is allegedly a reaction to pleas made by the Netherlands in its appeal of the Starbucks outcome."

The Commission Notice on the Notion of State Aid

The Commission published general guidance on all aspects of the definition of State Aid as part of the Notice, which comes under the State Aid Modernisation initiative that was launched in 2012.[12] The Notice clarifies the scope of the State Aid rules, and its stated purpose is to "provide legal certainty and cut red tape for public authorities and companies, and focus the Commission's resources on enforcing State aid rules in cases with the biggest impact on the Single Market."[13] As previously mentioned, the Notice is alleged to have been published in reaction to the Dutch appeal of the Commission's decision in the Starbucks case.

The Notice simplifies the interpretation of T.F.E.U. Article 107(1), as established by the E.U. Court of Justice and the General Court. The Notice explains the Commission's decision-making practice and how the Commission construes the notion of State Aid when issues have not yet been interpreted by the courts.[14] The Notice elaborates on the following fundamental notions of State Aid:

- The presence of a State Aid undertaking with respect to economic activity
- The imputability of a state measure to the Member State in question
- The notion of advantage and financing through State resources
- The selectivity, *i.e.*, selective advantage of the state measure
- The effect of a state measure on trade and competition between Member States[15]

To date, the Commission's State Aid investigations have focused on tax rulings granted by Member States to M.N.E.'s. However, the Commission is expected to expand its State Aid investigations to tax settlements. This adds to the uncertainty taxpayers face when operating within an E.U. Member State.[16]

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[11] *Id.*

[12] European Commission, "State Aid: Commission Clarifies Scope of E.U. State Aid Rules to Facilitate Public Investment," press release, May 19, 2016.

[13] *Id.*

[14] "Commission Notice on the Notion of State Aid."

[15] *Id.*; "European Commission Reclarifies the Scope of EU State Aid Rules."

[16] Ali Qassim, "Uncertainty Ahead: Tax Settlements Seen as Next EU State Aid

Authority of Tax Rulings

A Member State's grant of a tax ruling to a company must respect the State Aid rules. Tax rulings, such as A.P.A.'s or comfort letters, enable Member States to provide taxpayers with legal certainty and predictability on the application of a Member State's general tax rules. The Notice points out that a Member State's tax rulings are best ensured if its administrative ruling practice is transparent and the rulings are published. The Notice reiterates that the Commission has authority where a tax ruling may confer a selective advantage upon a company, in so far as that selective treatment results in a lowering of that company's tax liability in the Member State as compared to companies in a similar factual and legal situation.[17]

The Notice refers to the Court of Justice's rulings as support for the Commission's rationale for investigating individual rulings issued by Member States. The Court of Justice's rulings on transfer pricing cases have held that a Member State's tax ruling which endorses a transfer pricing methodology for determining a corporate group entity's taxable profit that does not result in a reliable approximation of a market-based outcome in line with the arm's length principle confers a selective advantage upon its recipient. The Notice elaborates on the phrase "reliable approximation of a market-based outcome," interpreting it to mean any deviation from the best estimate of a market-based outcome must be limited and proportionate to the uncertainty inherent in the transfer pricing method chosen or the statistical tools employed for that approximation exercise.[18]

"If a transfer pricing arrangement complies with the provisions of the O.E.C.D. Transfer Pricing Guidelines . . . a tax ruling endorsing that arrangement is unlikely to give rise to State Aid."

According to the Notice, this arm's length principle necessarily forms part of the Commission's assessment of tax measures granted to group companies under T.F.E.U. Article 107(1), independent of whether a Member State has incorporated this principle into its national legal system and, if so, in what form. A tax ruling that approves of a methodology that produces a reliable approximation of a market-based outcome, ensures that that company is not treated favorably under the ordinary rules of corporate taxation of profits in the Member State as compared to standalone companies that are taxed on accounting profit. The arm's length principle the Commission applies in assessing transfer pricing rulings under the State Aid rules is therefore an application of T.F.E.U. Article 107(1), which prohibits unequal treatment in taxation of undertakings in a similar factual and legal situation. This principle binds the Member States, and the national tax rules are not excluded from its scope.[19]

The Notice explains that, when the Commission examines whether a transfer pricing ruling complies with the arm's length principle inherent in T.F.E.U. Article 107(1), the Commission may refer to the guidance provided by the O.E.C.D., in particular the "O.E.C.D. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" (the "O.E.C.D. Transfer Pricing Guidelines"). Those guidelines do not deal with matters of State Aid per se, but they capture the international consensus on transfer pricing. The guidelines also direct tax administrations and M.N.E.'s on how to ensure that a transfer pricing methodology produces an outcome in line with market conditions. Consequently, if a transfer pricing arrangement complies with

Inquiry Target," *Checkpoint International Tax Monitor*, June 7, 2016.

17 "Commission Notice on the Notion of State Aid," p. 50.

18 *Id.*, p. 51.

19 *Id.*, pp. 51-52.

the provisions of the O.E.C.D. Transfer Pricing Guidelines, including guidance on selecting the most appropriate method that leads to a reliable approximation of a market-based outcome, a tax ruling endorsing that arrangement is unlikely to give rise to State Aid.[20]

The Notice summarizes that, in particular, a tax ruling confers a selective advantage on an entity where

- the ruling misapplies national tax law, and this results in a lower amount of tax;
- the ruling is not available to undertakings in a similar legal and factual situation;[21] or
- the Member State's administration applies a more favorable tax treatment compared with other taxpayers in a similar factual and legal situation.[22]

The Notice's clarification of a selective advantage supports the Commission's argument that it has legal authority to enforce the State Aid decisions. The bulk of the Commission's State Aid investigations have been on transfer pricing rulings, with a focus on the arm's length principle. Although the arm's length principle may not be codified under E.U. law, it is established in the O.E.C.D. Transfer Pricing Guidelines, which have been adopted by the Member States. The Commission has already decreed that the Starbucks's transfer pricing ruling from the Netherlands amounted to unlawful State Aid, but the Commission is still investigating transfer pricing rulings between Ireland and Apple, Luxembourg and Amazon, and Luxembourg and McDonald's.

Authority of Tax Settlements

The Notice also justifies the Commission's authority to investigate tax settlements between Member States and taxpaying entities, by clarifying the scope of these settlements under E.U. law. Tax settlements have yet to be the subject of State Aid investigations, but the Notice's explanation of how tax settlements provide a selective advantage establishes grounds for future Commission investigations.

The Notice defines tax settlements as a common practice in many Member States that generally occurs in the context of disputes between taxpayers and the tax authorities concerning the amount of tax owed. Tax settlements allow tax authorities to avoid long-standing disputes before the domestic courts and ensure quick recovery

20 *Id.*, p. 52.

21 The Notice provides, as an example, that this would be the case if some undertakings involved in transactions with controlled entities are not allowed to request tax rulings, contrary to a pre-defined category of undertakings.

22 For instance, this will be the case where the tax authority accepts a transfer pricing arrangement that is not at arm's-length, because the methodology endorsed by that ruling produces an outcome that departs from a reliable approximation of a market-based outcome (as in the Starbucks decision). The same applies if the ruling allows the taxpaying entity to use alternative, more indirect methods for calculating taxable profits (*e.g.*, the use of fixed margins for a cost-plus or resale-minus method for determining an appropriate transfer pricing, while more direct ones are available). ("Commission Notice on the Notion of State Aid," p. 54.)

of the tax due. While the competence of Member States in this field is not in dispute, State Aid may be involved in the conclusion of a tax settlement. In particular, it may arise where the amount of tax appears to have been reduced without clear justification (such as optimizing the recovery of debt) or in a manner that is disproportionately beneficial to the taxpayer.[23]

"As the Commission's State Aid investigations into tax rulings become more robust, it is only a matter of time before the investigations extend to tax settlements."

The Notice explains that a transaction between a Member State's tax administration and a taxpayer may, in particular, entail a selective advantage in the following situations:

(a) in making disproportionate concessions to a taxpayer, the [Member State's] administration applies a more 'favourable' discretionary tax treatment compared to other taxpayers in a similar factual and legal situation;

(b) the settlement is contrary to the applicable tax provisions and has resulted in a lower amount of tax, outside a reasonable range. This might be the case, for example, where established facts should have led to a different assessment of the tax on the basis of the applicable provisions (but the amount of tax due has been unlawfully reduced).[24]

The Commission is expected to start investigating tax settlements between Member States and multinational taxpayers. For example, many thought the multimillion-pound tax settlement between the U.K. and Google should have been several billion pounds instead. Such tax settlements could be construed as sweetheart tax deals that provide favorable treatment, and thus unlawful State Aid, to multinational taxpayers.[25] The Notice lays out the legal authority for the Commission to examine such settlements. As the Commission's State Aid investigations into tax rulings become more robust, it is only a matter of time before the investigations extend to tax settlements.

OBSERVATIONS FROM A U.S. PERSPECTIVE

The Commission's State Aid decisions raise various complex issues with significant importance to U.S. companies currently or potentially under investigation.

E.U. Law Superseding Income Tax Treaties with Non-E.U. Countries

Within the E.U., E.U. law supersedes the domestic laws of the Member States. If the Commission finds that a Member State provided a taxpayer with illegal State Aid, that state must act without delay to recover that aid from the taxpayer.[26] Generally, rules on State Aid therefore trump bilateral income tax treaties. From a U.S. legal perspective, the T.F.E.U. and State Aid-related rules are not, and cannot, be granted this quasi-constitutional status.

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23 *Id.*, p. 53.

24 *Id.*, p. 55.

25 Ali Qassim, "Uncertainty Ahead."

26 "Council Regulation (EC) No 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 of the EC Treaty," *Official Journal of the European Communities* L 083 (1999), art. 14, para. 3.

U.S. Foreign Tax Credit on State Aid Assessment Payments – Timing

Under U.S. Federal income tax law, a foreign tax credit is subject to the condition that all legal remedies, including appeals, have been exhausted.[27] Consequently, a foreign tax credit, if deemed applicable in this context,[28] may not be available under U.S. tax rules as long as the appeals procedures are pending. Another interesting aspect is that, upon an appeal of the Commission's State Aid decision, the courts may only accept or reject the Commission's decision in its entirety. If the decision is accepted, the courts are not entitled to decide on adjustments of the amount of State Aid that must be recovered by the Member State.

A New Arm's Length Standard Introduced by the Commission

In the Commission's decisions on Belgian tax rulings and the Luxembourg Fiat case, it made a notable statement, which based on the Netherland's reaction, also appears in the Starbucks decision:

> The arm's length principle therefore necessarily forms part of the Commission's assessment under Article 107(1) of the TFEU of tax measures granted to group companies, independently of whether a Member State has incorporated this principle into its national legal system. It is used to establish whether the taxable profits of a group company for corporate income tax purposes has been determined on the basis of a methodology that approximates market conditions, so that that company is not treated favourably under the general corporate income tax system as compared to non-integrated companies whose taxable profit is determined by the market.[29] *Thus, for any avoidance of doubt, the arm's length principle that the Commission applies in its State aid assessment is not that derived from Article 9 of the OECD Model Tax Convention, which is a non-binding instrument, but is a general principle of equal treatment in taxation falling within the application of Article 107(1) of the TFEU, which binds the Member States and from whose scope the national tax rules are not excluded.*[30] [emphasis added]

Does this mean the European Commission introduces a new arm's length standard? If so, how would it deviate from the standard found in the O.E.C.D. Model Convention and O.E.C.D. Tranfer Pricing Guidelines? Does the T.F.E.U. provide authority for the Commission on Competition – previously a non-tax focused body – to set forth an arm's length standard for transfer pricing (*i.e.*, tax purposes)? According to

27 Treas. Reg. §1.901-2(e)(5).

28 Note that it is still unclear whether assessment payments under State Aid procedures should qualify as creditable tax payments for U.S. foreign tax credit purposes or as (non-creditable) damages.

29 The same language appears in Commission Decision no. SA.37667 (*Belgium*), para. 150 (January 1201, 16), except that it refers to the O.E.C.D. Transfer Pricing Guidelines in addition to Article 9 of the O.E.C.D. Model Convention.

30 "See Joined Cases C-182/03 and C-217/03, *Belgium and Forum 187 v. Commission*, ASBL ECLI:EU:C:2006:416, paragraph 81. See also Case T-538/11 *Belgium v. Commission* EU:T:2015:188, paragraphs 65 and 66 and the case-law cited." (Commission Decision no. SA.38375 (*Luxembourg Fiat*), para. 228 (October 21, 2015))

the view held by the Netherlands in its appeal, this is definitely not the case. That the Notice includes clarifications in this respect is unlikely to provide sufficient legal basis and thus change the Dutch view. The constraints that the State Aid decisions put on the taxing authority of the Member States have already been pointed out. With these State Aid decisions, this would rise to another – international – level, in particular in view of dismantling competent authority procedures with non-E.U. countries.

"The only certainty for M.N.E.'s operating in the E.U. is that there is uncertainty in the outcome of any tax ruling or tax settlement that these entities may have with Member States."

CONCLUSION

The Commission has great latitude in investigating all aspects of State Aid, including when a Member State provides an individual tax ruling or tax settlement to a multinational taxpayer. As the Commission's State Aid probe expands, more Member States are taking the position that the Commission is impeding domestic sovereignty and acting beyond the scope of E.U. law. The tension is growing between protecting the right of a Member State to directly tax its constituents and the Commission's mandate to protect the E.U. single market from anti-competitive tax practices. From a U.S. legal perspective, the impact of the State Aid decisions is far reaching – timing of foreign tax credits, if applicable at all; dismantling of income tax treaties; and a new arm's length standard are just some examples. The only *certainty* for M.N.E.'s operating in the E.U. is that there is *uncertainty* in the outcome of any tax ruling or tax settlement that these entities may have with Member States.

TREASURY ATTACKS EUROPEAN COMMISSION ON STATE AID – WHAT NEXT?

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On August 30, 2016, the European Commission ("the Commission") ordered Ireland to claw back €13 billion ($14.5 billion) plus interest from Apple after favorable Irish tax rulings were deemed to be illegal State Aid by the Commission. Not only did the Commission issue this decision, but at the same time, it invited other nations to consider whether profits that flowed through Apple's nonresident Irish branch should instead be taxed in their respective jurisdictions.[1]

This interpretation was shared by O.E.C.D. Secretary-General Angel Gurria,[2] and France may follow suit. In a statement on September 9, 2016, French Finance Minister Michel Sapin called the decision against Apple "completely legitimate," but left it open as to whether France would assess back tax on the company.[3]

The offices of Google and McDonald's in France were raided by French authorities in May of this year. In Italy, Apple paid €318 million in a settlement of a ruling by the Italian tax authorities that the company had improperly booked €880 million in profits to an Irish subsidiary from 2008 to 2013. Apple is also believed to be the subject of investigations by Spanish tax authorities.[4]

European Tax Commissioner Pierre Moscovici defended the European Union's Apple ruling as neither "anti-U.S." nor "arbitrary." Upon his arrival in Slovakia for the Economic and Financial Affairs Council ("E.C.O.F.I.N.") meeting at the beginning of September, the commissioner told reporters that the ruling "is based on facts and data which apply to all companies wherever they come from, and especially from European Union countries." On another occasion, Competition Commissioner Vestager pointed out that BP Plc was forced to pay additional taxes, but was reluctant to comment on the investigation into IKEA.[5] Wherever one's the stance on

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1 In particular, two comments by E.U. Competition Commissioner Margrethe Vestager were noted: The first was that "the money belongs to Ireland," and the second was that "anybody who thinks they have a claim, bring the claim forward and tell us why you think you have a claim."

2 Secretary-General Gurria made the comment in response to a question posed during a September 10 news conference held at the conclusion of a two-day meeting of European Union finance ministers in Bratislava.

3 Notably, France has already had internet multinationals on its radar. In 2013, Amazon revealed that it was contesting a French assessment of $252 million in back taxes. In May of this year, the Paris offices of Google were raided by French officials in the course of a probe into whether Google's Irish unit has a permanent establishment in France.

4 Neither Apple nor representatives of the Spanish tax authorities confirmed the existence of a Spanish investigation.

5 Investigations were initiated by the Swedish Green Party, which provided information to the European Commission.

the U.S.-European debate, it is indisputable that, with limited exception,[6] the most recent tax-related State Aid cases ruled upon by the Commission have focused exclusively on U.S. multinationals' European operations.

THE APPLE CASE: BACKGROUND AND FURTHER DEVELOPMENTS

On June 11, 2014, the European Commission initiated an investigation into advance pricing arrangements provided by the Irish tax authorities to Apple, regarding the attribution of profits to an Irish branch of an Irish company that, under Irish law, was treated as nonresident. The company was not managed and controlled in Ireland. According to the E.U., Apple Sales International allocated the vast majority of its profits to a "head office" that, in the European Commission's opinion, was an entity without economic substance. Apple's tax plan reduced its taxable income considerably. The European Commission's view was that these Irish arrangements with Apple constituted State Aid.

"In an unprecedented procedure, the U.S. Treasury Department released a white paper shortly before the European Commission's Apple decision was issued."

Both Apple and Ireland[7] confirmed that they will appeal the European Commission's decision. It may take years until the case is settled and may ultimately be decided by the European Court of Justice ("E.C.J."). Interestingly, the E.C.J. can merit the Commission's decision or reject it in its entirety, but it cannot revise the amount of the claw-back. It should also be noted that an appeal does not affect the obligation to pay the claw-back amount stipulated in the Commission's decision.[8] To date, the European Commission has initiated State Aid investigations against Apple, Amazon, Starbucks, and Fiat (now Fiat Chrysler Automobiles). Appeals against the Commission's decisions in the Starbucks and Fiat cases are already pending at the European General Court.[9] The Commission has not yet reached a final decision in the Amazon case.

As has been previously noted, the fairness of the European Commission's examination of U.S. multinationals has been questioned. Robert Stack, Deputy Assistant Secretary for International Tax Affairs at the U.S. Treasury Department, believes that American companies are being unfairly targeted in the investigations.

