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INSIGHTS

2017 YEAR IN REVIEW – LOOKING FORWARD, LOOKING BACK

THE U.K. TRUST REGISTRATION SERVICE: IMPACT FOR TRUSTEES

AUSTRIAN GUIDANCE ON TAXATION OF BITCOIN AND OTHER CRYPTOCURRENCIES

TAX 101: VIRTUAL CURRENCY – WHAT IS IT? AND HOW IS IT TAXED?

A YEAR OF GUEST FEATURES

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EDITORS' NOTE

The December edition of *Insights* takes its theme from Janus, the Roman god with two faces, by contemplating tax events covered in 2017 and addressing events that remain timely today and in the future.

We begin by looking forward, with three new articles. First, **Jennifer Smithson** and **Isobel Morten** of Macfarlanes, London, address the U.K. trust registration service and its impact on trustees of trusts have certain contacts with the U.K. Then, **Niklas J.R.M. Schmidt** and **Eva Stadler** of Wolf Theiss, Vienna, discuss the treatment of cryptocurrencies under Austrian tax rules. Finally, **Alev Fanny Karaman** examines how virtual currencies work and the U.S. tax consequences arising from their use.

Then, we reminisce on the best of 2017, with articles contributed by 36 guest authors from around the world.

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LOOKING FORWARD – CURRENT FEATURES

- **The U.K. Trust Registration Service: Impact for Trustees.** The past few years have seen a steep increase in trust reporting obligations in the context of F.A.T.C.A. and the Common Reporting Standard. Trustees must come to grips with a new set of record keeping and disclosure obligations introduced by the U.K. Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017, which came into force from June 26, 2017. Jennifer Smithson and Isobel Morton of Macfarlanes LLP, London, explain the wide-ranging effect of the regulations and the dividing line between non-U.K. trustees that fall inside the regime and those who are outside.

- **Austrian Guidance on Taxation of Bitcoin and Other Cryptocurrencies.** While wild fluctuations in the value of Bitcoin are reported daily in global press and social media, the Austrian Ministry of Finance recently summarized its views on the tax consequences of investing in this relatively new asset class. Niklas J.R.M. Schmidt and Eva Stadler of Wolf Theiss, Vienna, explain the real-life consequences of the transacting in virtual currencies.

- **Tax 101: Virtual Currency – What Is It? And How Is It Taxed?** With the recent launch of Bitcoin futures trading, this once obscure asset class may soon become a mainstream investment. Alev Fanny Karaman delves into the details of virtual currency in the U.S. context. She explains the blockchain computations that make Bitcoin and other cryptocurrencies attractive to investors and the U.S. tax treatment and reporting obligations of virtual currency holders.

LOOKING BACK – PAST GUEST FEATURES

- **The New Transparency Register in Germany.** October 1, 2017, was the due date for entering information on Germany's beneficial owner registry. The register brings transparency to all sorts of entities, including private law foundations and trusts, as data will be open to public inspection from December 27, 2017. Dr. Andreas Richter of P+P Pöllath + Partners, Berlin, sheds light on the registration requirements.

- **Brazil 2017: Tax Developments for Business Transactions.** In Brazil, the year 2017 saw many important developments regarding cross-border and intrastate business transactions. These developments focus on the implementation of various B.E.P.S. actions, the categorization of software transactions, and subjecting certain intrastate transactions to competing levels of state and municipal tax, all done the Brazilian way by emphasizing gross basis taxation on consumption payments. Erika Tukiama, Rogério Gaspari Coelho, and Nathália Fraga of Machado Associados, São Paulo, provide guidance on these developments.

- **An American in London: Due Diligence Observations.** Performing due diligence on private companies for a potential merger or acquisition has been described as an exercise in educated guessing. The quality of the target's financial information, potential hidden liabilities, financing, and similar

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deficiencies may result in a valuation that is neither straightforward nor reliable. When the target is abroad, the culture, language, and business norms may cause the educated guess to be more guess and less educated. Knowing how to overcome this dilemma is a skill set that can be obtained only through experience. Nick Magone, founder of Magone & Company, P.C., in Roseland, New Jersey, shares his experiences in performing due diligence on potential target companies in the U.K. His advice? Numbers are only the beginning.

- **Double Dutch: Dividend Tax Reform Extends Exemption, Yet Tackles Abuse.** This year's budget in the Netherlands contains a legislative proposal that introduces a unilateral exemption applicable to corporate shareholders based in treaty countries, such as the U.S., subject to stringent anti-abuse rules. In addition, it proposes to bring cooperatives used as holding vehicles within the scope of the dividend withholding tax rules. Soon after the proposals were announced, a coalition government was formed and announced a complete elimination of dividend withholding tax. Paul Kraan of Van Campen Liem in Amsterdam explains.

- **Swiss Federal Council Opens Consultation Process on Tax Proposal 17.** When Swiss voters rejected the Corporate Tax Reform Act III ("C.T.R. III") in a referendum on February 12, 2017, Swiss tax reform was not derailed, only delayed. Events that took place in September have moved the process forward. Existing cantonal tax privileges will be abolished, as agreed with the E.U., and replaced by mandatory introduction of a patent box regime in all cantons, voluntary introduction of additional deductions for research and development ("R&D") expense, and a step-up in basis of hidden reserves created under the old tax regimes or before immigration to Switzerland. Reto Heuberger, Stefan Oesterhelt, and Martin Schenk of Homburger AG, Zurich, explain the most important aspects of these and other aspects of T.P. 17.

- **Spontaneous Exchange of Tax Rulings – The Swiss Angle.** Most – but not all – global tax advisers know that the tax planning universe has changed. The few holdouts hoping that the old ways may yet be available were disappointed, again, when Switzerland announced procedures for the spontaneous exchange of tax rulings. Rulings issued on and after January 1, 2010, will be exchanged beginning January 1, 2018. Michael Fischer and Marc Buchmann of Attorneys Fischer Ramp Partner AG, Zurich, explain the new procedures and how taxpayers may take steps to stop the spontaneous exchange of existing rulings.

- **India: Legal and Practical Strategies for Managing Tax Disputes.** Most readers of this journal are front-end tax planners, proposing plans to be implemented by clients. Regrettably, not all plans escape examination by the tax inspector, and in India, that number is on the rise. Sanjay Sanghvi of Attorneys Khaitan & Co., Mumbai explains how to prepare for a tax examination in India and provides practical insights into the examination, appeals, and judicial review processes.

- ***Caveat Dominus*: A Comparison of Post-Employment Entitlements in the U.S. and Italy When Executive Employment Is Terminated Without Cause.** When companies expand business operations across the Atlantic Ocean, various cultural differences between the U.S. and Europe come to the fore. The most noticeable are found in the area of employment, and among those are expectations of the rights of employers, employees, and executives at the time of termination of employment. George Birnbaum of the Law Offices of George Birnbaum P.L.L.C. and Ariane Rauber and Fabio Tavecchia of Palmer Studio Legale compare and contrast employee rights in the U.S. and Italy.

- **Circular Letter No. 17/E Clarifies Special Tax Regime for Italian "New Residents."** Late last year, the Italian government enacted a new regime designed to entice wealthy individuals into becoming tax residents. In late May, operating rules for the new tax regime were announced. In broad terms, the regime imposes an annual tax charge of €100,000 in lieu of tax imposed at standard rates and an exclusion from inheritance and gift tax on foreign assets. Andrea Tavecchio and Riccardo Barone of Tavecchio Caldara & Associati in Milan, Italy explain the details of the new regime.

- **Pancake Day – End to Permanent Non-Domicile Status and Charging Non-Doms I.H.T. on U.K. Residential Property.** In July, the U.K. government announced that proposals removed from the Finance Bill that was announced in March would be reproposed with a retroactive effective date, as if adopted when originally proposed. This is bad news for non-domiciled individuals ("Non-Doms") in general and for the estates of Non-Doms who died between March and the ultimate date of enactment. If retroactive effective dates remain in the bill, rights granted by the European Convention for the Protection of Human Rights and Fundamental Freedoms, which were incorporated into U.K. law by the Human Rights Act 1998, could be violated. William Hancock and Daniel Simon of Collyer Bristow L.L.P. explain that Non-Doms should expect "too little jam and too little cream" on their pancakes if the provisions are enacted retroactively.

- **High-Speed Tax Reform: The U.K. Diverted Profits Tax & Restrictions on Corporate Interest Deductions.** Among the most notable changes made to U.K. corporate tax over the past 24 months are the introduction of the diverted profits tax ("D.P.T.") and the reduction of tax relief for corporate interest payments. D.P.T. is aimed at multinationals operating in the U.K. that try to avoid maintaining a permanent establishment in order to escape U.K. corporate tax. D.P.T. is imposed at the rate of 25% and treaty relief is not available. The reduction in relief for corporate interest payments implements the recommendations of B.E.P.S. Action 4. Eloise Walker and Penny Simmons of Pinsent Masons, London, explain the working of these provisions.

- **New Proposal for Swiss Corporate Tax Reform.** Through the first ten days of February, Swiss tax advisers were contemplating life after the adoption of the Corporate Tax Reform III ("C.T.R. III"). Then, the bottom dropped out from under their feet as Swiss voters defeated the tax reform package by an almost 60-40 majority. Now, a Steering Committee representing the cantons and Swiss Federation has issued T.P. 17, recommending a modified version of corporate tax reform. Peter von Burg and Dr. Natalie Peter of Staiger Attorneys, Zurich, compare the provisions in T.P. 17 with those in C.T.R. III.

- **Economic Nexus Through Ownership and Use of Intellectual Property.** For many tax advisers outside the U.S., state corporate income tax is viewed simply as an add-on to the Federal tax. This relatively simplistic view ignores the requirements of U.S. Federal and Constitutional law that an activity must have a connection – called a nexus – to a state before tax can be imposed on profits allocated to the state. Alvan L. Bobrow of Akerman LLP in New York explains the concept of "economic nexus," a way by which digital activity within a state may trigger exposure to state tax. Companies that license marketing intangibles should be particularly wary.

- **Corporate Matters: Five Steps for Leveraging Your Start-Up's Emerging Intellectual Property.** For an emerging business, intellectual property ("I.P.") can be the business's most important asset and the difference between its success and failure. That is why steps must be taken early on to protect those "jewels." Barry Lewin of Gottlieb, Rackman & Reisman, P.C. in New York explains five important actions designed to protect and enhance value.

- **U.K. Drops Changes to Non-Domicile Regime, But Likely Not for Long.** After months of H.M.R.C. consultation, a new regime was put in place for U.K.-resident Non-Doms on April 6, 2017, only to see the legislation pulled from Finance Bill 2017 on April 25. The snap election in the U.K. put consideration of Non-Dom taxation on hold when 72 of the 135 clauses were removed from the bill. This allowed Parliament to approve the legislation in two hours. Gary Ashford of Harbottle Lewis, London, summarizes the short-lived provisions and those that failed to be enacted on April 6. The proposed regime remains a work in process, and enacting legislation could be back on the table as early as this fall.

- **Pre-Immigration Planning: Drop-Off Trusts + Private Placement Life Insurance – If the Tools Fit, Use Them.** Wealthy persons moving to the U.S. often engage a tax adviser to craft a pre-immigration plan. Typically, the plans focus on harvesting gains, stepping up the basis in appreciated assets that cannot be sold, and simplifying structures to ensure that future gains will benefit from favorable long-term capital gains rates. However, the truly sophisticated client may wish to take a long-range approach that maximizes the accumulation of wealth during life. John F. McLaughlin and Shelly Meerovitch of Bernstein's Wealth Planning and Analysis Group, New York, explain the benefits of forming a pre-immigration drop-off trust to invest in a private placement life insurance ("P.P.L.I.") policy. In optimal circumstances, the P.P.L.I. investment portfolio can maximize the accumulation of wealth, provided the client obtains timely and competent legal advice in the country of residence and the U.S.

- **India Budget 2017-18.** Provisions in Budget 2017-18 announced by the Finance Minister that relate to infrastructure, the financial sector, accountability, prudent fiscal management, and tax administration reflect a view that times are changing in India. The government appears to remain steadfast in its efforts to bring the Indian tax and regulatory environment up to global standards. Jairaj Purandare of JPM Advisors Pvt Ltd, Mumbai, explains the focus of the budget

- **Swiss Corporate Tax Reform Postponed.** Through the first ten days of February, Swiss tax advisers were contemplating life after the adoption of the Corporate Tax Reform III ("C.T.R. III"). Then, the bottom dropped out from under their feet as Swiss voters defeated the tax reform package by an almost 60-40 majority. Peter von Burg and Dr. Natalie Peter of Staiger Attorneys at Law in Zurich explain the benefits that were contemplated under C.T.R. III and ponder about what will be adopted in its place. Switzerland must act promptly to cobble together a replacement package that will appease opponents of C.T.R. III and meet the deadline under its agreement with the E.U. for eliminating existing special benefits allowed to base companies. How much of C.T.R. III can be salvaged?

- **Italy Introduces A 15-Year Preferential Tax Regime for Wealthy Individuals Taking Up Tax Residence in Italy.** As U.K. Non-Doms scramble to restructure in light of the new rules for persons holding Non-Dom status for more than 15 years, Italy has adopted new measures to attract high net worth individuals. The rules are clearly derived from the Non-Dom rules in the U.K., but the weather is better. Fabio Chiarenza of Gianni, Origoni, Grippo, Cappelli & Partners explains the new provisions.

- **Proposed Directive on the E.U. Common (Consolidated) Corporate Tax Base – A Primer.** For decades, European bureaucrats looked with disdain at the way the various states within the U.S. compute state tax. The arm's length principle within Europe trumped state apportionment. Now, however, the European Commission has issued three proposal directives that deal with (i) the Common Corporate Tax Base ("C.C.T.B.") and the Common Consolidated Corporate Tax Base ("C.C.C.T.B."), (ii) resolution of double tax disputes, and (iii) mismatches with non-E.U. countries. To the surprise of many, the C.C.C.T.B. includes a three-factor apportionment rule for the sharing of global income by the members of a corporate group operating throughout the E.U. Stefano Grilli of Gianni, Origoni, Grippo, Cappelli & Partners, Milan, explains proposals that have been introduced.

- **India – Guidelines Issued for Determining Place of Effective Management.** In Circular No. 6/2017, dated January 24, 2017, the Central Board of Direct Taxes issued final guidelines regarding the factors that will be looked to under Indian income tax treaties when determining the place of effective management ("P.O.E.M.") of a foreign company that is part of an Indian-based group. Almost as important as the substantive rules, the Circular establishes the procedure that must be followed before a tax officer may determine that the P.O.E.M. of a foreign company is in India. There are winners and there are losers in the Circular. Ashutosh Dixit, Parul Jain, and Kaushik Saranjame of BMR & Associates L.L.P. explain the new rules.