In an unprecedented procedure, the U.S. Treasury Department released a white paper[10] ("White Paper") shortly before the European Commission's Apple decision was issued. It expressed profound concern with the European Commission's

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6 One case was directed at the Belgian excess profit scheme and not at a particular company. Another case is being pursued against French utility company Engie SA, formerly GDF Suez.

7 On September 7, 2016, Irish Finance Minister Michael Noonan issued a statement to the House of Representatives (*Dáil Éireann*), seeking support to appeal the European Commission's decision that tax rulings issued by Ireland to Apple in 1991 and 2007 constituted illegal State Aid. On the same date, the Irish Department of Finance issued an explanatory memorandum for Parliament detailing House support of the Irish government's plans to appeal the decision.

8 The amount may be held in escrow until the final decision.

9 Prior to the Lisbon Treaty becoming effective on December 9, 2009, known as Court of First Instance.

10 U.S. Department of the Treasury, "The European Commission's Recent State Aid Investigations of Transfer Pricing Rulings," August 24, 2016.

investigations. The White Paper focused on three points:

- The investigations departed from prior E.U. case law and decisions.
- Retroactive recoveries through the investigation process is inappropriate.
- The European Commission's approach is inconsistent with O.E.C.D. transfer pricing guidelines.

The U.S. Treasury Department believes that the European Commission's investigations undermine the development of transfer pricing norms, the B.E.P.S. Project, and the ability of countries to honor their bilateral tax treaties with the U.S. It additionally notes that any repayment ordered by the European Commission will be entitled to a foreign tax credit in the U.S., thereby reducing U.S. tax liability and effectively transferring tax revenue from the U.S. to the E.U. Finally, the U.S. Treasury Department believes that the investigations will freeze cross-border investment between the E.U. and the U.S. and that retroactive penalties will hinder the ability for companies to plan for the future.

TREASURY'S ANALYSIS OF STATE AID AND THE EUROPEAN COMMISSION INVESTIGATIONS

State Aid exists when a national measure is financed by the state or through state resources in a way that (i) provides an advantage for a business undertaking, (ii) is selective in its application, and (iii) as a result, affects trade between member states by distorting competition.[11] The White Paper focuses primarily on the selectivity and business advantage elements of the definition.

"Advantage" was defined in prior case law to mean "any economic benefit which an undertaking could not have obtained under normal market conditions." For an advantage to be found, it had to be granted in a "selective way to certain undertakings of categories or to certain economic sectors."[12] According to the White Paper, once an advantage has been found, an analysis must be performed to determine whether the advantage is "selective." To be selective, a measure must provide a benefit to certain undertakings in comparison with other comparable undertakings.[13]

The White Paper concludes that prior European Commission rulings stated that measures available to companies with foreign affiliates but not available to domestic companies without foreign affiliates did not constitute "selective measures." Based on these prior rulings, a U.S. multinational would reasonably assume that a transfer pricing ruling granted in good faith by an E.U. Member State would not constitute a "selective measure" simply because a multinational has foreign affiliates whereas a

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11 *Air Liquide Industries Belgium SA v. Ville de Seraing a.o.*, Joined Cases C-393/04 & C-41/05, ECLI:EU:C:2006:403, ¶28. See also "Tax Rulings in the European Union – State Aid as the European Commission's Sword Leading to Transparency on Rulings," *Insights* 6 (2015).

12 Commission Notice on the notion of state aid as referred to in Article 107(1) of the TFEU, 2016 O.J. C 262/1, ¶¶5, 66 and 117.

13 *Portugal v. Commission*, Case C-88/03, ECLI:EU:C:2006:511, ¶54 (citing, among others, *Adria-Wien Pipeline*, Case C-143/99, ECLI:EU:C:2001:598, ¶41).

standalone European company has no affiliates.[14]

The White Paper notes that the European Commission previously separated its advantage analysis from its selective analysis in 65 prior cases. Now, however, in cases involving U.S.-based multinationals, the European Commission has merged the concepts of advantage and selectivity to conclude that a transfer pricing ruling is a selective advantage for a company that is part of a multinational group. According to the U.S. Treasury, the European Commission expanded protection of local companies because "selectivity" was often the largest barrier to finding the existence of a State Aid violation.

Observation

On this point, the U.S. Treasury Department is in line with the applicants in their appeal against the Commission's decisions in Starbucks and Fiat, focusing on the Commission's assessment of the two key State Aid conditions, *i.e.* advantage and selectivity. The Commission's new approach of collapsing the advantage and selectivity requirements has important substantive significance. Now, the Commission can find advantage if it disagrees with the Member State's application of the arm's length principle to a particular set of facts that are often highly complicated. The Commission's new approach reduces a State Aid inquiry to the question of whether the Commission believes that a transfer pricing ruling satisfies its view of the arm's length principle.[15]

RETROACTIVE RECOVERY

For a violation of State Aid regulations, the European Commission may require recovery for up to 10 years, with interest accruing for the period that the illegal aid was granted until the aid is recovered. According to the White Paper, U.S. multinational groups could not have foreseen the European Commission's new approach. Consequently, the recovery amount is a retroactive penalty.

In effect, because the transfer pricing was held to be valid in certain countries and due to the fact that the European Commission had tacitly accepted such arrangements for a long period, multinationals could not know that they would be considered to be infringing E.U. law. The U.S. Treasury Department notes that such a retroactive penalty is a fundamental violation of the principles stated by the G-20, the E.U., and the B.E.P.S. Project, which provide certainty to taxpayers while respecting each country's domestic transfer pricing agreements.

Finally, while the European Commission rulings make reference to an "arm's length principle," the U.S. Treasury Department notes that such a term remains undefined in the rulings. The White Paper implies what most U.S. tax advisers believe: that the

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14 Treatment by the Netherlands tax authorities of a technolease agreement between Philips and Rabobank, Commission Decision 2000/735/EC, 2000 O.J. L 297/13, ¶36

15 In a summary of its claims, Fiat stated:

> The contested decision breaches the principle of legal certainty since the commission's novel formulation of the arm's length principle introduces complete uncertainty and confusion as to when an advance pricing agreement, and indeed any transfer pricing analysis, might breach EU state aid rules.

investigations are politically motivated to punish E.U. countries with low tax rates or favorable practices, and multinationals that plan structures using those jurisdictions.

Observation

The introduction of a new arm's length standard by the European Commission has been previously noted in *Insights*.[16] The U.S. is joined in this assessment by Fiat and the Netherlands. In their appeals, Fiat touched the heart of the matter when it accused the Commission of failing to show how it derived the arm's length principle from Union law, or even what the principle is. These are harsh words, and a similar argument was put forward by the Netherlands in an even more unequivocal manner, when it was argued that there is no arm's length principle in E.U. law and that that principle is not part of a State Aid assessment.

In addition, the claw-back of taxes poses the following question: who is bearing the cost? Eventually, it will be the U.S. taxpayer, due to the foreign tax credit system in effect in the U.S. Under the U.S. tax system, foreign income taxes imposed on foreign subsidiaries of U.S. companies may be credited by their U.S. parent company when dividends are paid.[17] Within the limitations of U.S. tax law,[18] the credit reduces U.S. tax imposed on foreign-source income.

Some believe that the State Aid cases brought by the European Commission will invite a transatlantic trade war, which is of concern to the U.S. Treasury Department. In the White Paper, the following comment was made:[19]

> A strongly preferred and mutually beneficial outcome would be a return to the system of international tax cooperation that has long fostered cross border investment between the United States and EU Member States. The U.S. Treasury Department remains ready and willing to look for a path forward that achieves the shared objective of preventing the continued erosion of the corporate tax base while ensuring our international tax system is fair for all.

A similar statement was made by a spokesman for the U.S. Treasury Department:

> The Commission's actions could threaten to undermine foreign investment, the business climate in Europe, and the important spirit of economic partnership between the U.S. and the EU. We will continue to monitor these cases as they progress, and we will continue to work with the Commission toward our shared objective of preventing the erosion of our corporate tax bases.

In an article published in the *Wall Street Journal* on September 13, 2016, Treasury Secretary Jack Lew called for a U.S. tax reform in view of "Europe's Bite Out of Apple."

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16 Beate Erwin and Christine Long, "E.U. State Aid – The Saga Continues," *Insights* 6 (2016).

17 In addition, a credit may apply when a U.S. shareholder of a controlled foreign corporation includes in income an item of Subpart F income. Code §960.

18 Primarily, Code §904.

19 U.S. Department of the Treasury, "Treasury Releases White Paper on European Commission's State Aid Investigations into Transfer Pricing Rulings," accessed September 26, 2016..

CONCLUSION

The U.S. Treasury Department notes that the European Commission's interference in Member States' tax authority effectively undermines relations among those countries and with the U.S. More importantly, if domestic decisions can be overridden using a European Commission ruling, an E.U. Member State's power to enter into a bilateral income tax treaty is ultimately dismantled. On a practical level, U.S. multinational groups will have no interest in obtaining advance pricing agreements with an E.U. Member State which makes all pricing arrangements subject to audit in the U.S. and Europe.

The decision of the General Court in the State Aid cases will have far-reaching consequences. Should the court reject one of the Commission's main arguments, most notably its assertion that a deviation from the Commission's interpretation of the arm's length principle confers a "selective advantage" on the recipient, then it is likely that all of its final decisions will be annulled, since they are based on the same doctrinal "pillars." Moreover, if the E.C.J. does not support the Commission's approach on appeal, the Commission's use of the State Aid mechanism to crack down on tax avoidance will have failed dramatically. However, it will take years before certainty is reached on this level.

"Should the court reject one of the Commission's main arguments . . . it is likely that all of its final decisions will be annulled, since they are based on the same doctrinal 'pillars.'"

Until then, it remains to be seen whether pressure by the U.S. tax authorities will restrain the European Commission, or whether the European Commission will expand its investigations to include other U.S. multinationals. At this stage, with both the U.S. and the European Commission adamant in their respective positions, the stage is set for a prolonged battle. Meanwhile, U.S. multinationals are faced with difficult decisions on pricing and must carefully consider their European strategies.

EUROPEAN STATE AID AND W.T.O. SUBSIDIES

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INTRODUCTION

Recent European Commission ("Commission") rulings involving Apple and Starbucks[1] and a World Trade Organization ("W.T.O.") ruling involving E.U. subsidies to Airbus[2] are viewed by some as evidence of a not-so *sub rosa* trade war between the U.S. and the European Union ("E.U."). The stated view in the E.U. is that these are two separate developments that should not be linked because one relates simply to fundamental harmony within the internal market of the E.U. and the other regards provisions in global trade agreements designed to settle disputes relating to export subsidies.

This article seeks to explain the basic internal procedures within the E.U. determining and outlawing State Aid. It also explains the global trade agreement embodied in the W.T.O. in connection with export subsidies and other actions designed to promote internal business in one country that harms competitors in other countries. This article concludes by evaluating the European position that State Aid within the E.U. and actionable or prohibited distortion of trade within the context of the W.T.O. are simply separate and distinct actions and that a discriminatory act under the latter cannot be compared with an illegal act under the former.

STATE AID TO STARBUCKS AND APPLE

In the past few years, the Commission has investigated many tax rulings between various companies and E.U. Member States to determine whether the agreements breached E.U. State Aid rules.

Starbucks in The Netherlands

The 2015 *Starbucks* decision addressed a Dutch advance pricing agreement obtained by the Netherlands-based entity Starbucks Manufacturing EMEA BV ("Starbucks Manufacturing"), the only wholly controlled Starbucks group entity (outside the U.S.) that roasts coffee. Starbucks Manufacturing supplied affiliates with roasted coffee. These were identified as controlled transactions for income tax purposes.

To obtain certainty regarding Dutch tax, a ruling was obtained allowing for a margin of between 9% and 12% over total production costs incurred to produce the roasted

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1 Beate Erwin, "Treasury Attacks European Commission on State Aid – What Next?" *Insights* 8 (2016).

2 *Id.*; Peggy Hollinger, Shawn Donnan, and Arthur Beesley, "W.T.O. Gives Boeing Lift with Airbus Ruling," *The Financial Times*, September 22, 2016; Jason Lange, "U.S. Accuses E.U. of Grabbing Tax Revenus with Apple Decision, *Reuters*, August 31, 2016.

coffee that was sold to affiliates. Because reported profits for financial statement purposes exceeded cost plus 12%, the Dutch tax authority agreed to allow a deduction in the form of a floating royalty payment to another group entity, Alki LP.

Alki LP then reduced its income through payments to the U.S. group under a cost sharing agreement. Alki LP made buy-in payments and annual payments reimbursing the U.S. group for the development of intangible property. Under U.S. practice, Alki LP could use the intangible property without payment of a royalty to the U.S. group. The cost sharing payments simply reduced net costs incurred by the group.

In the view of the Commission, this arrangement was not available to all and distorted the internal market because of the advantage received by Starbuck Manufacturing and Alki LP.

Apple in Ireland

In its most recent *Apple* decision, the Commission ordered Ireland to collect a record €13 billion ($14.6 billion) in unpaid taxes from Apple, holding that certain Irish tax rulings artificially lowered the tax paid in this country since 1991.[3] Apple Ireland recorded most of the profit for Apple's European operations. In turn, Apple Ireland allocated the bulk of its profits (and hence the European profits) to a fictitious "head office" that had no substance, thus essentially allowing Apple to be taxed "nowhere."

SUBSIDIES TO AIRBUS

In its recent *Airbus* ruling, the W.T.O.'s compliance panel report (the "Panel Report") confirms its 2011 Dispute Settlement Board Report (the "D.S.B. Report").[4] As a result, and in relevant part, several measures provided to Airbus by the European Communities, France, Germany, Spain, and the U.K. were characterized as specific subsidies[5] causing serious prejudice to the interests of the U.S.

The measures at issue constituted over 300 different allegations of illegal subsidies by the European Communities and the four W.T.O. member states participating in Airbus over a period of approximately 40 years. These measures enabled Airbus to develop and produce large civil aircraft that were sold globally. The principal subsidies can be summarized as follows:

- Launch aid/member state financing provided by France, Germany, Spain, and the U.K. for the development of certain large civil aircraft projects
- Certain equity infusions provided by France and Germany to companies that were part of the Airbus group
- Certain infrastructure measures provided to Airbus (*e.g.*, the lease of land in Germany, the right to exclusive use of an extended runway at a German airport, regional grants by German authorities and government, and regional grants in Spain)

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3 See Beate Erwin, "Apple in Europe – The Uphill Battle Continues." *Insights* 2 (2016), pp. 9-15.

4 See organizational chart of the W.T.O. below.

5 See below for a definition.

When compared to the aforementioned E.U. State Aid cases, the differences in the type of considered measures are substantial. The E.U. State Aid decisions fight fictitious tax arrangements allowed by certain Member States to specific taxpayers through the grant of a favorable ruling. The W.T.O. ruling condemns measures taken by a government that cause specific damage to another government.

E.U. STATE AID CONTROVERSY

One of the key concepts of the E.U. is its internal single market. The European Single Market seeks to treat the E.U. territories as one territory without any internal borders or other regulatory obstacles that may impede four fundamental principles:[6]

- The free movement of goods
- The free movement of services
- The free movement of capital
- The free movement of persons

The main objective of the European Single Market is to stimulate competition and trade, raise quality, and help cut prices.

In order to create and maintain this single market, the various E.U. Member States, relinquished national sovereignty, in part, to the E.U. This relinquishment was effected principally through the ratification of the Treaty on the Functioning of the European Union ("T.F.E.U."). While Member States relinquished the four freedoms, mentioned above, other aspects of national sovereignty were retained. Thus, the E.U., through its institutions, may only act within the limits of the grants of authority conferred to it by the Member States.

To further the achievement of the European Single Market, the E.U. State Aid rules were included in the T.F.E.U. These rules are designed to ensure fair and equal market conditions for commercial enterprises active within the various countries that comprise the European Single Market. Article 107 of the T.F.E.U. provides in relevant part that:

> Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.

The article further provides a list of deemed compatible aids and potential compatible aids.

In a 1998 Notice, the Commission further expanded the definition of State Aid.[7] It provides the following criteria upon which a measure by a Member State may be viewed to constitute State Aid:

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6 Article 26 of the T.F.E.U.

7 "Commission Notice on the Application of the State Aid Rules to Measures Relating to Direct Business Taxation," *Official Journal* C 384 (1998), pp. 3-9.

- The recipient of the measure is granted an advantage relieving it of certain charges it may otherwise incur. This advantage may reduce the taxpayer's tax burden in several ways, including
    - a tax base reduction (such as a special deduction, a special or accelerated depreciation arrangement, or the entering of reserves on the balance sheet),
    - a total or partial reduction in the amount of tax (such as an exemption or a tax credit), and
    - a deferment, cancellation, or even special rescheduling of tax debt
- The advantage must be granted either by the Member State (including its regional or local bodies) or through its resources. Whether that measure is provided for in a given Member State's tax laws or through the practice of its tax authorities is irrelevant. A loss of tax revenue is equivalent to consumption of Member State resources in the form of fiscal expenditure.
- The measure must affect competition and trade between Member States.
- The measure must be specific or selective in that it favours "certain undertakings or the production of certain goods."

"As the Commission is responsible for enforcing the E.U. State Aid rules, it may, on its own initiative, examine information regarding alleged unlawful aid from any source."

Article 108(1) of the T.F.E.U. states that "the Commission shall, in cooperation with Member States, keep under constant review all systems of aid existing in those States." Such review extends to tax measures because Article 107 applies to measures in any form whatsoever.[8] Thus, although the Member States retain sovereignty in terms of direct taxes, their direct tax systems must be compliant with the E.U. State Aid rules.[9] As the Commission is responsible for enforcing the E.U. State Aid rules, it may, on its own initiative, examine information regarding alleged unlawful aid from any source.[10]

In this area, the Commission operates in several steps. It begins by opening a preliminary investigation. If questions regarding the compatibility of the measure persist, the Commission then carries out an in-depth investigation.[11] The decision to initiate the formal investigation procedure is sent to the relevant Member State.

Pursuant to the formal investigation, a final decision is taken. There is no legal deadline to complete an in-depth investigation, and its actual length depends on many factors, including the complexity of the case, the quality of the information provided, and the level of cooperation by the Member State concerned.[12]

Three possible outcomes exist:

- The Commission reaches a favorable decision regarding the measure at issue. The measure is considered not to be aid or the aid is considered to be compatible with the internal market.

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[8] *Id.*

[9] *Italy v. Commission*, Case 173/73, EU:C:1974:71.

[10] Council Regulation 2015/1589, Article 12.

[11] "Competition: State Aid Procedures," European Commission.

[12] *Id.*

"The main purpose of the W.T.O. is to allow 'open, fair and undistorted competition' with regard to goods, services, and intellectual property, to the extent possible."

- The Commission reaches a conditional decision. The measure at issue is found compatible, but its implementation is subject to conditions stated in the decision.
- The Commission reaches a negative decision. The measure is incompatible with Article 107 of the T.F.E.U. and must be withdrawn retroactively. The Commission, in principle, orders the Member State to recover the State Aid that has already been paid out to the beneficiaries.

The Commission can order the retroactive recovery of unlawful State Aid for a period of up to ten years preceding the Commission's first action taken with regard to the unlawful aid.[13] The aim of recovery is to remove the undue advantage granted to a company and to restore the market to its state before illegal State Aid was granted. A Member State is deemed to comply with the recovery decision when the aid (plus compound interest) has been fully recovered.[14] If the relevant Member State does not comply with the decision in due time, the Commission may refer it to the C.J.E.U.[15]

W.T.O. PROHIBITION REGARDING SUBSIDIES

The W.T.O. was established on January 1, 1995, as a result of the Uruguay Round of the General Agreement on Tariffs and Trades ("G.A.T.T."). It is composed of 164 member states as of July 29, 2016.[16] The main purpose of the W.T.O. is to allow "open, fair and undistorted competition" with regard to goods, services, and intellectual property, to the extent possible.[17]

The W.T.O. also provides a forum for the settlement of disputes. The W.T.O. settlement procedures are directed at government actions that distort trade. The decisions of the W.T.O. are binding on the governments that are parties to the dispute.

Typical areas of dispute include

- dumping practices, occurring when a company exports a product at a price that is lower than the price it normally charges on its own home market;
- export subsidies; and
- emergency measures that temporarily limit imports to protect domestic industries.

The following organizational chart facilitates the understanding of the W.T.O.'s work:[18]

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13 Regulation 2015/1589, Article 17.

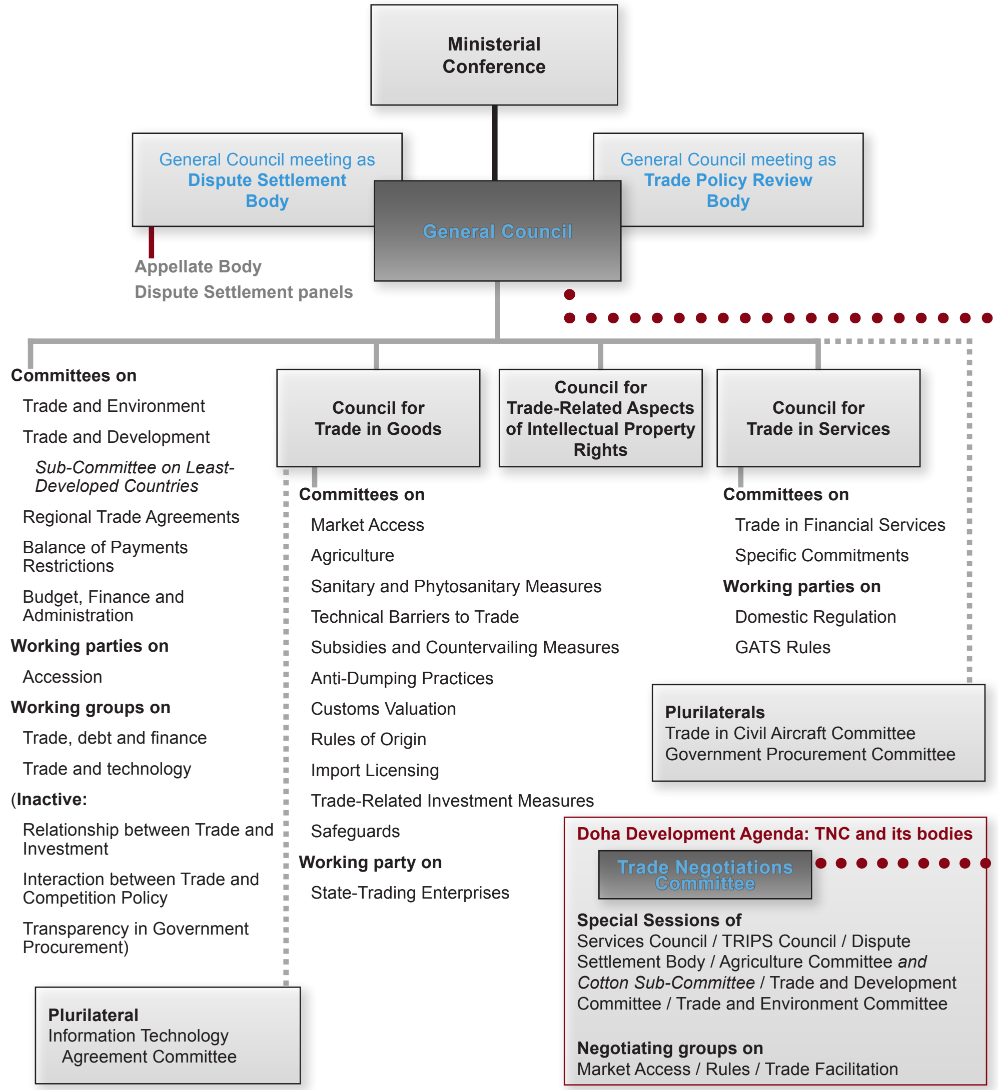
14 European Commission, "State Aid: Recovery of Illegal State Aid Gets Faster as Commission Tightens Procedures," press release, February 18, 2011.

15 Article 258 of the T.F.E.U.

16 "Understanding the WTO – Members," W.T.O.

17 *Understanding the WTO*, Fifth Edition, (Geneva: World Trade Organization Information and External Relations Division, 2015), pp. 10, 12, and 23.

18 "Understanding the WTO – Organization Chart," W.T.O.



Of the three main areas of dispute, the balance of this article focuses on the regulation of subsidies and the dispute settlement procedure.

Among the various agreements between the members of the W.T.O. is the Agreement on Subsidies and Countervailing Measures (the "S.C.M. Agreement"), which contains a definition of the term "subsidy." This definition is composed of three basic elements: (i) a financial contribution (ii) by a government or any public body within the territory of a W.T.O. member state (iii) that confers a benefit. All three of these elements must be satisfied in order for a subsidy to exist.

A financial contribution requires a charge on government funds. It can take the form of any of the following measures made directly or through payments to an intermediary:[19]

- A government practice involving a direct transfer of funds (*e.g.*, grants, loans, and equity infusion) or a potential direct transfer of funds or liabilities (*e.g.*, loan guarantees)

[19] Article 1 of the S.C.M. Agreement and Article 16 of G.A.T.T. 1994.

- The relinquishment of government revenue or the failure to collect revenue (as would be the case with a credit or an exemption from tax generally due on domestic sales)

- The provision of goods or services other than general infrastructure by a government or the purchase of goods by a government

- Any form of income or price support that operates, directly or indirectly, to increase exports of any product from or reduce imports of any product to its territory

A subsidy is subject to the terms of the S.C.M. Agreement only if it has been specifically provided to an enterprise or industry or group of enterprises or industries so that it is not broadly available within a given economy. The basic principle is that a subsidy that distorts the allocation of resources within an economy violates the S.C.M. Agreement. In comparison, a subsidy that is widely available within an economy does not distort resources and for that reason is not subject to the S.C.M. Agreement.

Article 2 provides that the following fact patterns involve subsidies that violate the S.C.M. Agreement because benefits are directed to certain enterprises:

- Access to the subsidy is explicitly limited to certain enterprises either by law or by administrative practice.

- The law or the administrative practice for granting the subsidiary does not provide objective criteria for eligibility, or if such criteria exists, the subsidy is not automatic or the administrative practice is not strictly followed.

- There is reason to believe that the subsidy may be specific, based on other factors, such as

  - the subsidy program is used by a limited number of enterprises;

  - the subsidy program is predominantly used by a limited number of enterprises; or

  - the way in which discretion has been exercised by the granting authority.

A subsidy also is subject to the S.C.M. Agreement if it is limited to certain enterprises located within a designated geographical region, or if it targets export goods or goods using domestic inputs.

Once a subsidy subject to the S.C.M. Agreement exists, a determination must be made whether the subsidy is prohibited or actionable. Prohibited subsidies are those that promote exports and those that have local content requirements. Actionable subsidies are subsidies that cause adverse effects to the interests of another member of the W.T.O. Most subsidies fall in this category.

There are three types of adverse effects. First, there is injury to a domestic industry caused by subsidized goods that are imported into the territory of the complaining member state. Second, there is serious prejudice, which usually arises because of adverse effects of the subsidy on the market of the complaining member state or a third country. Third, there is nullification or impairment of benefits accruing under

G.A.T.T., meaning an impairment of market access is presumed to flow from a tariff reduction as a result of the subsidy.[20]

CONCLUSION

As to procedure, Commission decisions regarding illegal State Aid of an E.U. Member State differs from W.T.O. rulings as to trade disputes that impair global trade.

- The Commission's rulings on State Aid are binding on the relevant Member State, which then must recover up to ten years in back taxes and interest.
- The W.T.O.'s rulings are based on good faith participation by the W.T.O. member states. Every member will then carefully consider whether a countermeasure, such as the implementation of an import duty, would be the appropriate remedy. No retroactive effect is given to a W.T.O. ruling.

However the goals of Article 107 of the T.F.E.U. to stop actions that distort free trade and those of Article 2 of the S.C.M. Agreement appear to be identical.

PROVISONS THAT MAY CONSTITUTE STATE AID	PURPOSE OF W.T.O. AGREEMENT; ACTIONABLE & PROHIBITED ACTS
The recipient of the measure is granted an advantage relieving it of certain charges it may otherwise incur.	A benefit conferred by a government or any public body within the territory of a member in the form of a financial contribution.
This advantage may reduce the taxpayer's tax, which amounts to a loss of tax revenue.	The foregoing of or absence of collection of revenue, for instance tax incentives such as tax credits.
The measure must affect competition and trade between Member States.	Government actions contrary to open, fair and undistorted competition.
The measure must be specific or selective in that it favors certain undertaking.	Access to a subsidy that is explicitly limited to a certain enterprise.

There may be many ways to look at the foregoing similarities between the Commission actions against Apple and Starbucks, and the W.T.O. decision in the *Airbus* case. However, the quantum of similarities in the goals of E.U. principles and W.T.O. principles leads one to question the judgment of the Commission to attack Member States and U.S. companies on the basis of illegal distortion to internal trade, while at the same time turning a blind eye on subsidies granted to European enterprises in a way that distorts a global market.

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20 Article 5 of the S.C.M. Agreement.

THE RESURRECTION OF CODE §385

TREASURY DEPARTMENT REVISES REGULATIONS ON RELATED-PARTY DEBT

RELATED-PARTY DEBT: PROPOSED CODE §385 REGULATIONS RAISE MAJOR NEW HURDLES

Author
Philip R. Hirschfeld

Tags
Code §163(j)
Code §385
Code §482
Code §7874
Earnings Stripping
Interest Deductions
Inversions
Related-Party Debt

INTRODUCTION

On April 4, the Treasury Department issued proposed regulations under Code §385[1] that will have a major impact on *any* tax planning involving related-party debt by potentially recharacterizing such debt as equity under three new rules.[2]

- First, a debt recharacterization rule provides that debt instruments are treated as stock if issued in certain disfavored transactions (such as when debt is distributed as a dividend to a shareholder).[3]
- Second, documentation requirements are imposed as a condition to retain the treatment of related-party debt as true debt (and not equity) for tax purposes.[4]
- Third, a bifurcation rule allows the I.R.S. to recharacterize certain related-party debt as part debt and part equity.[5]

While these proposals were accompanied by adoption of new inversion rules under Code §7874,[6] these new Code §385 rules are not limited to debt issued in an inversion. Rather, the Code §385 regulations apply to *any* debt issued between related parties, whether in an international or purely domestic context.

These sweeping changes demand a review of proposed debt arrangements to determine the modifications that are needed to minimize possible adverse impact and alternative action that may be needed if current planning comes within the crosshairs of the new rules.

If finalized, the new debt recharacterization rule would generally apply to any debt instrument issued on or after April 4, 2016.[7] By contrast, the new documentation rules and the bifurcation rule will generally apply to debt issued on or after publication of final regulations under Code §385.[8]

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1 References to a section are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

2 Prop. Treas. Reg. §§1.385-1, 2, 3, & 4.

3 Prop. Treas. Reg. §1,385-3.

4 Prop. Treas. Reg. §1,385-2.

5 Prop. Treas. Reg. §1.385-1(d).

6 T.D. 9761 (April 4, 2016). See also Philip Hirschfeld, "Inversions Under Siege: New Treasury Regulations Issued," *Insights* 3, no. 4 (2016).

7 Prop. Treas. Reg. §1.385-3(h).

8 Prop. Treas. Reg. §§1.385-1(f), 2(f).

At the May 2016 meeting of the American Bar Association's Section of Taxation (the "A.B.A. Meeting"),[9] the International Tax Counsel for the Department of the Treasury, Danielle Rolfes, indicated that these proposed regulations are a high priority item for the government. While she indicated that the Treasury is open to some modifications based on comments it receives, the primary goal is to finalize the regulations, especially the debt recharacterization rule, later this year. Rushing to finalize controversial regulations during the last months of an Administration's second term in office is not a new event, and can sometimes lead to less than optimum results.

BACKGROUND

In an attempt to thwart inversions, the Treasury previously issued Notice 2014-52[10] on September 22, 2014 and Notice 2015-79[11] on November 19, 2015. These notices indicated that the Treasury would issue regulations to limit the benefits of certain post-inversion tax avoidance transactions. Among other things, the notices also indicated that the Treasury considered guidance to restrict strategies that avoid U.S. tax on U.S. operations by shifting or "stripping" U.S.-source earnings to lower-tax jurisdictions through the use of intercompany debt. Such transactions are commonly done after an inversion transaction. Although these earlier notices focused solely on inversions, the actions taken on April 4 were not limited to debt issued in an inversion. Affected debt may include debt owed by any U.S. subsidiary to its foreign parent or debt issued by any U.S. corporation, including a real estate investment trust ("R.E.I.T."), to a related U.S. person.

The Treasury's decision to use Code §385 as the means to attack earnings stripping was a surprise. While Code §385 directly addresses debt-equity classification issues, this section was dormant for almost 40 years with no regulations having been issued, apart from a set of regulations that were withdrawn in 1983.[12] At the A.B.A. meeting, some practitioners expressed concern that the Treasury may have acted beyond its powers in adopting the debt recharacterization rule. The International Tax Counsel responded that the Treasury had broad regulatory power under Code §385 that justified its actions. In response to other questions, the International Tax Counsel stated unequivocally that the regulations do not violate the non-discrimination provisions of U.S. tax treaties or otherwise conflict with any treaty.

Code §385(a), as originally enacted,[13] authorizes the Treasury to issue regulations that are necessary to determine whether an interest in a corporation is treated as stock or indebtedness for purposes of the Code. Code §385(b) provides that the regulations shall set forth factors that are to be taken into account in making such determination. These factors may include (i) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of

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[9] References to the A.B.A. Meeting refer to the "Current Developments Panel" at the Foreign Activities of U.S. Taxpayers, Transfer Pricing and U.S. Activities of Foreigners & Tax Treaties Luncheon held on May 6, 2016, at which the author was present.

[10] 2014-42 IRB 712.

[11] 2015-49 IRB 775.

[12] T.D. 7920, 1983-2 C.B. 69.

[13] Tax Reform Act of 1969 (Pub. L. No. 91-172, 83 Stat. 487).

interest; (ii) whether there is subordination to or preference over any indebtedness of the corporation; (iii) the ratio of debt to equity in the corporation; (iv) whether there is convertibility into the stock of the corporation; and (v) the relationship between holdings of stock in the corporation and holdings of the interest in question.

In 1989, Congress amended Code §385(a) to expressly authorize the Treasury to issue regulations under which an interest in a corporation is to be treated as in part stock and in part indebtedness.[14] In 1992, Congress added Code §385(c),[15] which provides that the issuer's characterization (as of the time of issuance) as to whether an interest in a corporation is stock or indebtedness is binding on the issuer and on all holders of such interest (but shall not be binding on the I.R.S.).[16]

TAX BENEFITS OF DEBT

When an investor is asked to infuse capital into a company, it often is valuable for part of that capital to be treated as a loan, rather than an equity investment.[17] As described below, capitalizing a company with debt as well as equity can produce major tax benefits for all parties involved.

Consider a situation where a U.S. subsidiary of a foreign parent company needs more money from its parent company. If the money is advanced for added stock or as a capital contribution, repayment of the amount contributed typically will be made by cash distributions to the shareholder that are subject to the characterization rules of Code §301. These distributions are treated first as dividends to the extent of the company's current or accumulated earnings and profits ("E&P").[18] Dividends distributed to a foreign shareholder are subject to a 30% U.S. withholding tax,[19] which may be reduced or eliminated by an applicable tax treaty.[20] Redemptions may be subject to comparable treatment if the redemption is not treated as a sale or exchange.[21] The company is not allowed a deduction for dividends paid, which results in double taxation of corporate profits.