- **U.K. Criminal Penalties for Improper Tax Planning – Could You Be Effected?** New powers have been given to H.M.R.C. in recent legislation, and new criminal and civil penalties have been enacted as part of a massive legislative program designed to stop U.K. residents from participating in offshore tax avoidance and evasion schemes. Several criminal penalties are directed to advisory firms that facilitated tax offenses. In certain circumstances, advisory firms based outside the U.K. will be at risk of prosecution. Gary Ashford of Harbottle and Lewis L.L.P., London, and Stanley C. Ruchelman examine the new provisions.

- **Income Taxation of Trusts in Belgium.** How are foreign trusts, Belgian beneficiaries, and Belgian settlors taxed in Belgium when Belgian law civil law generally does not recognize the existence of trusts? Depending on facts and circumstances, the so-called Cayman Tax Law will tax either the settlor or the beneficiary. Gerd D. Goyvaerts of Tiberghien, Brussels explains.

- **New Zealand Foreign Trust Disclosure Regime.** In April 2016, the New Zealand government convened an independent inquiry into the use of New Zealand foreign trusts. Following this inquiry, a new foreign trust disclosure regime was proposed to obtain information on ultimate beneficial ownership. Heather Howell, who heads the office of Trident Trust Group in Auckland, New Zealand, explains.

We hope you enjoy this issue.

- The Editors

THE U.K. TRUST REGISTRATION SERVICE: IMPACT FOR TRUSTEES

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Jennifer Smithson and Isobel Morton are members of the private client department at Macfarlanes LLP in London. They have each spent time on secondment in New York with a large private bank and an international law firm respectively.

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E.U. DRIVE TOWARDS TRANSPARENCY

The past few years have seen a steep increase in trust reporting obligations in the context of F.A.T.C.A. and the Common Reporting Standard ("C.R.S."). Trustees must now come to terms with a new set of record keeping and disclosure obligations introduced by the U.K. Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (the "Regulations"), which came into force from June 26, 2017 to enact the E.U. Fourth Money Laundering Directive (E.U. 2015/849).

These obligations are potentially wide-ranging and onerous, but importantly, there are straightforward ways in which non-U.K. trustees can fall outside the regime.

From the trustee's perspective, the main impact of the Regulations is the introduction by HM Revenue & Customs ("H.M.R.C.") of a new Trust Registration Service ("T.R.S."). T.R.S. achieves two goals. The first is to digitize the registration of trusts for the purposes of filing U.K. tax returns in cases where trustees are required to pay U.K. income or capital gains tax. The second is to meet H.M.R.C.'s obligation under E.U. law to maintain a register of certain prescribed information by requiring the trustees of "taxable relevant trusts" to provide information on their settlors, beneficiaries, "power holders," and assets.

This information is, in some respects, significantly wider than the information that must be disclosed in other contexts (*e.g.*, C.R.S.) and arguably goes beyond what is required from the U.K. under E.U. law. The good news, however, is that – unlike the rules in other jurisdictions[1] – the Trust Register is not open to public inspections.

In addition to the Trust Register, the trustees of "relevant trusts" are obliged to maintain extensive internal written records relating to the trust's beneficial owners and potential beneficiaries. On request, this information must be shared with law enforcement authorities and other bodies that have anti-money laundering ("A.M.L.") client due diligence obligations.

On October 9, 2017, H.M.R.C. published guidance in the form of a series of FAQs, which sets out their interpretation of the relevant parts of the Regulations and explains how they intend the T.R.S. to work in practice. However, there were several areas of uncertainty and contradiction, and H.M.R.C. has had to engage in significant subsequent correspondence with interested professional bodies to clarify or amend their position (and amended FAQ's on December 6, 2017).

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1 *E.g.*, Germany. See, in detail, "The New Transparency Register in Germany," *Insights* 10 (2017).

KEY TERMS: WHICH TRUSTS DOES THIS AFFECT?

All relevant trusts fall within the new record keeping obligations introduced by the Regulations.

A "relevant trust" will include all U.K.-resident express trusts and any non-U.K.-resident express trust that has U.K.-source income arising at the trust level (*e.g.*, on assets held through a tax transparent entity for U.K. purposes) or that directly holds U.K. assets at the trust level.

An "express" trust is a trust established deliberately by a settlor. Consequently, it does not include a statutory trust, a resulting trust, or a constructive trust, each of which acknowledges a trust as a matter of law or equity, rather than intent. It also arguably does not include certain types of revocable trusts common in U.S. estate planning, which are more akin to bare trusts under English law, although each trust must be examined on its terms.

A trust will be U.K. resident if all the trustees are U.K. resident, or if there is at least one U.K. resident trustee and the settlor is resident or domiciled in the U.K. at any time when the funds are added to the trust. Trustees of non-U.K.-resident trusts should be aware of the potential for the trust to become inadvertently U.K. resident at the time assets are transferred to an existing trust.

A relevant trust is a "taxable relevant trust" in any year in which the trustees are liable to pay any of the following taxes on any U.K.-source income or directly held U.K. assets (referred to collectively as the "relevant taxes"):

- Income tax
- Capital gains tax
- Inheritance tax
- Stamp duty land tax ("S.D.L.T.," which is payable on purchases of U.K. real estate interests)
- Stamp duty reserve tax ("S.D.R.T.," which is a tax payable on purchases of U.K. securities made via a clearing house)
- Land and buildings transaction tax in Scotland

It is important to note that the U.K. tax liability must fall on the trustees directly and/or that taxable U.K. assets must be held directly. This means that the following scenarios will not create taxable relevant trusts:

- A trust that would have had a U.K. tax liability but for a relief (*e.g.*, hold-over relief on otherwise chargeable capital gains, business property relief from U.K. inheritance tax, or relief claimed under a double tax treaty)
- A trust that is taxable in respect of U.K. assets held through a non-U.K. holding company (including U.K. residential property held through a non-U.K. company) that is not "look-through" entity for U.K. tax purposes

- A circumstance in which a U.K. tax liability is attributed to someone other than the trustees (*e.g.*, a beneficiary under a life interest trust where income is mandated directly by the trustee to the life tenant so that the trustees do not receive the income in their bank account first and thus the trustees have no further U.K. tax liability for the year in relation to directly held assets)

- A trust that only has a liability to U.K. Value Added Tax ("V.A.T.") in any year (as this is not a relevant tax)

- A charitable trust – unless it has incurred a liability to pay any of the relevant taxes, which would normally only apply to a charity that owns a company engaged in business or that receives other non-exempt income (nevertheless, all relevant charitable trusts now have an obligation to keep written records in relation to the charity's beneficial owners)

- A bare trust

- A trust with a *de minimis* U.K. tax liability (less than £100 tax on bank or building society interest income)

"Non-U.K. trusts can fall inside or outside of the T.R.S. regime depending on when the relevant U.K. tax liability arises."

Non-U.K. trusts can fall inside or outside of the T.R.S. regime depending on when the relevant U.K. tax liability arises. For example, a non-U.K. trust that directly holds a non-income producing U.K. asset will only be a taxable relevant trust for a year in which an inheritance tax, decennial charge,[2] or exit charge[3] arises under the periodic charge regime – known as the "relevant property regime" – that applies to trusts for inheritance tax purposes. It will, however, still be a relevant trust for as long as it holds that asset and will have ongoing internal record keeping obligations.

Since the FAQs were first published, H.M.R.C. has confirmed that the holding of U.K. assets through a nominee would not prevent the trust from being a taxable relevant trust even though legal ownership of the assets is not direct, because the tax liability arising from the U.K. asset falls on the trustees directly.

Trustees should be particularly careful if they have made loans to any person in the U.K., as this could be a U.K. asset and, if interest bearing, produce U.K.-source income.

It seems that if a non-U.K. trust directly purchased U.K. shares it would be required to register using the T.R.S. even if the only foreseeable U.K. tax nexus for the trust is the S.D.R.T. payable on the transaction (which would normally be deducted automatically). Take, for example, a non-U.K. trust with no U.K.-resident beneficiaries and U.K. assets valued below the inheritance tax exempt nil rate band so that no inheritance tax liability arises under the relevant property regime. The trust would remain on the Register, but the information would not need to be updated unless, and until, another relevant U.K. tax charge arises for the trustees.

Importantly, this analysis should not apply where chargeable securities are purchased by a custodian because the liability then falls on the custodian as legal

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[2] Inheritance tax is charged at each ten-year anniversary of the trust on the net value of any relevant property in the trust on the day before that anniversary.

[3] Inheritance tax is charged up to a maximum of 6% on assets – such as money, land, or buildings – transferred out of a trust. This is known as an "exit charge" and applies to all transfers of relevant property.

purchaser (who would then recoup the liability through its fees) and the trustees would have no further reporting or payment obligations in relation to the purchase. We expect this to be confirmed by H.M.R.C. in due course.

RELEVANT DATES

As has always been the case, trustees must register to file U.K. tax returns the first time they have a U.K. income tax or capital gains tax liability. However, they are now required to use the T.R.S. rather than the old paper system. For non-U.K. trusts, this will normally only be the case if the trustees receive U.K.-source income and at least one beneficiary of the trust is resident in the U.K.

The registration deadline for self-assessment has not changed and falls six months after the end of the tax year in which the U.K. tax liability first arises (*e.g.*, for the tax year ended April 5, 2017, the deadline would normally be October 5, 2017). For this year only, the deadline has been extended to January 5, 2018, to allow all parties to get used to the new system (to which agents were only given access on October 17, 2017).

The deadline for populating the Trust Register with beneficial ownership information falls on January 31 following each year in which a relevant tax liability arises. The first relevant year is 2016/17, so the first deadline for providing the prescribed information would be January 31, 2018, but H.M.R.C. have extended the deadline to March 5, 2018, for this year only.

However, if a trust already registered for self-assessment with H.M.R.C. but has been wound up since April 6, 2017, it does not need to be included on the Register. A trust that was wound up since April 6, 2017, but was first liable to U.K. tax in 2016/17 must still register for self-assessment, but it seems it will not be required to populate the Trust Register if it does not exist on March 5, 2018.

By January 31 following the close of each tax year, taxable relevant trusts must update the Register with any changes or confirm that no changes occurred in the preceding year. However, changes can be made to the Register at any time, and in practice, trustees should ensure that their internal records are up to date at all times. Note that trusts that are not taxable relevant trusts for the year do not need to update the Register.

The relevant dates can be summarized as follows:

January 5, 2018	Deadline for trusts with a U.K. income tax or capital gains tax liability for the first time in 2016/17 to register for self-assessment using the T.R.S.
March 5, 2018	Deadline for all taxable relevant trusts with a relevant tax liability in 2016/17 to provide prescribed information on beneficial owners using the T.R.S.
October 5, 2018 (and later years)	Deadline for trusts with a U.K. income tax or capital gains tax liability for the first time in 2017/18 (and later years) to register for self-assessment using the T.R.S.

January 31, 2019 (and later years)	Deadline to notify H.M.R.C. of any changes (or confirm no changes) on the T.R.S. if the trust had a relevant tax liability in 2017/18 (and later years)

WHAT INFORMATION MUST TAXABLE RELEVANT TRUSTS PROVIDE ON THE TRUST REGISTER?

The full list of information required is beyond the scope of this article. Recently published FAQs have shed additional light on some of these categories.

One of the purposes of the T.R.S. is to identify the "beneficial owners" of taxable relevant trusts. These are considered to be

- the settlor(s),
- the trustees,
- the beneficiaries and potential beneficiaries, and
- any individual who has control over the trust, which could include a protector or anyone who has the power to change the trustees.

The first point to note is that information must be current and up to date, so if there are changes between now and the relevant registration or updating deadline, the outdated information can be disregarded (including where a trust has been wound up). For example, if a trustee or beneficiary is removed or added in the interim period, only the current trustees and beneficial class at the date of registration must be disclosed. When the Register is updated each year, any former beneficiaries and trustees will be removed from the record and will no longer appear on the Register.

IDENTIFYING BENEFICIARIES INDIVIDUALLY OR BY CLASS

This has perhaps been the most controversial area of the T.R.S. for trustees, as when first published, the H.M.R.C. guidance appeared to be wider than the disclosure obligations under other regimes, such as the C.R.S. The scope has since been narrowed by a change in approach by H.M.R.C.

The Regulations refer to "the beneficial owners of the trust and any other individual referred to as a potential beneficiary."

It is clear under the FAQs that any individual named in a trust deed or in a related document written by the settlor (*e.g.*, a letter of wishes) as a potential beneficiary must be disclosed, even if their prospects of actually benefitting are remote. However, if the settlor names a beneficiary subject to a contingency (*e.g.*, contingent on the deaths of all other named beneficiaries), that beneficiary need only be named if and when the contingency is fulfilled. H.M.R.C. have indicated that third-party reports of the settlor's wishes, such as a solicitor's attendance note, would not be considered as a "document written by the settlor" for these purposes.

Where there is a class of beneficiaries such as the settlor's descendants, the initial FAQs included seemingly contradictory examples. Does the requirement extend to identifying all individual members of a class who are in existence and providing information on each of them, or is it sufficient to describe the class and to identify only those individuals who have actually received a benefit? Since the publication of the FAQs, H.M.R.C. vacillated in their approach but have now confirmed their view that individual members of a discretionary class need only be disclosed if they actually receive a financial or non-financial benefit from the trust after June 26, 2016 – the commencement of the Regulations.

H.M.R.C.'s change in approach likely goes to the fact that their guidance, as initially published, went further than the Regulations require. It is stated in the Regulations that where the beneficial owners include "a class of beneficiaries, not all of whom has been determined" (emphasis added) then only a description of the class must be provided, and there is a specific carve-out from providing information on individual beneficiaries in these circumstances.

"Any individual named in a trust deed or in a related document written by the settlor (e.g., a letter of wishes) as a potential beneficiary must be disclosed."

This interpretation would also be in line with the wider guidance on concepts of beneficial ownership in similar A.M.L. contexts. For example, the recommendations published by the Financial Action Task Force in relation to beneficial ownership in the context of client due diligence suggest that it should be adequate for financial institutions to establish the identity of a beneficiary at the time of a pay-out or when the beneficiary intends to exercise vested rights. This would seem to be a proportionate obligation in light of the purpose of the Regulations to combat tax evasion and other forms of money laundering.

In this context, it is worth noting that personal data obtained by H.M.R.C. or any other relevant person for the purposes of the Regulations may only be processed for the purpose of preventing money laundering or terrorist financing. This supports the argument that the Regulations should be interpreted in a narrower sense.

DISCLOSURE OF TRUST ASSETS

The details of assets that have been added to the trust, including the addresses of any U.K. real estate, must be reported on the Register alongside a valuation of the assets when first contributed to the trust. This obligation extends to all added assets, not just those that have triggered a U.K. tax consequence, but does not extend to providing details of reinvested assets (unless otherwise reportable as triggering a U.K. tax liability).