By contrast, if the shareholder lends the money to the company, three major tax benefits may be derived:

- First, in comparison to a payment of a dividend or a redemption of stock that is treated as a dividend, repayment of the loan principal to a foreign lender is not subject to a 30% U.S. withholding tax.[22] If the lender is a U.S. person, principal payments are not considered to be taxable income.

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14 Omnibus Budget Reconciliation Act of 1989 (Pub. L. No. 101-239, 103 Stat. 2106).

15 Energy Policy Act of 1992 (Pub. L. No. 102-486, 106 Stat. 2776).

16 Code §385(c)(1).

17 Apart from tax concerns, if the company should face financial difficulty, it is sometimes easier to repay a loan to a shareholder rather than a dividend.

18 Code §301(c)(1).

19 Code §§871(a)(1), 881(a)(1), 1441(a), 1442(a).

20 Code §894.

21 Code §302.

22 See *Philadelphia Nat. Bank v. Rothensies*, 43 F. Supp. 923 (E.D. Penn. 1942).

> *"When an investor is asked to infuse capital into a company, it often is valuable for part of that capital to be treated as a loan. . . . Capitalizing a company with debt as well as equity can produce major tax benefits for all parties involved."*

- Second, while interest payments are subject to a 30% U.S. withholding tax that is subject to reduction or elimination by the terms of an applicable income tax treaty, interest payments are generally treated more favorably than dividend payments to portfolio investors. Treaties usually exempt interest from the 30% tax, whereas dividends are taxed at a reduced withholding rate – usually 5% when the dividend is paid to a foreign corporation that owns 10% or more of the stock of the U.S. company, but exempt under specified conditions in recent treaties.[23]

  There is also a portfolio interest exemption under U.S. domestic law. It eliminates U.S. withholding tax on certain payments of interest.[24] The exemption does not apply, *inter alia*, to debt paid to a related person. However, a shareholder of a corporation is only related if he or she owns 10% or more of the voting stock of the company.[25] Ownership includes direct ownership and ownership by attribution.[26] A shareholder may own most of the equity of a corporation and still not be related, if he or she owns only non-voting stock.

- Third, a corporation can claim an interest expense deduction to reduce or eliminate its taxable income.[27] This can serve to eliminate double taxation on corporate profits that occurs when a U.S. corporation is used to conduct business.

  As discussed in the next two sections of this article, there are two primary ways this interest deduction may not be allowed:

  ○ First, interest deductions may be deferred under the earnings stripping rules of Code §163(j).

  ○ Second, the I.R.S. may assert that the purported debt instrument should be recharacterized as equity under common law tax principles.

  However, the I.R.S. may be hesitant to challenge the classification under the common law, as it is highly subjective and therefore difficult to prove in most cases. Nonetheless, to avoid a common law challenge, practitioners will often limit lending to maintain a reasonable debt-to-equity ratio for the company.

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23 *E.g.*, under Article 10(2)(a) of the U.S.-German Income Tax Treaty, a 5% withholding rate applies to dividends paid by a U.S. company to a German company that owns at least 10% of the voting stock of the U.S. company – assuming the German company is a German tax resident that satisfies the limitation on benefits ("L.O.B.") provision of the treaty. Alternatively, if the German company owns 80% or more of the voting power of a U.S. company and certain conditions of the L.O.B. provision of the treaty are met, the withholding tax is eliminated. If neither of these conditions is met, a 15% withholding rate applies, under Article 10(2)(b), to dividends paid to a German resident that meets the L.O.B. requirements. Article 11(1) of the treaty eliminates the withholding tax on interest paid by a U.S. company to a German tax resident (assuming the L.O.B. requirements are met).

24 Code §§871(h), 881(c).

25 Code §§871(h)(3), 881(c)(3).

26 Code §871(h)(3)(C), 881(c)(3)(B).

27 Code §163.

EXISTING EARNING STRIPPING LIMITATIONS

"Earnings stripping" is a practice of reducing the taxable income of a corporation by paying interest to related third parties. Code §163(a) allows a deduction for all interest paid or accrued within the tax year on indebtedness. Code §163(j), enacted in 1989,[28] placed substantial restrictions on the amount of certain related-party interest expense deductions that a foreign-owned U.S. corporation may claim when computing its income tax.

The earnings stripping rules under Code §163(j)(2)(A)(ii) generally apply to a U.S. corporation that has a debt-to-equity ratio in excess of 1.5:1 and pays[29] interest to a related foreign person that is not subject to the full 30% U.S. withholding tax.[30] A related person[31] includes a foreign person who owns more than 50% of the value of the stock of the U.S. corporation.[32] If applicable, this provision denies a *current* deduction for the related-party interest expense equal to the *lesser of* (i) the related-party interest expense or (ii) the total interest expense of the corporation that exceeds 50% of the company's adjusted taxable income for the year (the "50% income limitation").[33] The 50% income limitation applies to the corporation's adjusted taxable income, which is the corporation's regular taxable income subject to certain modifications.[34] For example, depreciation deductions are not included in adjusted taxable income, which increases this amount and therefore limits the impact of this rule.[35] Adjusted taxable income is similar in function to the accounting concept of E.B.I.T.D.A. (earnings before interest, tax, depreciation, and amortization).

"Earnings stripping is a practice of reducing the taxable income of a corporation by paying interest to related third parties."

The disallowed interest is *deferred* until the following year[36] when it is then treated as an interest deduction subject to application of the earning stripping rules in that next year. In practice, deductions affected by these rules may be deferred for several years, but they are often allowed in a later year when the U.S. company has significant income (such as from a sale of its assets). This may eventually ameliorate the harsh treatment of the 50% income limitation by allowing the deduction.

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28 Enacted by the Revenue Reconciliation Act of 1989, these rules were a response to the perceived erosion of the U.S. tax base through excessive interest expense deductions.

29 Comparable treatment is provided for interest paid to an unrelated person that is not subject to full 30% withholding tax when a related person provides a credit enhancer that supports the loan. This disallowance applies to interest paid to both foreign creditors that benefit from an income tax treaty and domestic creditors that are subject to full U.S. domestic tax, but not to 30% withholding tax.

30 If the 30% withholding tax is reduced, but not eliminated, then these limitations only apply to a portion of the interest based on the amount of interest that is not subject to withholding tax.

31 Code §163(j)(4).

32 Code §§267(b)(2), (3), (f).

33 Code §§163(j)(1)(A), (2)(B).

34 Code §163(j)(6)(A).

35 Code §163(j)(6)(A)(i)(IV).

36 Code §163(j)(1)(B).

COMMON LAW ON RECHARACTERIZING DEBT AS EQUITY[37]

Recharacterization of a debt as equity involves a determination of whether a debt actually exists for tax purposes. This determination is decided on the basis of the facts presented.[38]

The exposure to recharacterization can be minimized by structuring the cash infusion in accordance with certain basic criteria reviewed by the courts.[39] Courts review these factors on a case-by-case basis and no single factor is dispositive. In making this determination, the courts have mentioned the following important factors that should be considered:

- Presence or absence of a written instrument evidencing the loan
- Names given to the certificates evidencing the indebtedness
- Presence or absence of a fixed maturity date
- Source of the payments
- Right to enforce payments
- Participation in management as a result of the advances
- Status of the advances in relation to regular corporate creditors
- Intent of the parties
- Identity of interest between creditor and stockholder
- "Thinness" of capital structure in relation to debt
- Ability of the corporation to obtain credit from outside sources
- Use to which the advances were put
- Failure of the debtor to repay
- Risk involved in making advances
- Provision of a fixed rate of interest
- Whether or not the indebtedness was secured.

A key factor indicative of a loan is the issuance of a bond, debenture, or note or the existence of a lien. The presence of a fixed maturity date, fixed interest rate, and

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37 For detailed examinations of the common law factors that distinguish debt from equity, see Galia Antebi and Nina Krauthamer, "Debt vs. Equity: Comparing HP Appeal Arguments to the Pepsico Case," *Insights* 3, (2015) pp.9-16, and Galia Antebi and Nina Krauthamer, "Tax 101: Financing a U.S. Subsidiary – Debt vs. Equity." *Insights* 3, (2014) pp. 27-32.

38 *E.g.*, *Berkowitz v. United States*, 411 F.2d 818 (5th Cir. 1969).

39 *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476, 493 (1980), acq., 1982-2 C.B. 1; *Estate of Mixon v. U.S.*, 464 F2d 394 (5th Cir. 1972).

fixed schedule for payments are also characteristic of a debt obligation, as opposed to equity. Additionally, repayment of the obligation should not be dependent upon the success of the business and the existence of corporate earnings, but rather, it should be made from cash flow.

The ratio of debt to equity, sometimes referred to as the "thin capitalization" issue, is an important factor.[40] Inadequate capitalization of the company is strong evidence of equity status and supports recharacterization of the debt as equity. The determination of undercapitalization is highly factual and may vary substantially by industry and company.

NEW DEBT RECHARACTERIZATION RULE

Background

The Treasury identified three types of transactions between related persons that raised significant policy concerns, which needed to be addressed in the Code §385 regulations. The three transactions are:

- distributions of debt instruments by corporations to their related corporate shareholders;
- issuances of debt instruments by corporations in exchange for stock of an affiliate (including "hook stock" issued by related corporate shareholders); and
- certain issuances of debt instruments as consideration in an exchange pursuant to an internal asset reorganization.[41]

In *Kraft Foods Co. v. Commissioner*,[42] the Second Circuit held that a debt instrument distributed by a U.S. corporation to its shareholder as a dividend was true debt for tax purposes. By contrast, in *Talbot Mills v. Commissioner*,[43] the First Circuit held that notes distributed to a shareholder in exchange for stock should be treated as equity for tax purposes. The Treasury noted that:

> In many contexts, a distribution of a debt instrument similar to the one at issue in *Kraft*, lacks meaningful non-tax significance, such that respecting the distributed instrument as indebtedness for federal tax purposes produces inappropriate results. For example, inverted groups and other foreign-parented groups use these types of transactions to create interest deductions that reduce U.S. source income without investing any new capital in the U.S. operations. In light of these policy concerns, the proposed regulations treat such a debt instrument as equity issued in fact patterns similar to that in *Kraft* as stock.[44]

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[40] *Schnitzer v. Commissioner*, 13 T.C. 43 (1949), aff'd, 183 F.2d 70 (9th Cir. 1950), cert. denied, 340 U.S. 911 (1951).

[41] REG 108060-15, Background, VI(C)(1) (April 4, 2016).

[42] 232 F.2d 118 (2nd Cir. 1956).

[43] 146 F.2d 809 (1st Cir. 1944), aff'd sub nom, *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946).

[44] *Id.*

Code §304 prevents taxpayers from acquiring affiliate stock to convert what otherwise would be a taxable dividend into a sale or exchange transaction. In a similar manner, the Treasury determined that "the issuance of a related-party debt instrument to acquire stock of a related person is similar in many respects to a distribution of a debt instrument and implicates similar policy considerations."[45]

The proposed regulations also address certain debt instruments issued by an acquiring corporation as consideration in an exchange pursuant to an internal asset reorganization.

> Internal asset reorganizations can operate in a similar manner to Code §304 transactions as a device to convert what otherwise would be a taxable dividend into a sale or exchange transaction without having any meaningful non-tax effect.[46]

Apart from the "general rule" to address these three types of transactions, the Treasury noted that:

> Similar policy concerns arise when a related-party debt instrument is issued in a separate transaction to fund (1) a distribution of cash or other property to a related corporate shareholder; (2) an acquisition of affiliate stock from an affiliate; or (3) certain acquisitions of property from an affiliate pursuant to an internal asset reorganization.

As a result, the regulations adopt an added test, called the "funding rule," to address these attempts to circumvent their new general rule.[47]

Debt Subject to New Rules

To address these concerns, Prop. Treas. Reg. §1.385-3 contains the new debt recharacterization rule. This rule applies to debt issued between members of an expanded group ("E.G."). An E.G. is an affiliated group of corporations within the meaning of Code §1504 (which generally requires 80% ownership) with some significant modifications.[48]

An E.G. expands the statutory definition of affiliated group – which is limited generally to domestic corporations -- by including foreign and tax-exempt corporations. For example, an E.G. will exist if a foreign corporation owns 80% or more of a U.S. corporation.[49] While the Code §1504 definition refers to ownership of 80% or more of stock having both value *and* vote, the E.G. definition covers ownership of 80% or more of either vote *or* value.[50] Also, the proposed regulations adopt the constructive ownership rules of Code §304(c)(3).[51] However, debt between members of a U.S.

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45 REG 108060-15, Background, VI(C)(3) (April 4, 2016).

46 REG 108060-15, Background, VI(C)(4) (April 4, 2016).

47 REG 108060-15, Background, VI(C)(1) (April 4, 2016).

48 Prop. Treas. Reg. §1.385-3(f)(6), §1.385-1(b)(3). An affiliated group of corporations generally files a consolidated federal income tax return.

49 Prop. Treas. Reg. §1.385-1(b)(3)(i)(A).

50 Prop. Treas. Reg. §1.385-1(b)(3)(i)(C).

51 Prop. Treas. Reg. §1.385-1(b)(3)(ii).

consolidated corporate group is not subject to these rules since all the members of that group are treated as one corporation.[52]

General Rule for Debt Recharacterization

Under the general rule, debt between members of an E.G. is subject to reclassification as equity if it is issued in any of the following three situations ("Targeted Transactions"):

- A *distribution* by an E.G. member to a shareholder who is part of that E.G. (*e.g.*, a dividend or return of capital distribution in the form of notes)
- A *transfer* in exchange for *stock* of another E.G. member (*e.g.*, a member of an E.G. acquires stock of another member in exchange for issuing a note to the selling member), other than in an "exempt exchange"
- A *transfer* in exchange for *property* of another E.G. member in the context of certain tax-free asset reorganizations, *but* only to the extent that, pursuant to a plan, a shareholder that is a member of the E.G. before the reorganization receives the debt instrument[53]

For purposes of the second Targeted Transaction listed above, an exempt exchange is an acquisition of E.G. stock where the transferor and transferee of the stock are parties to a reorganization that is an asset reorganization and one of the following conditions is met. Either (i) Code §§361(a) or (b) applies to the transferor of the E.G. stock and the stock is not transferred by issuance, or (ii) Code §1032 or Treas. Reg. §1.1032-2 applies to the transferor of the E.G. stock and the stock is distributed by the transferee pursuant to a plan of reorganization.[54] This limitation has the effect of causing exchanges of E.G. stock that are part of an asset reorganization to be covered only by the third Targeted Transaction, which, as noted above, also imposes limitations on its application.

A debt instrument treated as stock under this rule is treated as stock from the time the debt instrument is issued.[55]

Funding Rule for Debt Recharacterization

Under the funding rule, debt is subject to recharacterization as equity if it is a "principal purpose debt instrument."[56] This funding rule adds a great deal of complexity to the regulations. However, the Treasury felt that the additional rule was necessary.

> Without these funding provisions, taxpayers that otherwise would have issued a debt instrument in a one-step [Targeted Transaction] . . . would be able to use multi-step transactions to avoid the application of these proposed regulations while achieving economically similar outcomes. For example, a wholly-owned subsidiary that otherwise would have distributed a debt instrument to its parent

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[52] Prop. Treas. Reg. §1.385-1(e).

[53] Prop. Treas. Reg. §1.385-3(b)(2).

[54] Prop. Treas. Reg. §1.385-3(f)(5).

[55] Prop. Treas. Reg. §1.385-3(d)(1)(i).

[56] Prop. Treas. Reg. §1.385-3(b)(3)(i).

corporation in a distribution could, absent these rules, borrow cash from its parent and later distribute that cash to its parent in a transaction that is purported to be independent from the borrowing.[57]

A principal purpose debt instrument is a debt instrument issued with a principal purpose of funding one of the following distributions or acquisitions ("Targeted Funding Transactions"):

- A *distribution* of cash or property by the funded member to another E.G. member
- An *acquisition* of *stock* of another E.G. member for cash or property, other than in an exempt exchange (as defined above)
- An *acquisition* of *assets* of another E.G. member for cash or property in an asset reorganization, *but* only to the extent that, pursuant to the plan, a shareholder that is a member of the E.G. immediately before the reorganization receives cash or other property within the meaning of Code §356 with respect to its stock in the E.G. member who transferred assets to the funded member.[58]

"Under the funding rule, debt is subject to recharacterization as equity if it is a principal purpose debt instrument."

For example, if a foreign parent corporation lends $1,000 of cash to its wholly owned U.S. corporate subsidiary and one week later the U.S. subsidiary distributes the $1,000 cash back to the foreign parent as part of a pre-arranged plan, the funding rule applies and the debt instrument would be recharacterized as equity.

The principal purpose of the debt issuance is determined based on facts and circumstances.[59] However, the funding rule contains an irrebuttable presumption that an instrument is a principal purpose debt instrument if the debt is issued at any time during the 72-month period beginning 36 months before and ending 36 months after the issuing member makes a distribution or acquisition that is considered a Targeted Funding Transaction.[60] For example, if a foreign parent corporation lends $1,000 cash to its wholly owned U.S. corporate subsidiary and 30 months later, the U.S. subsidiary distributes $1,000 cash back to the foreign parent but *not* as part of a pre-arranged plan, then this 72-month *per se* funding rule would apply and the debt instrument is recharacterized as equity.

At the A.B.A. Meeting, the International Tax Counsel indicated that adoption of this 72-month *per se* rule provides for ease of administration and allows for implementation of the funding rule without the difficult task of determining the principal purpose based on facts and circumstances. However, this same rule may catch transactions that were not structured with any purpose of avoiding the debt recharacterization rules. In these cases, taxpayers must rely on the limited exceptions and exclusions to these rules provided in the regulations that are discussed below.

There is an exception from this 72-month *per se* rule for debt instruments arising in the ordinary course of the issuing member's trade or business in connection with the purchase of property or receipt of services (*e.g.*, accounts payable). This ordinary

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57 REG 108060-15, Background, VI(C)(5) (April 4, 2016).

58 Prop. Treas. Reg. §1.385-3(b)(3)(ii).

59 Prop. Treas. Reg. §1.385-3(b)(3)(iv)(A).

60 Prop. Treas. Reg. §1.385-3(b)(3)(iv)(B)(1).

course exception only applies if (i) the debt instrument reflects an amount that is currently deductible under Code §162 or it is currently included in the issuer's cost of goods sold or inventory; and (ii) the amount of the debt obligation does not exceed an amount that would be ordinary and necessary if it were owed to an unrelated person.[61] If this exception applies in lieu of the 72-month *per se* rule, this ordinary course debt instrument can still be challenged under the general principal purpose test.

A debt instrument, treated as stock under the funding rule, is treated as stock in the year when the debt instrument is issued, but only if it is issued in the same year as the Targeted Funding Transaction, or in a subsequent year.[62] However, if the debt instrument is issued in a taxable year prior to that of the Targeted Funding Transaction, the debt instrument is respected as debt until the date of the Targeted Funding Transaction.[63]

Exclusions

Three major types of borrowings are excluded from the general rule and the funding rule.

First, an exception exists if a threshold amount of debt does not exist. Under this exception, debt is not recharacterized if, immediately after the debt is issued, the aggregate adjusted issue price of all such E.G. debt held by members of the E.G. group does not exceed $50 million.[64]

Second, debt issued by an E.G. member that may be recharacterized as equity under the general rule is *reduced* by the member's current year E&P.[65] To illustrate, if a U.S. subsidiary distributes a $1,000 note to its foreign parent and the U.S. subsidiary has $1,000 of current E&P for that year, the note continues to be characterized as a debt instrument for U.S. tax purposes, and accordingly, the issuance of the note continues to be treated as a distribution of $1,000 that is taxable as a dividend. However, if the U.S. subsidiary has $700 of current E&P, only the portion of the debt instrument in excess of such current E&P (*i.e.*, $300) is recharacterized as equity of the issuer of the subsidiary. The exception applies to $700 of the $1,000 face amount of the note. Note that the exception is not extended to accumulated E&P, which cannot be used to fit within the exception.

Because the funding rule is subject to the E&P exception,[66] a foreign parent corporation that lends $1,000 cash to its wholly-owned U.S. corporate subsidiary is not deemed to receive stock of the subsidiary if the latter distributes $1,000 to the parent corporation within the following 36 months and in the year of the distribution, the U.S. subsidiary has $1,000 of current E&P.

Complications exist in applying the current E&P exception where more than one distribution or acquisition occurs in a single taxable year. The proposed regulations

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[61] Prop. Treas. Reg. §1.385-3(b)(3)(iv)(B)(2).

[62] Prop. Treas. Reg. §1.385-3(d)(1)(i).

[63] Prop. Treas. Reg. §1.385-3(d)(1)(ii).

[64] Prop. Treas. Reg. §1,385-3(c)(2).

[65] Prop. Treas. Reg. §1,385-3(c)(1).

[66] Prop. Treas. Reg. §1.385-3(g)(3), Ex. 17(ii), Analysis (C).

contain an ordering rule under which the current year E&P exception is applied to the various transactions in the order in which each occurred.[67] Consider the case of a U.S. subsidiary that makes a distribution of $30,000 to its foreign parent on March 1 and a distribution of a $19,000 note to its foreign parent on July 1. The U.S. subsidiary has $35,000 of current E&P for that year. Under the ordering rule, the $30,000 cash distribution comes from $30,000 of current E&P leaving only $5,000 of current E&P to cover the $19,000 note. The remaining $14,000 of the note is caught by the general rule and characterized as equity.[68]

At the A.B.A. Meeting, practitioners expressed concern about the narrowness of this exception, which would not apply to distributions made shortly after year-end that are attributable to the prior year's E&P, as well as concern about how this exception will be applied. In response to these concerns, the International Tax Counsel indicated that the current E&P exception may need some modifications to better protect taxpayer actions not principally motivated by avoidance of these rules.

"At the A.B.A. Meeting, practitioners expressed concern about the narrowness of the current year E&P exception, which would not apply to distributions made shortly after year-end that are attributable to the prior year's E&P."

Third, the proposed regulations contain a more limited exception for funded acquisitions of subsidiary stock.[69] This exception applies where the acquisition results from a transfer of property by a funded member (the transferor) to an E.G. member (the issuer) in exchange for stock of the issuer. The exception applies only where the transferor holds, directly or indirectly, more than 50% of the total combined voting power of all classes of stock of the issuer entitled to vote and more than 50% of the total value of the stock of the issuer for the 36-month period immediately following the issuance of the shares.

Cash Pooling and Treasury Centers

When issuing these proposed regulations, the Treasury requested comments regarding the need for special rules that would be applicable for cash pools, cash sweeps, and similar arrangements that are used to manage cash of an E.G.[70] Cash pooling is a cash management system that allows a group of related corporations to combine the credit and debit positions of various member into one account to reduce costs and enhance flexibility in managing group liquidity.[71]

At the A.B.A. Meeting, a practitioner requested that the Treasury not apply the debt recharacterization rules to cash pooling arrangements or treasury centers used by corporate groups. The International Tax Counsel indicated support for an exclusion covering cash pooling and cash sweeps, but not to treasury centers. Treasury centers should be viewed differently because they deal with longer-term needs.

Anti-abuse Rule

An anti-abuse rule is also included in the proposed regulations.[72] It provides that a debt instrument will be treated as stock if it is issued with a principal purpose of avoiding the application of the proposed regulations. In addition, other interests that

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67 Prop. Treas. Reg. §1,385-3(c)(1).

68 Prop. Treas. Reg. §1.385-3(g)(3), Ex. 17(ii), Analysis (C).

69 Prop. Treas. Reg. §1,385-3(c)(3).

70 REG 108060-15, Comments & Public Hearing (April 4, 2016).

71 "What Is Cash Pooling? Definition and Meaning," InvestorWords.

72 Prop. Treas. Reg. §1.385-3(b)(4).

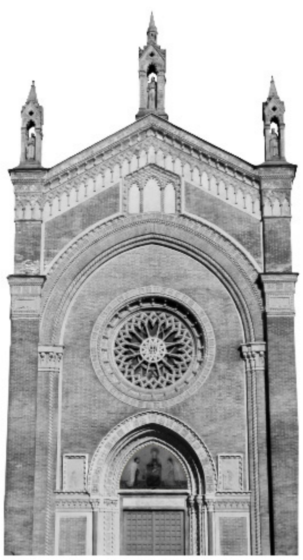
are not debt instruments for purposes of these rules (*e.g.*, contracts to which Code §483 applies or non-periodic swap payments) will be treated as stock if issued with the principal purpose of avoiding the application of these rules. A non-exhaustive list of illustrative examples is provided in the proposed regulations.[73]

Partnerships

To prevent avoidance of these rules through the use of partnerships, the new rules do not treat a controlled partnership as an entity, but rather they take an aggregate approach to controlled partnerships.[74] For example, when an E.G. member becomes a partner in a controlled partnership, the member is treated as acquiring its proportionate share of the controlled partnership's assets. A partnership is a controlled partnership if one or more members of an E.G. own 80% or more of the interests in the capital or profits of the partnership, either directly or indirectly.

Disregarded Entity

A debt instrument issued by a disregarded entity ("D.R.E."), that is treated as stock under these rules, is treated as stock of the sole member of the D.R.E. rather than as an equity interest in the D.R.E.[75] At the A.B.A. Meeting, one practitioner observed that this result is different than the treatment of a D.R.E. debt instrument subject to the documentation rules that is recharacterized as an equity interest in the D.R.E.[76] Responding to this observation, a senior counsel for the Office of International Tax Counsel, said that the Treasury was attempting to provide a more taxpayer-friendly result under the debt recharacterization rules. By taking such action, the regulations avoid creating an added entity, but only for purposes of the debt recharacterization rule.



Debt Instruments that Leave the E.G.

When (i) a debt instrument, that is treated as stock under these rules, is transferred to a person that is not an E.G. member or (ii) the obligor with respect to such debt instrument ceases to be an E.G. member, the interest ceases to be treated as stock.[77]

Effective Date

If finalized, the new rules regarding classification of certain debt as equity generally would apply to any debt instrument issued on or after April 4, 2016.[78]

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73 Prop. Treas. Reg. §1.385-3(b)(4). *E.g.*, the anti-abuse rule may apply if a debt instrument is issued to, and later acquired from, a person that is not a member of the issuer's E.G., and it is issued with the principal purpose of avoiding the application of the proposed regulations.

74 Prop. Treas. Reg. §1.385-3(d)(5).

75 Prop. Treas. Reg. §1.385-3(d)(6).

76 Prop. Treas. Reg. §1.385-2(c)(5).

77 Prop. Treas. Reg. §1.385-3(d)(2).

78 Prop. Treas. Reg. §1.385-3(h). This new rule will also apply to any debt instrument treated as or deemed to be issued before April 4, 2016, as a result of a "check-the-box" entity classification election that is made or filed on or after April 4, 2016.

DOCUMENTATION REQUIREMENTS

Background

Prop. Treas. Reg. §1.385-2 addresses the documentation and information requirements for a debt instrument issued between related parties to be treated as true debt for tax purposes. The Treasury is exercising its regulatory authority granted under Code §385(a) to treat the timely preparation and maintenance of this documentation as a necessary factor to be taken into account in determining if the interest is characterized as stock or indebtedness.

Compliance with these rules is not, however, a guarantee that the I.R.S. will treat the related-party debt as true debt for tax purposes. The common law Federal income tax principles discussed earlier still remain, and the documentation requirements under the rules are not determinative as to true debt characterization.

Debt Instruments Subject to These Documentation Rules

The documentation rules only apply to expanded group interests ("E.G.I.'s"), which are applicable instruments that are issued and held by members of an E.G.[79] There is no requirement that they be issued in connection with an inversion or any other specific transaction, so this rule has widespread impact. The aforementioned definition of an E.G. generally applies in this context as well. Thus, debt held by a controlled partnership will be subject to these rules.[80]

An E.G.I. only applies to applicable instruments that are interests issued in the form of debt instruments.[81] These rules are designed for traditional debt instruments. The proposed regulations reserved issuing guidance on the treatment of instruments that may be treated as debt for tax purposes but are not issued in the form of debt.[82] Comments are requested on how to address these other instruments.

These rules only apply to large taxpayer groups. An E.G.I. is subject to these rules only if (i) the stock of any member in the E.G. is publicly traded; (ii) all or any portion of the E.G.'s financial results are reported on financial statements with total assets exceeding $100 million; or (iii) the E.G.'s financial results are reported on financial statements that reflect annual total revenue that exceeds $50 million.[83] Only applicable financial statements, prepared within three years of the E.G.I. becoming subject to these rules, are relevant for determining whether an E.G.I. is subject to these rules.[84]

In response to practitioner comments at the A.B.A. Meeting, Marjorie Rollinson, Associate Chief Counsel (International) for the I.R.S., indicated that adoption of the documentation rule was reasonable and within the Treasury's power

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79 Prop. Treas. Reg. §1.385-2(a)(4)(ii).

80 See text accompanying note 70 *supra.*

81 Prop. Treas. Reg. §1.385-2(a)(4)(i).

82 Prop. Treas. Reg. §1.385-2(a)(4)(i)(B). Neither the Proposed Regulation nor the accompanying Treasury explanation gave examples of these unique debt instruments.

83 Prop. Treas. Reg. §1.385-2(a)(2).

84 Prop. Treas. Reg. §1.385-2(a)(4)(iv).

under Code §385. It was recognized, however, that application of the documentation rules to loans between two foreign entities that are members of an E.G. may impose a harsh burden and that the Treasury would consider comments that these rules not apply in this particular situation.

Proposed Documentation Requirements

The documentation rules are organized into four requirements, discussed below. The documentation must be maintained for all taxable years that the E.G.I. is outstanding, and it must be retained until the period of limitations expires on all returns to which the Federal tax treatment of the E.G.I. is relevant. While these four requirements represent fundamental case law principles for determining if an instrument is genuine tax indebtedness, they are now a mandatory component of true debt tax treatment, rather than relevant factors for making this determination.

The first requirement is there must be a binding obligation to repay the funds advanced. The rules require evidence in the form of a timely prepared written document executed by the parties.[85]

"The documentation rules only apply to E.G.I.'s. . . . There is no requirement that they be issued in connection with an inversion or any other specific transaction, so this rule has widespread impact."

The second requirement is for the loan agreement (or other written document) to delineate the creditor's rights to enforce the terms concerning the issuer's obligation to repay.[86] The creditor will need to have the legal rights to enforce the terms of the E.G.I. Typical creditor rights include the right to trigger a default, the right to accelerate payments, and the superior right over shareholders to share in the assets of the issuer in the event that the issuer is dissolved or liquidated. The impact of this requirement is that a one-page note evidencing the loan will likely no longer serve as adequate documentation.

The third requirement is a reasonable expectation of repayment by the issuer of the loan.[87] The proposed regulations indicate documentation requirements such as cash flow projections, financial statements, business forecasts, asset appraisals, determination of debt to-equity and other relevant financial ratios of the issuer. This documentation may not have been prepared in the past. Special rules are provided to address disregarded entities that issue an E.G.I. and whether the assets of the sole member of such entity can be considered in determining whether repayment is expected.

The final requirement is there must be evidence of a genuine debtor-creditor relationship.[88] The taxpayer asserting debt treatment must prepare and maintain timely evidence of an ongoing debtor-creditor relationship. This documentation can take two forms. In the case of an issuer that complied with the terms of the E.G.I., the documentation must include timely prepared documentation of any payments on which the taxpayer relies to establish such treatment under general Federal tax principles. If the issuer failed to comply with the terms of the E.G.I., either by failing to make required payments or by otherwise suffering an event of default under the terms of the E.G.I., the documentation must include evidence of the holder's reasonable exercise of the diligence and judgment of a creditor. The proposed regulations indicate acceptable forms of documentation, including evidence of the

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[85] Prop. Treas. Reg. §1.385-2(b)(2)(i).

[86] Prop. Treas. Reg. §1.385-2(b)(2)(ii).

[87] Prop. Treas. Reg. §1.385-2(b)(2)(iii).

[88] Prop. Treas. Reg. §1.385-2(b)(2)(iv).

holder's efforts to enforce the terms of the E.G.I., as well as evidence of any efforts to renegotiate the E.G.I.

Timing of Preparation of Documentation

The documentation generally must be prepared no later than 30 calendar days after the later of (i) the date that the instrument becomes an E.G.I. or (ii) the date that the E.G. member becomes an issuer with respect to an E.G.I. The preparation of the documentation of the debtor-creditor relationship can be prepared up to 120 calendar days after the payment or relevant event occurred, which gives more time to comply.[89]

Revolving Credit Agreements and Cash Pooling

The documentation requirements provide special rules for determining the timeliness of documentation preparation in the case of certain revolving credit agreements and similar arrangements, as well as cash pooling arrangements. The rules generally look to the documents pursuant to which the arrangements were established.[90]

Reasonable Cause Exception

If a taxpayer can show that failure to satisfy these rules is due to reasonable cause then appropriate modifications may be made to the requirements of this section in determining whether the requirements of this section have been met.[91] While the reasonable cause exception may benefit taxpayers in the event of an audit, it is not useful for planning purposes.

Effective Date

This documentation rule will apply to any debt instrument issued on or after publication of final regulations under Code §385.[92]

BIFURCATION RULE

Prop. Treas. Reg. §1.385-1(d) gives the I.R.S. the ability to recast only a portion of a debt instrument as equity and treat the remaining portion as debt (the "bifurcation rule"), instead of taking an "all-or-nothing" approach, as under current law. According to the Treasury and I.R.S., the existing all-or-nothing approach frequently does not reflect the economic substance of related-party debt.[93]

This bifurcation rule applies to a modified expanded group ("M.E.G."),[94]

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89 Prop. Treas. Reg. §1.385-2(a)(3)(i).

90 Prop. Treas. Reg. §1.385-2(b)(3)(iii).

91 Prop. Treas. Reg. §1.385-2(c)(1). The regulation adds that "[t]he principles of §301.6724-1 of this chapter apply in interpreting whether reasonable cause exists in any particular case."

92 Prop. Treas. Reg. §1.385-2(f). This new rule will also apply to any debt instrument treated as debt issued or deemed issued before April 4, 2016, as a result of a check-the-box entity classification election that is made or filed on or after April 4, 2016.

93 REG 108060-15, Background, VI(A) April 4, 2016).

94 Prop. Treas. Reg. §1.385-1(d)(2).

which covers a broader range of taxpayers than those affected by the other Code §385 rules. An M.E.G. means an E.G. where the threshold for determining relatedness is 50% ownership, not 80% as otherwise stipulated in the new rules.[95] Notably, the Treasury declined to apply this bifurcation rule to debt between unrelated persons since that "could result in uncertainty in the capital markets."[96]

Unlike the inversion guidance, which contained many illustrative examples, the new bifurcation rule does not provide much explanation as to when bifurcation may be appropriate. The only guidance is the following:

> For example, if the Commissioner's analysis supports a reasonable expectation that, as of the issuance of the E.G.I., only a portion of the principal amount of an E.G.I. will be repaid and the Commissioner determines that the E.G.I. should be treated as indebtedness in part and stock in part, the E.G.I. may be treated as indebtedness in part and stock in part in accordance with such determination, provided the requirements of §1.385-2, if applicable, are otherwise satisfied and the application of federal tax principles supports this treatment.[97]

Effective Date

This bifurcation rule will apply to any debt instrument issued on or after publication of final regulations under Code §385.[98]

CONSOLIDATED GROUPS

As noted earlier,[99] these new rules do not apply to debt issued between members of a U.S. consolidated group (a "consolidated group debt instrument"), since all the members are treated as a single corporation.[100] Prop. Treas. Reg. §1.385-4 was adopted to address situations where a debt instrument becomes or ceases to be a consolidated group debt instrument.