It seems that H.M.R.C. are taking a pragmatic approach to valuation (as they did under the old regime) and will not expect formal valuations to be obtained. If a valuation has already been provided on first registration under the old regime, the exercise need not be repeated.

DETAILS OF ADVISERS

H.M.R.C. have clarified that the obligation to report the identity of "all advisers who are being paid to provide legal, financial, tax or other advice to the trustees" extends only to details of the agent (if any) who is notified to H.M.R.C. (under Form 64-8) as acting on the trustees' behalf in relation to these registration requirements.

RECORD KEEPING OBLIGATIONS

All relevant trusts are required to maintain accurate and up-to-date written records relating to the trust's beneficial owners and potential beneficiaries (reflecting the information required to be disclosed on the Trust Register), which they must share on request from law enforcement authorities and other bodies who have A.M.L. client due diligence obligations (*e.g.*, investment managers, law firms, and banks). Records are to be kept for five years from the final distribution and, in general, may be deleted thereafter. Anyone to whom this information is communicated in a business context must be notified of any changes within 14 days.

This means that all relevant trusts must maintain internal records even when they have no U.K. tax liability to report.

WHO CAN ACCESS THIS INFORMATION?

Under the Regulations, access may only be given to named law enforcement agencies in the U.K. and other E.E.A. countries through the National Crime Agency.

Some parties have expressed concern that "persons with a legitimate interest with respect to money laundering, terrorist financing . . . [etc.]" – N.G.O.'s or investigative journalists would be examples – could challenge the scope of the Regulations as this wording is included in the original E.U. Directive. Indeed, under the draft Fifth E.U. Money Laundering Directive currently being negotiated in the E.U. Parliament, the proposal is for all beneficial ownership registers to be made public.

This concern may be heightened in light of the recent "Paradise Papers" hack of 13.4 million documents from one of the leading firms in offshore finance, along with corporate registries in 19 tax jurisdictions. The papers reveal the financial dealings of politicians, celebrities, corporate giants, and business leaders. Journalists claim that investigation is in the public interest because such leaks and hacks from the offshore world repeatedly expose wrongdoing. Facilitating a global system of transparency and information exchange through such mechanisms as the T.R.S. and C.R.S. will likely be considered a way to tackle abusive offshore practices.

However, public demand for increased transparency should be balanced by domestic and European privacy and data protection rules. When a similar trust register was created in France, it was initially announced that this would be made public. However, public access to the information was held to be unconstitutional in a decision of the French Constitutional Court (Conseil Constitutionnel) on October 21, 2016. The court found that public access to the French trust register was a disproportionate breach of privacy rights for those individuals with trust arrangements. Consequently, the French government issued a new Ordinance, which transposes the E.U. Fourth Money Laundering Directive, limiting access to the French trust register to named law enforcement agencies.

It would seem unlikely that wider public access would be permissible under European data protection laws, especially once these are strengthened by the E.U. General Data Protection Regulation, which will be fully enforceable across the E.U. from May 2018.

PENALTIES FOR NONCOMPLIANCE

Trustees are expected to take “all reasonable effort and steps” to obtain and update the information requested and will be in compliance if they can show that they have acted in accordance with that standard. Record keeping will be all the more important in this context.

Both civil and criminal penalties may be imposed for noncompliance, including the imposition of “appropriate” financial penalties, public statements of censure, and up to two years of imprisonment. The details of these will be set out in the “near future,” but H.M.R.C. have noted in the guidance that any civil penalty imposed must be proportionate to the offence committed and that there will be a robust appeals process.

Enforcement of such penalties against non-U.K. trustees in other jurisdictions may bring practical difficulties, but most trustees will be more concerned about reputational issues resulting from non-compliance and their continued ability to interact with other financial institutions. However, trustees in non-E.U. jurisdictions with strict privacy laws must consider how to balance these conflicting obligations and may require specific domestic legislation allowing them to make disclosures in these circumstances.

WHAT SHOULD TRUSTEES BE DOING NOW?

Trustees should review their assets and income to determine whether trusts they administer are relevant trusts and whether it would be appropriate to put corporate blockers in place before a tax charge arises. Trustees who incurred a U.K. income or capital gains tax liability for the first time in 2016/17 have relatively little time to register before January 5, 2018, although beneficial ownership information is not due until March 5, 2018.

Information should, in any event, be collected now in relation to relevant trusts for which internal record keeping obligations are current and ongoing.

Trustees should also consider – in conjunction with settlors and beneficiaries as appropriate – whether the beneficial class wording in the trust or in written documents from the settlor is suitably drafted. It may be prudent to include only those who have a real prospect of benefitting from the trust in order to reduce the due diligence, reporting, and record keeping burden on the trustees.

AUSTRIAN GUIDANCE ON TAXATION OF BITCOIN AND OTHER CRYPTOCURRENCIES

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Tags
Austria
Bitcoin
Income Tax
V.A.T.
Virtual Currency

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Recently, the Ministry of Finance published guidance on the Austrian income and value added tax aspects of investing in the crypto space.

Given the recent roller-coaster rise and fall of the value of Bitcoins and other cryptocurrencies (such as Ethereum, Ripple, and Litecoin), and given the resulting interest of the mainstream media and the public at large, it is in principle good that the Ministry of Finance has summarized (and partly reiterated) its views on the tax consequences of investing in this new asset class.

Pursuant to the guidance, the following applies regarding income tax:

- For individuals holding cryptocurrencies as non-business assets, any gains (*e.g.*, upon the conversion of Bitcoin into euros) are tax-free if realized upon expiry of the one-year "speculation period" but are taxable if realized before that point in time (with a tax-exempt amount of €440 per annum applying).

- These rules also apply to the conversion of one cryptocurrency into another cryptocurrency (*e.g.*, conversion of Bitcoin into Litecoin). This is inconsistent, since it has long been held that the conversion of one foreign currency into another foreign currency (*e.g.*, conversion of U.S. dollars into pounds sterling) normally does not lead to a taxable event; only if the conversion gain is permanently secured (*e.g.*, by converting into euros or into a foreign currency that is tied to the euro) are gains realized for tax purposes and thus taxable. In the authors' view, the same should apply to conversions between cryptocurrencies. Apart from this legal argument, there is also a practical aspect to be considered: As every trader in cryptocurrencies knows, exchange rates on the various cryptocurrency exchanges are highly disparate (even more than normal forex rates) and it remains totally unclear which exchange rate is to be used for calculating the taxable gain.

- Where an investor purchases a specific cryptocurrency at different times and then sells a portion of his or her holdings from one wallet, the investor can freely determine which portion was sold, provided that he or she can fully document the acquisition dates and the acquisition costs of the individual purchases; otherwise, the F.I.F.O. (first in, first out) method is to apply when calculating the taxable income.

- The rules mentioned above (taxable within one year, tax-free after one year) shall not apply if cryptocurrencies are "rented out," with "interest" being earned *pro rata* temporis. In such a case, a later sale would lead to capital gains that qualify as investment income, which is taxable at a flat income tax rate of 27.5% (irrespective of the holding period). Yet again, this seems inconsistent: Interest is income from capital claims. Thus, only if one qualifies cryptocurrencies as capital claims (such as loans, bank deposits, and bonds) could

a gain from the sale of cryptocurrencies lead to investment income. Further, even if cryptocurrencies were to be qualified as capital claims, should such gains not be taxable at the flat income tax rate of 27.5% (but rather at the progressive income tax rate)?

- Further, the guidance states that income from the operation of cryptocurrency exchanges, from the operation of Bitcoin A.T.M.'s, and from the mining of cryptocurrencies will normally be considered as income from an active trade or business, which is taxable at the progressive income tax rate. While the authors would concur with the first two cases, a more nuanced conclusion is warranted in case of cryptocurrency "mining" (a term that unluckily evokes an association with large-scale heavy industrial operations, which probably led to this classification).
- What is missing in the guidance is an explanation of under which circumstances the trading of cryptocurrencies is to be considered as an active trade or business.
- What is also striking is that the Ministry of Finance does not deal with cryptoassets (such as Augur or Monaco). This seems to be an oversight, and we believe there should be no difference whether an investor sells Bitcoins or, for example, crypto-graphic tokens acquired in an initial coin offering ("I.C.O.").

Pursuant to the guidance, the following applies regarding value added tax:

- Following the E.C.J.'s case law,[1] the exchange of fiat currency into Bitcoins and vice versa is exempt from value added tax.
- Similarly, the mining of cryptocurrencies is not to be seen as a taxable service for lack of an identifiable recipient of the service.
- On the other hand, the supply of goods and services with Bitcoins used as consideration is to be treated in the same way as supplies of goods and services that are sold against fiat currency.

In summary, the guidance issued shows that trading with virtual assets can have real life tax consequences.

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[1] *Cf.* E.C.J. October 22, 2015, C-264/14 – *Hedqvist*.

TAX 101:
VIRTUAL CURRENCY – WHAT IS IT? AND HOW IS IT TAXED?

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Tags
Bitcoin
Cryptocurrency
Virtual Currency

INTRODUCTION

The use of virtual currency is on the rise, and investors and government agencies are taking notice. The recent surge and subsequent decline in the value of Bitcoin – which hit a record high exceeding $17,000 in early December[1] – is prompting worldwide legislative attention.[2] It has also caught the financial market's eye, with the first Bitcoin futures trading launched on December 10, 2017.[3] Adding to this frenzy is Venezuelan president Nicolas Maduro's announcement of the "petro," which, if launched, would be the first government-backed cryptocurrency, backed by Venezuela's oil and other natural resources.

The market's clear attraction to this alternative, decentralized currency-type asset comes despite criticism from high-profile personalities, such as JPMorgan's Jamie Dimon who recently referred to cryptocurrency as a fraud,[4] and scrutiny from law enforcement agencies. Cryptocurrency-based websites facilitating illicit commerce are highly targeted by worldwide law enforcement agencies. AlphaBay, the largest darknet market, was shut down on July 20, 2017, along with its competitor Hansa.[5] The operation required the cooperation of worldwide law enforcement agencies, including the F.B.I., the D.E.A., the Dutch Police, and Europol. It follows the 2013 crackdown on Silk Road, another Bitcoin-based website facilitating criminal activities.[6]

So, where does this lead? To understand the dynamics at play, this article begins with a brief explanation of Bitcoin before examining the U.S. tax treatment and reporting obligations of virtual currency holders.

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1 See Coindesk.

2 "Bitcoin: UK and EU Plan Crackdown Amid Crime and Tax Evasion Fears," *The Guardian*, December 4, 2017.

3 "Cboe Announces Bitcoin Futures to Start Trading Sunday," CNBC, December 4, 2017.

4 "JPMorgan CEO Jamie Dimon Says Bitcoin Is a 'Fraud' that Will Eventually Blow Up," CNBC, September 12, 2017.

5 Department of Justice, Office of Public Affairs, "AphaBay, the Largest Online 'Dark Market,' Shut Down," news release, July 20, 2017; Europol, "Massive Blow to Criminal Dark Web Activities After Globally Coordinated Operation," news release, July 20, 2017.

6 "Silk Road Shut Down and 'Owner' Ross William Ulbricht Arrested," *Coindesk*, October 2, 2013.

A BRIEF OVERVIEW OF BITCOIN

Bitcoin was created in 2008, allegedly by a person (or group) known as Satoshi Nakamoto.[7] The first Bitcoin was generated in early January 2009 and the first Bitcoin transaction took place later that month.[8]

Bitcoin was created to constitute a peer-to-peer, decentralized version of electronic cash.[9] It is a cryptocurrency, meaning a convertible virtual currency.[10] Think of it as a long code. This code is divided into several blocks. All the blocks together are referred to as a blockchain.

The various blocks are not created by one or more identifiable individuals, but rather by a worldwide network of individuals often referred to as "miners" or "nodes." The miners are essentially individual hosts that agree to implement and use the Bitcoin protocol.

This network of miners constitutes one of the particularities of Bitcoin: Instead of having a trusted central institution, such as a central bank, verify the validity of a given Bitcoin transaction, a widespread network of miners works together, or "mines," to verify the transaction. The incentive for the miners is their entitlement to a sort of "transaction fee."

If, for example, individual A holds six Bitcoins and wishes to transfer three Bitcoins to individual B, A would indicate his or her wish to transfer six Bitcoins and to get two Bitcoins back. The one Bitcoin difference would be a transaction fee paid to the miners, as an incentive for their work.

A good way to understand the underlying logic of Bitcoin and other cryptocurrencies is to start with our current banking system: When A wishes to wire X amount to B, A's bank will send the wire information to a central bank, which would then effectuate the transfer to B's bank to have the amount deposited into B's account. The central bank would retain records of the interbank transaction and make certain that no double-spending occurs.[11] In the Bitcoin system, no such central institution and record retention is needed. The decentralized mining system, coupled with the blockchain technology and good faith, makes it almost impossible to duplicate a given Bitcoin. The traditional record retention is embedded into the blockchain and, thus, is irreversible.

Another characteristic of Bitcoin is that it prevents double spending, whereas regular wire transfers of fiat currencies can be fraudulent.

Take, for example, the mobile payment service Venmo: If A wishes to wire X amount to B, and sends such amount to B via Venmo on date Y, B's Venmo account will

7 See History of Bitcoin. Also see "Bitcoin: A Peer-to-Peer Electronic Cash System," Satoshi Nakatomo Insititute, October 31, 2008.

8 Dates vary depending on the source. See, for instance, History of Bitcoin.

9 "Bitcoin: A Peer-to-Peer Electronic Cash System."

10 Treasury Inspector General for Tax Administration, "As the Use of Virtual Currencies in Taxable Transactions Becomes more Common, Additional Actions Are needed to Ensure Taxpayer Compliance," September 21, 2016, p. 1.