If a consolidated group debt instrument was not initially treated as stock solely due to the rule treating all members of a consolidated group as a single corporation, then the debt instrument is referred to as an "exempt consolidated group debt instrument." If either the creditor or debtor of an exempt consolidated group debt instrument leaves the consolidated group then the debt instrument is deemed to be exchanged for stock immediately after the departing member leaves the group.[101] By contrast, if a consolidated group debt instrument would not have been treated as equity under these rules in any event ("nonexempt consolidated group debt

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95 Prop. Treas. Reg. §1.385-1(b)(5).

96 REG 108060-15, Background, VI(A) April 4, 2016).

97 Prop. Treas. Reg. §1.385-1(d)(1).

98 Prop. Treas. Reg. §1.385-1(f). This new rule will also apply to any debt instrument treated as debt issued or deemed issued before April 4, 2016, as a result of a check-the-box entity classification election that is made or filed on or after April 4, 2016.

99 See text accompanying note 48 *supra*.

100 Prop. Treas. Reg. §1.385-1(e).

101 Prop. Treas. Reg. §1.385-4(b)(1)(i).

instrument") then such debt instrument retains its character as debt when either the debtor or creditor leaves the group. However, a nonexempt consolidated group debt instrument can be treated as equity under the funding rule[102] discussed earlier as a result of a later distribution or acquisition.[103]

When a member of a consolidated group transfers a consolidated group debt instrument to a member of the E.G. that is not part of the consolidated group, the debt instrument is treated as newly issued by the debtor or issuer that is held by the transferee E.G. member. The deemed date of issuance is the date of transfer.[104] That new issuance must then be tested under these rules to determine if debt status should be retained for tax purposes. Detailed examples are included in the regulations to assist in this determination.[105]

"These proposed Code §385 regulations cast a wide net and various related-party debt is affected. These rules go far beyond what was previously thought sufficient for related-party debt instruments to be respected as true debt."

When a debt instrument that was treated as stock under the debt recharacterization rule of Prop. Treas. Reg. §1.385-3 becomes a consolidated group debt instrument, the issuer is treated as issuing a new debt instrument to the holder in exchange for the debt instrument that was treated as stock under Treas. Reg. §1.385-3.[106]

Effective Date

These consolidation rules generally apply to any debt instrument issued on or after April 4, 2016,[107] which mirrors the effective date of the debt recharacterization rule of Prop. Treas. Reg. §1.385-3.

CONCLUSION

These proposed Code §385 regulations cast a wide net and various related-party debt is affected. These rules go far beyond what was previously thought sufficient for related-party debt instruments to be respected as true debt for tax purposes. While previously proposed Code §385 regulations were withdrawn in 1983,[108] it is likely that these regulations will be finalized in whole or in part before year-end. Given the effective dates of these new rules, and the need to accommodate their many new requirements, planning should begin immediately and be completed before year-end to ensure that related-party debt retains its tax character and usefulness.

As stated at the beginning of the article, the International Tax Counsel emphasized the current view of the Treasury Department as to the importance of issuing final regulations this year. A broader question that was not asked is the length of time such final regulations will remain in existence depending on the outcome of the Presidential election. Are these rules an anomaly or do they preview the future of U.S. tax policy?

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102 Prop. Treas. Reg. §1.385-3(b)(3)(ii)

103 Prop. Treas. Reg. §1.385-4(b)(1)(ii).

104 Prop. Treas. Reg. §1.385-4(b)(2).

105 Prop. Treas. Reg. §1.385-4(d), Ex. 1 and 2.

106 Prop. Treas. Reg. §1.385-4(c).

107 Prop. Treas. Reg. §1.385-4(e). This new rule will also apply to any debt instrument treated as debt issued or deemed issued before April 4, 2016, as a result of a check-the-box entity classification election that is made or filed on or after April 4, 2016.

108 T.D. 7920, 1983-2 C.B. 69.

UPROAR OVER PROPOSED §385 REGULATIONS: WILL TREASURY DELAY ADOPTION?

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Tags
Code §163(j)
Code §385
Code §482
Code §7874
Earnings Stripping
Interest Deductions
Related-Party Debt

OVERVIEW

On April 4, the U.S. Treasury Department issued comprehensive and detailed proposed regulations under Code §385 that address whether a debt instrument will be treated as true debt for U.S. income tax purposes or re-characterized, in whole or in part, as equity.[1] While the initial motivation for the Treasury action was an attempt to deter inversions by American companies, the proposed regulations have a far greater impact. They affect companies with no intent to create an inversion and U.S. companies having shareholders that are all U.S.-based and operated. This was discussed in an earlier article in *Insights*.[2]

As noted in *Insights*, senior Treasury Department officials have indicated that these proposed regulations are a high priority item for the government. While these officials have indicated that they are open to some modifications based on comments they have received, their primary goal is to finalize all or a major part of the regulations later this year. On July 14, about 15 business representatives lined up to speak at an I.R.S. hearing on the proposed regulations. While the speakers advanced a number of compelling arguments in favor of modifying the tax regulations, I.R.S. and Treasury officials remained mostly silent regarding their plans for the regulations.[3]

In an unprecedented reaction outside the public hearing, the proposed regulations have received widespread criticism from members of Congress, the business community, bar and accounting groups, and practitioners. The comments generally fall into two groups. One raises technical issues and the other raises policy issues. Comments in the former group focus on the unintended impact of the regulations on routine business transactions. These commentators call for more time to revise the regulations in order to address the technical problems in a more detailed manner, which cannot be completed by the end of the year. Comments in the latter group focus on the potential harm that could be inflicted on the business community under the proposals as currently drafted. Several commentators, including the leaders of the two tax-writing committees in Congress, asked for a complete withdrawal of the regulations and a more comprehensive review of all pertinent issues. These commentators also call for additional study, but do so with the goal of defining the boundaries of the proposed regulations.

The Treasury has been listening, and indicated in some public forums that they

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1 Prop. Treas. Reg. §§1.385-1, -2, -3, and -4.

2 Philip Hirschfeld, "Related-Party Debt: Proposed Code §385 Regulations Raise Major New Hurdles," *Insights*, Vol. 3, No. 5 (May 2016).

3 S. Olchyk and A. Norman, "Business Reps Urge Overhaul of US Debt/Equity Proposed Regulations at Hearing," *MNE Tax* (July 15, 2016)..

are considering changes. The rules regarding cash pooling arrangements within a multinational group, foreign-to-foreign loans within a group, and the so-called "current year's earnings" rule are likely to be reworked. In addition, changes are under consideration for the documentation requirements of the proposals. However, the Treasury has not retreated from its initial goal of having a significant portion of the regulations finalized this year. The Treasury has not yet announced that it would delay adoption, but also has not indicated a specific target date for final adoption.

EXECUTIVE SUMMARY OF THE PROPOSED REGULATIONS

The proposed regulations under Code §385[4] will have a major impact on *any* tax planning involving related-party debt by potentially re-characterizing such debt as equity under three new rules:[5]

- First, a debt re-characterization rule provides that debt instruments are treated as stock if issued in certain disfavored transactions (such as when debt is distributed as a dividend to a shareholder).[6]
- Second, contemporaneous documentation requirements are imposed as a condition to retain the treatment of related-party debt as true debt (and not equity) for tax purposes.[7]
- Third, a bifurcation rule allows the I.R.S. to re-characterize certain related-party debt as part debt and part equity.[8]

Debt Re-characterization Rule

The debt re-characterization rule will reclassify as equity debt issued between members of a related party group called an expanded group ("E.G.") if issued in any of the following three fact patterns ("Targeted Transactions"):

- A debt instrument is distributed by an E.G. member to a shareholder who is part of that E.G. (*e.g.*, a dividend or return of capital distribution in the form of notes).
- A debt instrument is transferred in exchange for stock of another E.G. member (*e.g.*, a member of an E.G. acquires stock of another member in exchange for issuing a note to the selling member), other than in an exempt exchange.
- A debt instrument is transferred in exchange for property of another E.G. member in the context of certain tax-free asset reorganizations, but only to

4 References to a code section designate a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

5 Prop. Treas. Reg. §§1.385-1, 2, 3, & 4.

6 Prop. Treas. Reg. §1.385-3.

7 Prop. Treas. Reg. §1,385-2. In general, the documentation must be prepared no later than 30 calendar days after the date that the instrument becomes a related-party debt instrument.

8 Prop. Treas. Reg. §1.385-1(d).

the extent that, pursuant to a plan, a shareholder that is a member of the E.G. before the reorganization receives the debt instrument.[9]

The regulations adopt an anti-abuse rule called the "funding rule" in order to combat cases where companies may engage in two transactions that together have the same impact as a one-step direct issuance of debt in a Targeted Transaction. For example, a company may want to issue a debt instrument as a dividend to its sole shareholder, but that type of transaction is a Targeted Transaction. The company and its sole shareholder may attempt to circumvent the Targeted Transaction by having the shareholder lend funds to the company after which the company distributes a dividend to the shareholder in the same amount in a pre-arranged transaction. Before the loan, the shareholder held cash and after the dividend, the shareholder held the same amount of cash and a note of the subsidiary. If the roundtrip of the cash is ignored, the only transaction left is the creation of a note distributed to the shareholder. When integrated, this two-step transaction produces the same result as a simple distribution of a note.

The funding rule in the proposed regulations addresses two-step transactions by re-characterizing the debt as equity. Under the funding rule, debt is subject to re-characterization as equity if it is a "principal purpose debt instrument."[10] A principal purpose debt instrument is a debt instrument issued by "the funded member" with a principal purpose of funding one of the following distributions or acquisitions ("Targeted Funding Transactions"):

- A distribution of cash or property by the funded member to another E.G. member
- An acquisition by the funded member of stock of another E.G. member for cash or property, other than in an exempt exchange (as defined above)
- An acquisition by the funded member of assets of another E.G. member in an asset reorganization, but only to the extent that, pursuant to the plan, a shareholder in the funded member that is, itself, a member of the E.G., receives cash or "other property"[11] with respect to its stock in the transferor corporation.[12] To illustrate, the common parent of acquirer and transferor lends funds to acquirer that is used as part of the consideration to acquire the assets of transferor in a reorganization involving stock and boot. The integrated transaction concludes with a distribution of the stock and boot to the common parent.

The principal purpose of the debt issuance is determined based on facts and circumstances.[13] However, the funding rule contains a "non-rebuttable" presumption that an instrument is a principal purpose debt instrument if the debt is issued at any time during the 72-month period beginning 36 months before and ending 36 months

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9 Prop. Treas. Reg. §1.385-3(b)(2). As discussed in the prior article in *Insights*, there are certain limitations or exceptions to this rule.

10 Prop. Treas. Reg. §1.385-3(b)(3)(i). As discussed in the prior article in *Insights*, there are certain limitations or exceptions to this rule.

11 In other words, "boot" within the meaning of Code §356.

12 Prop. Treas. Reg. §1.385-3(b)(3)(ii).

13 Prop. Treas. Reg. §1.385-3(b)(3)(iv)(A).

after the issuing member makes a distribution or acquisition that is considered a Targeted Funding Transaction.[14] For example, if a foreign parent corporation lends $1,000 to its wholly-owned subsidiary in the U.S., and 30 months later, the U.S. subsidiary distributes $1,000 cash back to the foreign parent, but not as part of a pre-arranged plan, the non-rebuttable presumption applies and the debt instrument is characterized as equity.

Interestingly, the I.R.S. justifies the non-rebuttable presumption because it has encountered difficulty in proving loans and dividend distributions are connected. To that end, the preamble to the regulations provides the following justification:

> The Treasury Department and the IRS have determined that this non-rebuttable presumption is appropriate because money is fungible and because it is difficult for the IRS to establish the principal purposes of internal transactions. In the absence of a *per se* rule, taxpayers could assert that free cash flow generated from operations funded any distributions and acquisitions, while any debt instrument was incurred to finance the capital needs of those operations. Because taxpayers would be able to document the purposes of funding transactions accordingly, it would be difficult for the IRS to establish that any particular debt instrument was incurred with a principal purpose of funding a distribution or acquisition.[15]

The non-rebuttable presumption has been identified as one of the biggest problems of the debt characterization rule because of the length of the period and the inability of taxpayers to demonstrate the absence of tax avoidance.

Documentation Rules

There are four parts to the documentation rules that impose a new set of requirements in order to support true debt status for U.S. tax purposes.

The first requirement is there must be a binding obligation to repay the funds advanced. This rule requires evidence in the form of a timely-prepared written document executed by the parties.[16] The preamble explains the reason for this requirement:

> The proposed regulations are intended to impose discipline on related parties by requiring timely documentation and financial analysis that is similar to the documentation and analysis created when indebtedness is issued to third parties. This requirement also serves to help demonstrate whether there was intent to create a true debtor-creditor relationship that results in *bona fide* indebtedness and also to help ensure that the documentation necessary to perform an analysis of a purported debt instrument is prepared and maintained. This approach is consistent with the long-standing view held by courts that the taxpayer has the burden of substantiating its

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14 Prop. Treas. Reg. §1.385-3(b)(3)(iv)(B)(1).

15 Preamble to Prop Regs. 04/08/2016. Fed. Reg. Vol. 81, No. 68, p. 20911, [REG-108060-15] (“Preamble”) Explanation §IV.B.2.b.i.

16 Prop. Treas. Reg. §1.385-2(b)(2)(i).

treatment of an arrangement as indebtedness for federal tax purposes. *Hollenbeck v. Commissioner*, 422 F.2d 2, 4 (9th Cir. 1970).[17]

The second requirement is for the loan documentation to delineate the creditor's rights to enforce the debtor's obligation to repay.[18] Typical creditor rights include the right to trigger a default, the right to accelerate payments, and the superior right over shareholders to share in the assets of the issuer in the event that the issuer is dissolved or liquidated.

"There are four parts to the documentation rules that impose a new set of requirements in order to support true debt status for U.S. tax purposes."

The third requirement is a reasonable expectation of repayment by the issuer of the loan.[19] This rule requires that the taxpayer prepare and maintain supporting documentation such as cash flow projections, financial statements, business forecasts, asset appraisals, and the determination of debt to-equity and other relevant financial ratios of the issuer. For those advising multinational groups on the documentation required to support an intercompany debt as true debt, this is not a new requirement. The I.R.S. has routinely examined the credit-worthiness of U.S. borrowers in determining whether interest expense is deductible. Credit-worthiness is determined under an objective standard. When a disregarded entity having limited liability, such as a wholly-owned U.S. L.L.C., is the borrower, credit-worthiness is based on the assets of the disregarded entity.

The final requirement is evidence of a genuine debtor-creditor relationship.[20] This means that payment of interest and principal is made when and as provided in the loan documentation and such payment must be demonstrated. Examples of proof of payment include wire transfer records and account statements.

Bifurcation Rule

The proposed regulations give the I.R.S. the power to split a single debt instrument into part equity and part debt. A major problem with this new rule is there are few guidelines as to when it may apply. Again, advisers to multinational groups that have paid attention to the credit-worthiness issue of a U.S. borrower from a foreign parent have often split lending transactions into two documents with different maturity dates so that a challenge to the status of debt could be limited to one of the lending transactions.

CONGRESSIONAL REACTION

The regulations have been criticized by members of the tax-writing committees of Congress. All Federal tax legislation must originate in the House of Representatives and the House Ways and Means Committee has jurisdiction. In the summer, Ways and Means Committee Chairman Kevin Brady (R.-T.X.) released a statement after meeting with the Treasury Department to discuss the proposed regulations.[21]

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17 Preamble Background §VI.B.2.

18 Prop. Treas. Reg. §1.385-2(b)(2)(ii).

19 Prop. Treas. Reg. §1.385-2(b)(2)(iii).

20 Prop. Treas. Reg. §1.385-2(b)(2)(iv).

21 "Ways & Means GOP to Treasury: Proposed Regulations Threaten Jobs & Economic Growth." U.S. House of Representatives Ways and Means Committee. June 28, 2016.

Congressman Brady expressed strong opposition to the adoption of the regulations in their current form, and called on the Treasury Department to reconsider the approach.

> Ways and Means Republicans . . . have serious concerns about the economic impact of Treasury's proposed section 385 regulations. Instead of preventing corporate inversion transactions, these regulations will actually discourage U.S. and international companies from investing in America and our workers.
>
> Today we had an opportunity to have a frank discussion with Treasury about the negative consequences of the proposed regulations and about the Administration's response to the American people's extensive comments and concerns about this proposal. The proposed regulations as currently drafted would be a damaging disruption in well-settled law with far-reaching implications for common business financing practices. During our discussion, I made it clear that this is neither the time nor the place for such unilateral action from the Administration.
>
> In the days and months ahead, there must be a robust conversation among the Administration, the tax-writing committees, and affected stakeholders about the next steps in this process. We intend to continue to work with Treasury and the business community to protect American workers and their jobs. Ways and Means Members will consider all legislative options going forward.[22]

The Senate Finance Committee has jurisdiction for tax legislation in the Senate. In the summer, Senate Finance Committee Chairman Orrin Hatch (R-U.T.) wrote to the Treasury department, citing concerns over the policy and regulatory process of the Treasury Department. He called on Treasury Secretary Jack Lew to re-issue the regulations in proposed form.[23]

> I ask you to re-propose the regulations not because I wish for there to not be any section 385 regulations. Rather, I am seeking to ensure that, should the Treasury Department issue regulations under IRC section 385, the Department does so in a thoughtful, prudent, and legal manner.

Senator Hatch commented that the regulations in their current form could lead to unintended consequences for American businesses given the Administration's expedited timeline for issuance in final form. He questioned the regulatory transparency of the proposals, contending that statutory and executive order requirements may not have been followed properly.

> Your consideration of these concerns needs to be done in a thoughtful and deliberate manner. Moving swiftly to finalize the proposed regulations would not be consistent with such an approach. . . . The

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22 "Brady Statement after Discussion with Administration Officials Regarding Section 385 Regulations." U.S. House of Representatives Ways and Means Committee. July 06, 2016.

23 "Hatch Calls on Treasury to Re-Propose Debt-Equity Rules." U.S. Senate Committee on Finance. August 22, 2016.