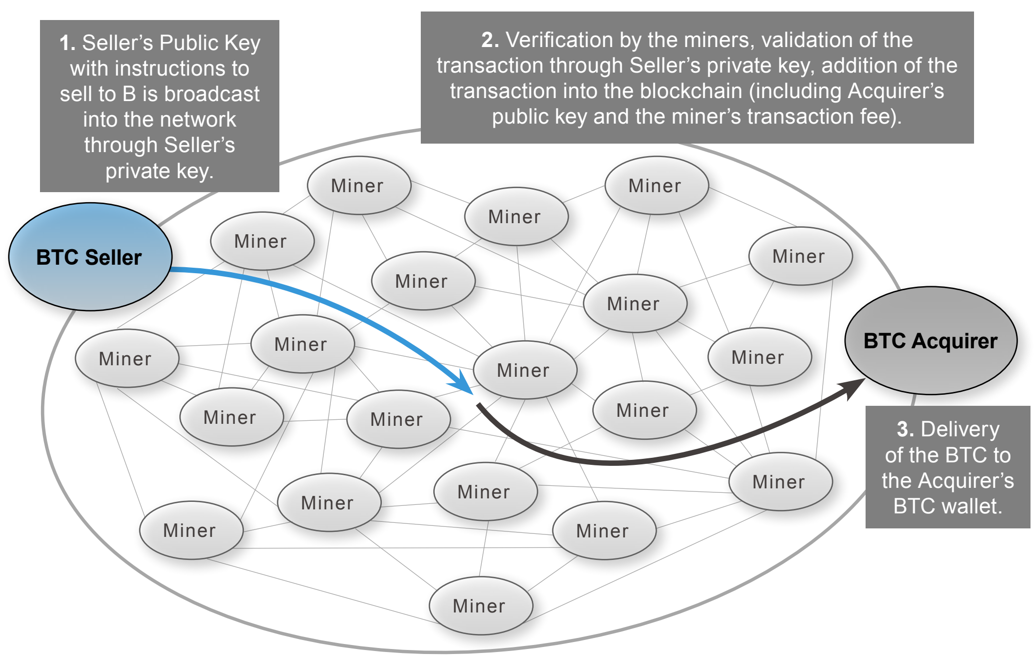
11 For a clear illustration, see the IMF staff discussion note "Virtual Currencies and Beyond: Initial Considerations," SDN/16/03, January 2016, p. 20.

indicate the payment as of date Y. However, A's actual bank account linked to A's Venmo account will only debit the funds on Y+1 or Y+2. This leaves A the time to withdraw the funds from A's account and B's receipt of X will be reversed. A simpler example would be counterfeit money.

As stated earlier, in the case of Bitcoin, the transaction chain constituting the cryptocurrency, and essentially created by the miners, is unique and not reversible. In the example, this transaction chain records all transactions up to and including A's transfer to B. It will include A's virtual identity ("public key") and B's public key. This public key is simply a chain of numbers and constitutes the owner's virtual identity. The transfer can only be completed once the miners verify the transaction and once A uses his or her "private key," which is unique and specific to every Bitcoin user.

A third characteristic of the Bitcoin system is the anonymity it provides to Bitcoin owners. Every Bitcoin owner is identified through a public key. The public key is broadcast into the network of miners when a Bitcoin owner wishes to enter into a transaction. Only when the transaction is coupled with the Bitcoin owner's private key can the transaction be verified by the miners. A private key is essentially the equivalent of the owner's signature to the transaction.

The Bitcoin system can be explained by the following diagram:



In comparison to other virtual currencies, the Bitcoin system is designed to generate a maximum of 21 million Bitcoins. It is currently estimated that this number will be reached by 2140.[12] Further, Bitcoin allows for fractional ownership, with the smallest fraction being 0.00000001 Bitcoin (or 1/100,000,000 of one Bitcoin), referred to as a Satoshi.[13]

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12 "Controlled Supply," Bitcoinwiki.

13 "Denominations," Bitcoin.org.

I.R.S. GUIDANCE ON CONVERTIBLE VIRTUAL CURRENCY

On March 25, 2014, the I.R.S. issued Notice 2014-21 providing guidance on convertible virtual currency transactions. The notice was drafted in Q&A format and applied existing general tax principles to convertible virtual currency transactions.

In the notice, the I.R.S. acknowledges the rising use of virtual currencies as an investment or to pay for goods or services. It defines "virtual currency" in the following terms:

> . . . a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like 'real' currency — *i.e.*, the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance — but it does not have legal tender status in any jurisdiction.

The notice further defines "convertible virtual currency" as a virtual currency having an equivalent value in real currency or acting as a substitute for real currency. It cites Bitcoin as an example.

The notice only applies to convertible virtual currencies and provides the following Federal tax treatment for U.S. persons and their foreign subsidiaries:

- Convertible virtual currency is considered property.
- Convertible virtual currency is not treated as currency for foreign currency gain or loss purposes (*i.e.*, a transfer to a branch will not trigger currency gain or loss).
- Convertible virtual currency received as payment for goods or services must be included in the recipient's gross income at its U.S. dollar fair market value as of the date of receipt. (It also triggers gain or loss for the purchaser, as discussed below.) This fair market value constitutes the recipient's basis in the convertible virtual currency.
- The notice does not provide an exact rule for determining the real market value of the convertible virtual currency. Rather, it states that if the currency is listed on an exchange; such exchange rate can be used "in a reasonable manner that is consistently applied."
- A taxpayer must recognize gain or loss upon an exchange of convertible virtual currency for property. The gain or loss is the difference between the received property's fair market value and the taxpayer's adjusted basis in the convertible virtual currency. No indication is given as to how to determine the taxpayer's adjusted basis in the currency, other than a reference to Publication 544, *Sales and Other Dispositions of Assets*, which in itself does not address virtual currency. The gain or loss is capital in nature if the currency constitutes a capital assets in the hands of the taxpayer, and ordinary if it doesn't. As examples of capital assets, the notice cites "stocks, bonds, and other investment property" as "generally" constituting capital assets.

Inventory and other property held for the sale to customers generally do not constitute capital assets. Again, the notice references to Publication 544 for more information.

- Miners must include convertible virtual currency received for their mining activities in their gross income. The notice refers to Publication 525, *Taxable and Nontaxable Income*, for more information on taxable income. Although referring to virtual currency as taxable income, this publication does so only in the context of employee compensation.

- A taxpayer engaged in the trade or business of "mining" convertible virtual currency in a capacity other than as an employee, is subject to the self-employment tax on the net earnings derived from this mining activity. The notice refers to Publication 334, *Tax Guide for Small Business*, and Publications 535, *Business Expenses*. Here again, none of these publications make a reference to virtual currency.

"A common misconception is that capital gains and losses need only be reported when the virtual currency is converted back into fiat currency."

- Also subject to self-employment tax is convertible virtual currency received by an independent contractor for performing services. Here again, it is the fair market value of the virtual currency measured in U.S. dollars as of the date of receipt that constitutes self-employment income.

- Employment taxes must be withheld from the fair market value of convertible virtual currency paid as compensation to an employee, and the employee's W-2 must reflect such payment and withholdings. A reference is made to Publication 15, *(Circular E) Employer's Tax Guide*, but the publication itself does not address wages paid by means of virtual currency. Because the I.R.S. does not accept virtual currency as a payment medium, an employer must indicate gross wages based on the fair market value in U.S. dollars on each payment date, then deduct the amount of withholdings measured in dollars from the payment and pay the withheld amounts to the I.R.S. using U.S. dollars. The amount withheld is converted back into virtual currency and subtracted to arrive at the net amount due to the employee expressed in terms of the virtual currency used. These computations would be tracked by computer to determine the net basis for the virtual currency on hand.

- Virtual currency payments are subject to the same reporting obligations as any other payment made in property. They are also subject to the same backup withholdings as other payments made in property. As a result, the payor must solicit the payee's taxpayer identification number ("T.I.N.").

- Virtual currency payments to an independent contractor in excess of $600 must be reported to the I.R.S. on Form 1099-MISC.

Besides the basic character of the above guidance and the already mentioned practical issues relating to employment taxes, the myriad of computations based on fluctuating amounts present many issues, which include the following:

- How is gain or loss determined when property is acquired in exchange for virtual currency or vice versa? Imagine the acquisition of a small item, such as a Starbucks coffee using the IPayYou app. Should this transaction be recorded on Form 8949, *Sales and Other Disposition of Capital Assets?*

- How is the virtual currency's basis determined in the hands of the taxpayer?