> only prudent way to move forward – given the complexity of the subject matter, given the many significant substantive concerns that have been pointed out, and given the procedural irregularities – is to issue the regulations in re-proposed form.

U.S. Senators Dean Heller (R.-N.V.), Mike Crapo (R.-I.D.), Pat Roberts (R.-K.S.), John Cornyn (R.-T.X.), John Thune (R.-S.D.), Johnny Isakson (R.-G.A.), and Tim Scott (R.-S.C.) sent letters to Jacob Lew, Secretary of the Treasury, regarding the regulations. The letters requested an extension of the public comment period and asked the Treasury to ensure that ordinary business transactions, such as cash pooling, are not caught by the rules or subject to burdensome compliance requirements.[24]

BUSINESS COMMUNITY REACTION

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than three million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.[25] The Chamber sent a letter to Treasury Secretary Lew expressing its opposition to the adoption of the regulations in their current form.[26] The Chamber asked that the regulations be withdrawn or, alternatively, suggested numerous changes.

> The Chamber continues to believe that additional time is needed to analyze and review the impact of these rules on both ordinary business operations as well as more extraordinary transactions. The breadth, scope, and consequences of these regulations for Chamber members are vastly greater than ever suggested in prior notices and other guidance. Rather than address base erosion concerns in the context of inversions as suggested in the earlier notices, these regulations impact the use of intercompany debt among all multinational groups, both domestic and foreign, except where those instruments are issued between U.S. consolidated group members. In certain instances, even wholly domestic groups are impacted.[27]

The Business Roundtable is an association of chief executives who lead companies that operate in every sector of the U.S. economy.[28] In a letter dated July 8, 2016 to Secretary Lew,[29] the Roundtable expressed very serious concerns about adoption

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24 "Heller Leads Letter to Treasury Secretary Lew Expressing Concerns Over Proposed 385 Rules." United States Senator Dean Heller. July 5, 2016.; "Letter to the Secretary of the Treasury." Dean Heller, Mike Crapo, Pat Roberts, John Cornyn, John Thune, Johnny Isakson, and Tim Scott to Jacob Lew. August 24, 2016.

25 See U.S. Chamber of Commerce webpage, https://www.uschamber.com/.

26 "Letter on Proposed Treasury Regulations under Section 385." U.S. Chamber of Commerce. May 6, 2016.

27 "Proposed Regulations Under §385 (REG-108060-15)." Caroline L. Harris to Internal Revenue Service. July 6, 2016. In U.S. Chamber of Commerce.

28 See Business Roundtable webpage, http://businessroundtable.org/.

29 "Report: Treasury's Rules Will Cause Serious Economic Harm." Business Roundtable. July 8, 2016.

of the regulations:

> Business Roundtable . . . has very serious concerns about the business disruption and consequent harmful impact on the economy that would result from the Proposed Regulations. As drafted, the Proposed Regulations have an extremely broad impact, create significant uncertainty, have adverse consequences completely unrelated and disproportionate to the Treasury Department's stated concerns regarding 'inversion transactions' and 'earnings stripping.' . . . Business Roundtable believes the approach taken in the Proposed Regulations exceeds the regulatory authority granted to Treasury by Congress under Section 385. Further, the Proposed Regulations are inconsistent with fundamental principles of U.S. tax law, prior regulatory guidance, case law precedents, and Congressional intent.

BAR GROUP AND PRACTITIONER REACTION

The American Bar Association Section of Taxation issued a detailed 153-page report on the proposed regulations that raised a multitude of issues, especially in regards to the timetable for adoption of final regulations.[30]

> The Proposed Regulations represent a stark departure from a century of federal income tax law on the treatment of such instruments, and, as a result, we are concerned with the abbreviated comment period being afforded with respect to such sweeping changes. . . . [W]e strongly urge Treasury and the Service to take the time necessary to evaluate and develop these rules, even if that means that the final version of the Proposed Regulations ("Final Regulations") cannot be issued as swiftly as the Treasury would have desired, and even if all or parts of the rules must be reproposed. We note that the April 4, 2016, effective date of Proposed Regulation section 1.385-3 has the effect of deterring targeted transactions pending the adoption of final rules, allowing Treasury and the Service time to study and develop responses to all of the comments that are received.

The New York State Bar Association Section of Taxation issued a detailed 172-page report on the proposed regulations that raised a multitude of issues that need to be addressed.[31] Again, the timetable for adoption was criticized:

> The Proposed Regulations represent a substantial change from settled law, with far-reaching implications, the full breadth of which may not be grasped by taxpayers, or the government, for some time

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30 "Comments on Proposed Regulations under Section 385." George C. Howell, III to John Koskinen, William J. Wilkins, and Mark Mazur. July 13, 2016. In American Bar Association, Section of Taxation.

31 See "Report No. 1351 on Proposed Regulations under Section 385." Stephen B. Land to Mark J. Mazur, John Koskinen, and William J. Wilkins. June 29, 2016. In New York State Bar Association, Tax Section.; see also *Report on Proposed Regulations under Section 385*. Report no. 1351. Tax Section, New York State Bar Association. June 29, 2016.

> to come. For well-advised taxpayers, the Proposed Regulations in their current form would have significant and disruptive effects on ordinary commercial activities and on other transactions that may not implicate tax policy concerns. For other taxpayers, the Proposed Regulations – and, in particular, Prop. Treas. Reg. § 1.385-3 – will often operate as a trap for the unwary, in which taxpayers may learn only after the fact that an intercompany loan with customary debt terms can cause adverse tax consequences, even if the loan would (absent the Proposed Regulations) clearly constitute debt for U.S. federal income tax purposes. The fact that the Proposed Regulations raise these issues may to some extent be unavoidable, since Section 385 appears designed to distinguish between debt and equity based on a variety of factors germane to that analysis, rather than drawing the debt-equity distinction in a manner designed to achieve other tax policy goals.
>
> We recognize the importance of the government's policy objectives in issuing the Proposed Regulations. However, we are concerned that Prop. Treas. Regs. §§ 1.385-1 and 1.385-2 both need to be substantially revised in order to operate properly. In addition, we strongly recommend that Prop. Treas. Reg. § 1.385-3 not be issued as a final regulation, due to the deep problems inherent in the proposed rule. We urge that the government instead put forward alternative guidance for taxpayers' and practitioners' review and comment.

"The A.B.A. Section of Taxation issued a detailed 153-page report on the proposed regulations that raised a multitude of issues, especially in regards to the timetable for adoption of final regulations."

Other bar and professional groups have spoken out in opposition to the proposed regulations, including the District of Columbia Bar Association[32] and the American Institute of Certified Public Accountants.[33]

CONCLUSION

While Code §385 directly addresses debt-equity classification issues, this section was dormant for almost 40 years, with only one set of regulations that were issued and immediately withdrawn in 1983.[34] The Treasury decision to resurrect Code §385 as a tool to combat inversions was expected, but the Treasury's decision to expand the scope of the attack to all forms of related-party debt caught nearly everyone by surprise. Major issues and problems have been raised by commentators. However, the most immediate problem is the announced timetable for the adoption of the regulations in final form.

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32 "Comments Regarding the Proposed Regulations on Related-Party Debt Instruments, Prop. Treas. Reg. Sections 1.385-1, -2, -3 and -4." Letter to Mark J. Mazur, John Koskinen, and William J. Wilkins. June 30, 2016.

33 "Proposed Regulations Regarding the Treatment of Certain Interests in Corporations as Stock or Indebtedness (REG-108060-15)." Troy K. Lewis to Jacob Lew, John Koskinen, Mark Mazur, and William Wilkins. July 7, 2016. In American Institute of CPAs.

34 T.D. 7920, 1983-2 C.B. 69.

§385 REGULATIONS ADOPTED WITH HELPFUL CHANGES, BUT SIGNIFICANT IMPACT REMAINS

Author
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Code §163(j)
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Code §482
Code §7874
Earnings Stripping
Interest Deductions
Inversions
Related-Party Debt

OVERVIEW

On April 4, 2016, the U.S. Treasury Department surprised the tax community by issuing comprehensive and detailed proposed regulations under Code §385 that address whether a debt instrument will be treated as true debt for U.S. income tax purposes or recharacterized, in whole or in part, as equity.[1] As discussed in an earlier article in *Insights*,[2] these regulations contained: (i) new documentation requirements that must be met to support debt tax treatment, (ii) a debt recharacterization rule that will treat debt as equity when issued in a certain manner (such as when the debt constitutes property that is issued as a dividend to a shareholder) or when caught by an anti-abuse rule applicable to dividends funded by a borrowing of cash from the shareholder or a related party and certain other situations, and (iii) a bifurcation rule giving the I.R.S. authority to split a debt instrument into part equity and part debt as of the date of issuance.

In an unprecedented reaction, the proposed regulations received widespread criticism from members of Congress, the business community, bar and accounting groups, and practitioners. As discussed in an earlier follow-up article in *Insights*,[3] the comments raised policy and technical issues. Some commentators and members of Congress called for a complete withdrawal of the regulations. Other commentators called for major revisions to narrow the impact on transactions that are primarily motivated by business or acceptable Treasury procedures rather than tax savings.

On October 13, 2016, the Treasury Department released final and temporary regulations under Code §385 relating to the tax classification of debt.[4] The final and temporary regulations make several helpful changes to the proposed regulations including the following:

- Elimination of the bifurcation rule[5]

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1 Prop. Treas. Reg. §§1.385-1, 2, 3, and 4.

2 Philip Hirschfeld, "Related-Party Debt: Proposed Code §385 Regulations Raise Major New Hurdles," *Insights* 5 (2016).

3 Philip Hirschfeld, "Uproar Over Proposed §385 Regulations: Will Treasury Delay Adoption?," *Insights* 8 (2016).

4 T.D. 9790 adopting Treas. Reg. §§1.385-1, 2, 3, and 4, and Treas. Reg. §§1.385-3T and 4T.

5 The bifurcation rule was found in Prop. Treas. Reg. §1.385-1(d). The proposed regulations contained few guiding principles on how such a bifurcation would be determined. While the final regulations omitted the bifurcation rule, the "Treasury and the IRS continue to study the comments received [on the bifurcation rule]" (T.D. 9790, Background III(D)). Thus, the bifurcation rule may resurface in the future.

- Adoption of a provision narrowing the scope of the regulations so that they will not impact non-U.S. issuers of debt,[6] S Corporations, non-controlled real estate investment trusts ("R.E.I.T.'s"), or regulated investment companies ("R.I.C.'s")[7]
- Adoption of a grandfathering rule preventing the application of the documentation rules for debt issued before January 1, 2018
- Adoption of expanded exceptions to the debt recharacterization rule for distributions of earnings and profits ("E&P"), equity contributions, and certain other transactions
- Adoption of an exception that removes from coverage short-term cash pooling arrangements and debt instruments issued by regulated financial groups and insurance companies
- Expansion of the $50 million threshold (so that it covers all corporations) and a limitation that prevents recharacterization on a cascading basis
- Revision of the effective date and transition rules

However, the basic structure of the regulations remains unchanged, including documentation rules – albeit with relaxed due dates – and the anti-abuse funding rule previously mentioned.[8]

In final form, these regulations will have a major impact on the way debt is structured to ensure classification as true debt for tax purposes. Challenges to the validity of these regulations are anticipated.

SUMMARY OF THE REGULATIONS

The final and temporary regulations under Code §385[9] may cause related-party debt to be recharacterized as equity in two instances:[10]

- First, debt instruments may be treated as stock if issued in certain disfavored transactions, such as when a debt instrument issued by the taxpayer is distributed to its shareholder as a dividend.[11]
- Second, timely compliance with documentation requirements is required for related-party debt to be treated as true debt for tax purposes.[12]

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6 A covered member included a foreign corporation under the Prop. Treas. Reg. §1.385-1(c)(2)(ii). The final regulations reserved on treating a foreign corporation as a covered member (Treas. Reg. §1.385-1(c)(2)(ii)).

7 Treas. Reg. §1.385-1(c)(4).

8 Treas. Reg. §§1.385-2(b)(1) and 3(b)(1). The debt recharacterization regulations, however, provide a sole exception so that for purposes of the consolidated return rules, recharacterization will not apply (Treas. Reg. §1.385-3(d)(7)).

9 References to a section designate a section of the Internal Revenue Code of 1986, as amended, (the "Code") unless otherwise indicated.

10 Prop. Treas. Reg. §§1.385-1, 2, 3, and 4.

11 Treas. Reg. §1.385-3.

12 Treas. Reg. §1.385-2.

Debt Subject to New Rules

These rules apply to debt issued between members of an expanded group ("E.G."). An E.G. is an affiliated group of corporations within the meaning of Code §1504 (which generally requires 80% ownership) with significant modification:[13]

- The E.G. includes foreign and tax-exempt corporations. For example, an E.G. will exist if a foreign corporation owns 80% or more of a U.S. corporation.[14]
- The E.G. definition is satisfied by ownership of stock representing 80% or more of either vote *or* value, rather than vote *and* value.[15] The final regulations rely on the constructive ownership rules of Code §318(a) when determining whether the ownership test is met.[16]
- Debt between members of a U.S. consolidated corporate group is not subject to these rules since all the members of that group are treated as one corporation.[17]

In response to comments made to the proposed regulations, the final regulations exempt S Corporations, R.I.C.'s, and R.E.I.T.'s from being members of an E.G. This exemption does not apply when the R.I.C. or R.E.I.T. is controlled by members of the E.G.[18] The Treasury Department rejected requests to exempt tax-exempt entities and insurance companies from membership in an E.G.[19]

While a foreign corporation can be a part of an E.G., the final regulations exempt a foreign corporation from being a "covered member" of the E.G.[20] Consequently, debt issued by the foreign corporation is not subject to the documentation and recharacterization rules.

Debt Recharacterization Rule

The debt recharacterization rule reclassifies debt issued between members of an E.G. if issued in any of the following three fact patterns ("Targeted Transactions"):

- A debt instrument issued by an E.G. member is distributed to a shareholder who is part of that E.G. It does not matter whether the instrument is treated as a dividend because there is sufficient E&P or a return of capital.
- An E.G. member acquires stock of another member in exchange for the

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13 Treas. Reg. §1.385-1(c)(4)(i). An affiliated group of corporations generally files a consolidated Federal income tax return.

14 *Id.*

15 Treas. Reg. §1.385-1(c)(4)(i)(A).

16 Treas. Reg. §1.385-1(c)(4)(iii). While the proposed regulations modified the indirect ownership test of Code §1504(a)(1)(B)(i) by adding a "directly or indirectly" test, the final regulations retained and expanded that concept by adding the directly or indirectly test to the application of Code §1504(a)(1)(B)(i) (Treas. Reg. §1.385-1(c)(4)(i)).

17 Treas. Reg. §1.385-4T(b).

18 Treas. Reg. §1.385-1(c)(4).

19 T.D. 9790, Summary of Comments and Explanation of Revisions, III(B)(2)(a).

20 Treas. Reg. §1.385-1(c)(2)(ii).

issuance of a note to the selling member, other than in an exempt exchange.

- A debt instrument is transferred in exchange for property of another E.G. member in the context of certain tax-free asset reorganizations when and to the extent that
  - a shareholder that is a member of the E.G. before the reorganization receives the debt instrument,
  - the receipt of the debt instrument is part of the plan of reorganization.[21]

The Treasury Department rejected most requests to modify the second and third prong of the definition of Targeted Transactions. However, it expanded an exception for an acquisition of *newly issued* stock from a majority-owned subsidiary to apply to acquisitions of *existing* stock from a majority-owned subsidiary.[22]

"The final regulations adopt an anti-abuse rule called the 'funding rule' to combat cases where companies engage in two transactions that together have the same effect as a direct issuance of debt in a Targeted Transaction."

The final regulations adopt an anti-abuse rule called the "funding rule" to combat cases where companies engage in two transactions that together have the same effect as a direct issuance of debt in a Targeted Transaction. To illustrate, the shareholder lends funds to a subsidiary that is an E.G. member, and the E.G. member distributes a dividend to the shareholder in the same amount. Before the loan, the shareholder held cash, and after the dividend, the shareholder held the same amount of cash and a note of the subsidiary. If the roundtrip of the cash is ignored, the only transaction left is the creation of a note distributed to the shareholder. When integrated, this two-step transaction produces the same result as a simple distribution of a note.

The funding rule in the regulations addresses two-step transactions by recharacterizing the debt as equity. Under the funding rule, debt is subject to recharacterization if the debt instrument is considered to be a "principal purpose debt instrument."[23] A principal purpose debt instrument is a debt instrument issued by "the funded member" with a principal purpose of funding one of the following distributions or acquisitions ("Targeted Funding Transactions"):

- A distribution of cash or property by the funded member to another E.G. member
- An acquisition by the funded member of stock of another E.G. member for cash or property other than in an exempt exchange (as defined above)
- An acquisition of assets of one E.G. member by another, if the E.G. lends funds to the acquirer that are used as part of the consideration to acquire the assets of the transferor in a reorganization involving stock and boot[24] when the integrated transaction concludes with a distribution of the stock and boot to the common parent[25]

The principal purpose of the debt issuance is determined based on facts and

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21 Treas. Reg. §1.385-3(b)(2). As discussed in the prior article in *Insights*, there are certain limitations or exceptions to this rule.

22 *Id.*; T.D. 9790, Background V(C)(3)(c).

23 Treas. Reg. §1.385-3(b)(3)(i). As discussed in a prior article in *Insights*, there are certain limitations or exceptions to this rule.

24 In other words, "boot" within the meaning of Code §356.

25 Treas. Reg. §1.385-3(b)(3)(ii).

circumstances.[26] However, the funding rule contains a "nonrebuttable" presumption that an instrument is a principal purpose debt instrument if the debt is issued at any time during the 72-month period beginning 36 months before and ending 36 months after the issuing member makes a distribution or acquisition that is considered a Targeted Funding Transaction (the "72-Month Testing Period").[27] For example, if a foreign parent corporation lends $1,000 to its wholly-owned subsidiary in the U.S. and 30 months later the U.S. subsidiary distributes $1,000 cash back to the foreign parent (but not as part of a pre-arranged plan), the nonrebuttable presumption applies and the debt instrument is characterized as equity.

The nonrebuttable presumption has been retained in the final regulations in much the same manner as it existed under the proposed regulations but with broadened exceptions discussed below.

Documentation Rules

There are four parts to the documentation rules that impose a new set of requirements to support true debt status for U.S. tax purposes:

- The first requirement relates to the need for there to be a binding obligation to repay the funds advanced. This rule requires evidence in the form of a timely-prepared written document executed by the parties.[28]
- The second requirement is for the loan documentation to delineate the creditor's rights to enforce the debtor's obligation to repay.[29] Typical creditor rights include the right to trigger a default, the right to accelerate payments, and the superior right over shareholders to share in the assets of the issuer if the issuer is dissolved or liquidated.
- The third requirement is a reasonable expectation of repayment by the issuer of the loan.[30] This rule requires that the taxpayer prepare and maintain supporting documentation such as cash flow projections, financial statements, business forecasts, asset appraisals, and the determination of debt to equity and other relevant financial ratios of the issuer. Credit-worthiness is determined under an objective standard. When a disregarded entity having limited liability (such as a wholly-owned U.S. L.L.C.) is the borrower, credit-worthiness is based on the assets of the disregarded entity.
- The final requirement is evidence of a genuine debtor-creditor relationship.[31] This means that payment of interest and principal is made when and as provided in the loan documentation, and such payment must be demonstrated. Examples of proof of payment include wire transfer records and account statements.

The final regulations retained these four requirements, which were set forth in the proposed regulations, but added some changes discussed below to ease compliance

[26] Treas. Reg. §1.385-3(b)(3)(iv)(A).

[27] Treas. Reg. §1.385-3(b)(3)(iv)(B)(1).

[28] Treas. Reg. §1.385-2(b)(2)(i).

[29] Treas. Reg. §1.385-2(b)(2)(ii).

[30] Treas. Reg. §1.385-2(b)(2)(iii).

[31] Treas. Reg. §1.385-2(b)(2)(iv).

and exempt certain debt instruments from their application.

BENEFICIAL CHANGES TO THE DEBT RECHARACTERIZATION RULE

While retaining the debt recharacterization rule largely in its proposed form, the final and temporary regulations made a few helpful changes to address comments that were received.

Expanded E&P Exception

As noted above, the funding rule is triggered if there is (i) an issuance of a debt instrument and (ii) a Targeted Funding Transaction (*e.g.*, a distribution made by the issuing company), made during the 72-Month Testing Period. The proposed regulations contained an exception where the Targeted Funding Transaction was a distribution of *current* E&P,[32] meaning the earnings generated during the year in which the loan is made. The proposed regulations reduced the amount of tainted distribution made by the amount of the current E&P. This reduced or eliminated the Targeted Funding Transaction.

The Treasury Department received comments that the E&P exception should apply to both *current* and *accumulated* E&P.[33] The final regulations adopted this recommendation but with a limitation. Under the final regulations, *current* E&P and *accumulated* E&P are to be considered if the accumulated E&P was accumulated in taxable years ending after April 4, 2016.[34] Thus, the Treasury Department decided to limit E&P to "the period of a corporation's membership in a particular expanded group."[35]

Expanded Access to $50 Million Threshold Exception

The proposed regulations contained a $50 million threshold exception so that the debt recharacterization rule would not apply if a taxpayer's related-party debt does not exceed $50 million. Commentators highlighted the cliff effect of the provision. If a taxpayer issued $1 of debt in excess of the $50 million threshold, the benefit of

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32 Prop. Treas. Reg. §1.385-3(c)(1). The technical approach taken in the regulations is to reduce the amount of distributions made by the amount of the current E&P. To illustrate how the proposed regulations worked, a U.S. company borrows $100 million from its foreign parent and issues its note to the foreign parent for $100 million. The following year, the U.S. company makes a $10 million cash distribution to its foreign parent. The $10 million distribution is treated like a taxable dividend since the U.S. company has $4 million of current E&P and $5 million of accumulated E&P. Since $4 million of the distribution is from current E&P, only the remaining distribution of $6 million is a Targeted Funding Transaction triggering the funding rule and recharacterization of $6 million of the debt as equity.

33 T.D. 9790, Summary of Comments and Explanation of Revisions, V(E)(3)(a).

34 Treas. Reg. §1.385-3(c)(3)(i). Thus, for the prior example, the full amount of the $10 million distribution would be excluded assuming that the accumulated E&P was attributable to taxable years ending after April 4, 2016. If the accumulated E&P is partially for prior years, the prior year accumulated E&P cannot be used for this exclusion to apply.

35 T.D. 9790, Summary of Comments and Explanation of Revisions, V(E)(3)(a).

this rule would be lost, entirely.[36] The final regulations eliminate this cliff effect[37] so that all taxpayers can exclude the first $50 million of debt that would otherwise be recharacterized.[38]

Exclusion of Qualified Short-Term Debt Instruments

The proposed regulations contained an exception that excluded debt issued in the ordinary course of the issuer's business. The Treasury Department received comments that the ordinary course exception was very narrow and the regulations should be revised so that these rules should not apply to non-tax motivated cash management techniques, such as cash pooling or revolving credit arrangements, nor to ordinary course short-term lending outside a formal cash management arrangement.[39]

In response to these comments, the final regulations include an exception for qualified short-term debt instruments.[40] The definition of a qualified short-term debt instrument is set forth in the temporary regulations[41] and is subject to further change.

The definition of a qualified short-term debt instrument is long and complex and likely best understood by those involved in the treasury function of the E.G. A debt instrument is a qualified short-term debt instrument if the debt instrument is (i) a short-term funding arrangement that meets one of two alternative tests (the specified current assets test or the 270-day test),[42] (ii) an ordinary course loan,[43] (iii) an interest-free loan,[44] or (iv) a deposit with a qualified cash pool header.[45]

"The final regulations include an exception for qualified short-term debt instruments."

To satisfy the specified current assets test, two requirements must be satisfied:

> First, the rate of interest charged with respect to the debt instrument is less than or equal to an arm's length interest rate, as determined under section 482 and the regulations thereunder, that would be charged with respect to a comparable debt instrument with a term that does not exceed the longer of 90 days and the issuer's normal operating cycle.[46]
>
> Second, . . . immediately after the covered debt instrument is issued, the issuer's outstanding balance under covered debt instruments issued to members of the issuer's expanded group that satisfy any of (i) the interest rate requirement of the specified current assets test, (ii) the 270-day test . . . , (iii) the ordinary course loan exception, or

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36 Prop. Treas. Reg. §1.385-3(c)(4).

37 T.D. 9790, Summary of Comments and Explanation of Revisions, V(E)(4).

38 Treas. Reg. §1.385-3(c)(4).

39 T.D. 9790, Summary of Comments and Explanation of Revisions, V(D)(8)(c).

40 Treas. Reg. §1.385-3(b)(3)(i).

41 Treas. Reg. §1.385-3T(b)(3)(vii).

42 *Id.*, (A).

43 *Id.*, (B).

44 *Id.*, (C).

45 *Id.*, (D).

46 *Id.*, (A)(1)(ii).

(iv) the interest-free loan exception, does not exceed the amount expected to be necessary to finance short-term financing needs during the issuer's normal operating cycle.[47]

For a debt instrument to satisfy the 270-day test, three conditions must be met:[48]

- First, the debt instrument must (i) have a term of 270 days or less, or be an advance under a revolving credit agreement or similar arrangement, and (ii) bear a rate of interest that is less than or equal to an arm's length interest rate, as determined under Code §482, that would be charged with respect to a comparable debt instrument with a term that does not exceed 270 days.
- Second, the issuer must be a net borrower from the lender for not more than 270 days during the taxable year of the issuer, and in the case of a covered debt instrument outstanding during consecutive taxable years, the issuer may be a net borrower from the lender for not more than 270 consecutive days.
- Third, a debt instrument will satisfy the 270-day test only if the issuer is a net borrower under all covered debt instruments issued to any lender that is a member of the issuer's E.G. that otherwise would satisfy the 270-day test, other than ordinary course loans and interest-free loans, for 270 or fewer days during a taxable year.

The temporary regulations generally broaden the ordinary course exception in the proposed regulations to provide that a debt instrument constitutes a qualified short-term debt instrument if issued as consideration for the acquisition of property other than money, in the ordinary course of the issuer's trade or business. In contrast to the proposed regulations, the temporary regulations provide that, to constitute an ordinary course loan, an obligation must be reasonably expected to be repaid within 120 days of issuance.[49]

Exclusion of Debt Instruments Issued by Regulated Financial Groups and Insurance Entities

The final regulations add an exception to the debt recharacterization rule so that a covered debt instrument does not include a debt instrument issued by either a regulated financial company or a regulated insurance company.[50] The rationale for this exclusion is that abuse is not viewed as being likely since these entities are subject to a specified degree of regulatory oversight regarding their capital structures.[51]

Limiting Certain Cascading Recharacterization

Several comments requested that the final and temporary regulations should include rules to address cascading recharacterizations. These are situations in which the recharacterization of one covered debt instrument could lead to deemed transactions that result in the recharacterization of one or more other covered debt instruments

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47 *Id.*, (A)(1)(iii).

48 *Id.*, (A)(2).

49 *Id.*, (B).

50 Treas. Reg. §1.385-3(g)(3)(i).

51 T.D. 9790, Summary of Comments and Explanation of Revisions, V(G)(1), (2).

in the same E.G.[52] The final regulations narrow the application of the funding rule by preventing the cascading consequences of recharacterizing a debt instrument as stock in certain circumstances. The final regulations provide that once a covered debt instrument is recharacterized as stock under the funding rule, the distribution or acquisition that caused that recharacterization cannot cause a recharacterization of another covered debt instrument after the first instrument is repaid.[53]

Credit for Certain Capital Contributions

Numerous comments requested that capital contributions to a member should be netted against distributions or acquisitions by the member for purposes of applying the debt recharacterization and funding rules. The commentators reasoned that, to the extent of capital contributions, a distribution does not reduce a member's net equity.[54]

The Treasury Department agreed that it is appropriate to treat distributions or acquisitions as funded by new equity before related-party borrowings.[55] The final and temporary regulations provide that a distribution or acquisition that may trigger application of this rule is reduced by the aggregate fair market value of the stock issued by the covered member in one or more qualified contributions (the "Qualified Contribution" reduction).[56] A Qualified Contribution is a contribution of property (other than excluded property) to the covered member by any member of the covered member's E.G. in exchange for stock of the covered member during the qualified period. The qualified period generally means the period beginning 36 months before the date of the distribution or acquisition, and ending 36 months after the date of the distribution or acquisition.

Exception for Equity Compensation

Some comments requested an exception to the extent that the acquiring entity makes an actual payment for the stock of the issuing corporation that is conveyed to a person as consideration for services.[57] The final regulations adopt this approach by adding an exception for the acquisition of stock delivered to employees, directors, and independent contractors as consideration for services rendered.[58]

Expansion of the 90-Day Transition Rule for Recharacterization

The proposed regulations provided for a 90-day delay in implementation for debt instruments issued on or after April 4, 2016, but prior to publication of the final regulations in the Federal Register.[59] The final regulations expand this delayed implementation to any debt instrument issued on or after the date that is 90 days after publication of the final regulations in the Federal Register. This 90-day delayed

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52 *Id.*, V(B)(4).

53 Treas. Reg. §1.385-3(b)(6).

54 T.D. 9790, Summary of Comments and Explanation of Revisions, V(E)(3)(b).

55 *Id.*

56 Treas. Reg. §1.385-3(c)(3)(ii).

57 T.D. 9790, Summary of Comments and Explanation of Revisions, V(E)(2)(b).

58 Treas. Reg. §1,385-3(c)(2)(ii).

59 Prop. Treas. Reg. §1.385-3(j).

date is January 11, 2017.[60]

BENEFICIAL CHANGES TO THE DOCUMENTATION RULES

While retaining the documentation rule largely in its proposed form, the final and temporary regulations make a few helpful changes.

Delayed Implementation

Under the final regulations, the documentation rules only apply to debt instruments issued on or after January 1, 2018.[61] This change will allow taxpayers more time to properly implement procedures to comply with the new documentation rules.

Extension of Period Required for Compliance

The proposed regulations generally required documentation to be prepared not later than 30 calendar days after the date the instrument becomes a related-party debt instrument.

The final regulations eliminate the 30-day timely preparation requirement and instead treat documentation and financial analysis as having been timely prepared if it is in existence at the time the issuer's Federal income tax return is filed (taking into account all applicable extensions).[62] At a minimum, a taxpayer will have until the filing date of the tax return of the taxable year that includes January 1, 2018, to complete the documentation requirements.

Limited Rebuttable Presumption

The proposed regulations provided that compliance with the documentation rules is required for true debt status. If any debt instrument is not timely documented, it would be treated as equity regardless of any argument in support of debt treatment.[63]

The final regulations add a rebuttable presumption, rather than a mandatory recharacterization. However, the rebuttable presumption applies only if an E.G. is highly compliant with the documentation rules.[64] Consequently, the relaxed standard applies in a narrow class of situations.

To demonstrate that a high degree of compliance exists, a taxpayer must meet one of two tests:

- Under the first test,[65] a taxpayer must demonstrate that covered instruments representing at least 90% of the aggregate issue price of all covered instruments within an E.G. are in compliance with the documentation rules.

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60 Treas. Reg. §1.385-3(j).

61 Treas. Reg. §1.385-2(d)(2)(iii).

62 Treas. Reg. §1.385-2(c)(4).

63 Prop. Treas. Reg. §1.385-2(b).

64 Treas. Reg. §1.385-2(b)(2)(i).

65 *Id.*, (B)(1).

- Under the second test,[66] a taxpayer must demonstrate either that
  - no covered instrument with an issue price of more than $100 million and less than 5% of the covered instruments outstanding failed to comply with the documentation rules, or
  - no covered instrument with an issue price of more than $25 million and less than 10% of the covered instruments outstanding failed to comply with the documentation rules.

“The rebuttable presumption applies only if an E.G. is highly compliant with the documentation rules. Consequently, the relaxed standard applies in a narrow class of situations.”

An anti-stuffing rule applies to these requirements so that a debt instrument will not be counted in applying these requirements if it was entered into with a principal purpose of satisfying these rules.[67]

If a taxpayer is eligible for rebuttable presumption treatment, then the debt will continue to be treated as debt for tax purposes if the taxpayer clearly establishes that there are sufficient common law factors present to treat the instrument as indebtedness, including that the issuer intended to create indebtedness when the instrument was issued.[68]

Master Agreements Allowed for Revolving Credit Agreements, Cash Pooling, and Similar Arrangements

The Treasury Department received comments requesting relief in the case of revolving credit agreements or cash pooling and similar arrangements. The concern expressed was that a technical application of these rules could lead to a burdensome need to prepare documentation for each advance under the lending arrangement.

In response, a special rule is added to cover

- a revolving credit agreement,
- a cash pool agreement,
- an omnibus or umbrella agreement that governs open account obligations or any other identified set of payables or receivables, or
- a master agreement that sets forth general terms of an instrument with an associated schedule or ticket that sets forth the specific terms of an instrument.[69]

The documentation requirements regarding a separate note or written obligation to repay the loan and documentation of creditor’s rights in each written agreement are deemed satisfied if the material documentation associated with the instrument, including all relevant documents, is prepared and maintained in accordance with the requirements of the regulations.[70] A single master agreement can satisfy the two requirements.

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66 *Id.*, (B)(2).

67 Treas. Reg. §1.385-2(b)(2)(i)(B)(4).

68 Treas. Reg. §1.385-2(b)(2)(i)(A).

69 Treas. Reg. §1.385-2(c)(3)(i)(A).

70 *Id.*, (2).

With respect to the requirement of a reasonable expectation of repayment, the written documentation need only be prepared once every year for all advances in the year, rather than multiple times, once each for all advances. This documentation should demonstrate that the issuer's financial conditions support a reasonable expectation that the issuer would be able to pay interest and principal in respect of the maximum principal amount outstanding under the terms of the revolving agreement.[71]

Partnership Debt Exclusion

The Treasury Department decided that the documentation rules should not apply to partnership debt.[72] However, the Treasury Department indicated that it remains concerned about partnership debt so that an anti-abuse rule can bring partnership debt into coverage under the documentation rules if the partnership is used with a principal purpose of avoiding the application of the documentation rules for corporations.[73]

Treatment of Disregarded Entities

The final regulations provide that if debt issued by a disregarded entity does not satisfy the documentation rules, the debt is recharacterized as equity of the corporation that is the sole member.[74] This approach reflects comments that the debt recharacterization rules should not cause a disregarded entity to be treated as a partnership.[75] Consequently, if equity treatment is mandated, the equity is in the sole member, not its disregarded subsidiary.

CONCLUSION

Despite numerous comments made to the Treasury Department for major modification or deferral of adoption of these rules, the final and temporary regulations under Code §385 retain the basic approach of the proposed regulations, with some modifications to restrict the impact of the rules to large corporations. The Treasury Department cautions that the final regulations provide an additional level of tests that must be met in addition to the tests under case law.[76] They supplement the rules under existing law rather than replace those rules. As a result, the common-law concerns about what debt-to-equity ratio is acceptable, as well as the reasonableness of other terms of the debt (such as fixed maturity date and interest rate), remain.

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[71] Treas. Reg. §1.385-2(c)(3)(i)(A)(3).

[72] T.D. 9790, Summary of Comments and Explanation of Revisions, IV(B)(1)(a).

[73] Treas. Reg. §1.385-2(f).

[74] Treas. Reg. §1.385-2(e)(4).

[75] T.D. 9790, Background IV(A)(4).

[76] Treas. Reg. §1.385-1(b). For a discussion of these common-law principles, see Hirschfeld, "Related-Party Debt: Proposed Code §385 Regulations Raise Major New Hurdles."

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