Because of its high value, an acquisition of property in exchange for Bitcoins is likely to result in property acquired for less than one Bitcoin. In theory, the taxpayer would then be required to (i) find out the Bitcoin-U.S. dollar exchange rate applicable as of the date of the Bitcoin acquisition, (ii) retain the amount of Satoshis used to purchase the property, (iii) determine the basis of these Satoshis by reference to the basis of the initial Bitcoin, and (iv) compute the gain or loss realized on the exchange. This issue gets even more complicated when the Satoshis were acquired through various smaller U.S. dollar for Bitcoin exchanges and several Satoshis acquired at different times were used to acquire the property. Although the basis and holding period determination rules of Treas. Reg. §1.1012-1 expressly applies to the determination of basis and holding period of stock, can the underlying logic apply to Bitcoin? Should the "first in, first out" method of Treas. Reg. §1.1012-1 be applied to virtual currency, or rather the actual delivery rule of Treas. Reg. §1.1012-1 (c)(2)?

- How is convertible virtual currency treated for F.A.T.C.A. purposes, and more specifically for Form 8938, *Statement of Foreign Financial Assets, purposes?* Since convertible virtual currency is treated as property pursuant to the notice and the only income for U.S. Federal tax purposes is the sale of that virtual currency, it could be considered "property not giving rise to income" and, hence, a Subpart F item under Code §954(c)(1)(B)(iii) for a U.S. shareholder of a controlled foreign corporation. Or, it could be excluded from this definition if it were to be considered intangible property under Code §936(h)(3)(B).[14] Better yet, as at least one author suggested,[15] convertible virtual currency could constitute a commodity and thus be included in the definition of Subpart F income under Code §954(c)(1)(C). Such an inclusion would then have substantial U.S. tax consequences when the income is generated by a controlled foreign corporation or a passive foreign investment company.

In addition, as a result of the I.R.S. notice, individual taxpayers with virtual currency accounts must report their virtual currency capital gains or losses on Form 8949, *Sales and Other Dispositions of Capital Assets*, attached to Schedule D, *Capital Gains and Losses*, of Form 1040, *U.S. Individual Income Tax Return*. A common misconception is that capital gains and losses need only be reported when the virtual currency is converted back into fiat currency. In reality, taxpayers exchanging virtual currency for other virtual currency are entering into a taxable transaction upon every exchange. Basis tracking is thus of essence. Absent further guidance on this point, the safest way to keep track of cryptocurrency basis is to keep the confirmation emails summarizing the type of cryptocurrency bought, the acquisition date, and the applicable exchange rate on such date.

FINCEN APPROACH TO VIRTUAL CURRENCY

On the Institutional Side

The Bank Secrecy Act ("B.S.A.") was enacted to help prevent money laundering, by creating a number of registration, reporting, and recordkeeping obligations for

[14] Treas. Reg. §1.954-2(e)(3)(iv).

[15] Jim Calvin, "Adequately Identifying Bitcoin Dispositions for Federal Income Tax Purposes," BNA 58 Tax Management Memorandum 363, September 4, 2017.

financial institutions and money service businesses ("M.S.B."), the definition of which includes money transmitters.

On March 18, 2013, the Treasury Financial Crimes Enforcement Network ("FinCEN") issued interpretative guidance to clarify the application of the B.S.A. regulations to persons creating, obtaining, distributing, exchanging, or transmitting virtual currencies.[16] The guidance refers to such persons as users, exchangers, or administrators. It applies only to convertible virtual currency, which it defines as:

> A medium of exchange that operates like a currency in some environments, but does not have all the attributes of real currency. In particular, virtual currency does not have legal tender status in any jurisdiction. . . . [Convertible] virtual currency either has an equivalent value in real currency, or acts as a substitute for real currency.

Pursuant to the guidance, users are not money transmitters. However, administrators and exchangers may be money transmitters. For this purpose, the following definitions apply:

- A user is a person obtaining virtual currency to purchase goods or services. This includes a person mining the virtual currency or a person purchasing the virtual currency.[17]
- An exchanger is a person engaged in the business of exchanging virtual currency for real currency, funds, or other virtual currency.
- An administrator is a person engaged in the business of issuing a virtual currency and having the authority to redeem such virtual currency (*i.e.*, withdraw such currency from circulation).

Under the guidance, an exchanger or administrator generally is a money transmitter when such person

- accepts and transmits a convertible virtual currency, or
- buys or sells convertible virtual currency for any reason.

When applied to decentralized virtual currencies, such as Bitcoin, a person acquires money transmitter status and thus is subject to B.S.A. reporting and record retention obligations in the following cases:

- The person creates convertible virtual currency and sells it to another person for real currency or its equivalent.
- The person accepts decentralized convertible virtual currency from one person and transmits it to another person as part of the acceptance and transfer of currency, funds, or other value that substitutes for currency.

Elaborating on the above, FinCEN issued guidance FIN-2014-R001 on January 30, 2014. Pursuant to this guidance, FinCEN stated:

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16 "Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies," FIN-2013-G001, March 18, 2013.

17 Notice 2014-21; *supra* note 7.

> What is material to the conclusion that a person is not an MSB is not the mechanism by which a person obtains the convertible virtual currency, but what the person uses the convertible virtual currency for, and for whose benefit.

It concluded that a company mining Bitcoins is a user and not a money transmitter if the company either

- uses the Bitcoins to purchase goods and services or pay debts it has previously incurred (including debts to its owners),
- converts the Bitcoins into currency of legal tender and uses the currency to purchase goods or services, or
- transfers the Bitcoin to the owner of the company.

“Thus, U.S. taxpayers otherwise meeting the F.B.A.R. requirements and having accounts with non-U.S. cryptocurrency exchanges . . . should disclose such accounts on their F.B.A.R.’s.”

This is provided that all the above are performed exclusively for the user’s own purposes and not as a business service performed for the benefit of others.

In guidance FIN-2014-R002, also issued on January 30, 2014, FinCEN took the same position with regard to a company that periodically invests in convertible virtual currency and that produces and distributes software to facilitate such purchases for purposes of its own investments. To the extent the company’s activities are performed for its own account, it acts as a user and not as a money transmitter.

Finally, in two guidances issued on October 27, 2014,[18] FinCEN stated that the following are money transmitters for B.S.A. purposes:

- A company setting up a convertible virtual currency payment system
- A company setting up a convertible virtual currency trading and booking platform

As a result of the above guidance, cryptocurrency-related businesses qualifying as money transmitters, and thus as M.S.B.’s, and conducting such business wholly or in substantial part within the U.S.[19] must register within 180 days of beginning operations and must renew their registration every two years.[20] In the case of M.S.B.’s located outside the U.S., the appointment of a U.S.-resident agent is mandatory.[21] In addition, they must also develop, implement, and maintain a written anti-money laundering program in order to avoid being a channel for money laundering or for the financing of terrorist activities.[22]

The above guidance is not to be taken lightly: Following the January 17, 2017, indictment of BTC-e – one of the world’s largest and most widely used digital currency exchanges – and its owner Alexander Vinnik,[23] FinCEN assessed a $110,003,314

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18 FIN-2014-R011; FIN-2014-R012.

19 31 C.F.R. §1010.100(ff).

20 31 U.S.C. §5330; 31 C.F.R. §1022.380(b)(2).

21 31 U.S.C. §5330; 31 C.F.R. §1022.380(a)(2).

22 31 U.S.C. §§5318(a)(2), (h); 31 C.F.R. §1022.210(a).

23 U.S. v. BTC-e a/k/a/ Canton Business Corporation and Alexander Vinnik, CR 16-00227 SI (N.D. CA. January 17, 2017).

willful penalty on BTC-e and a $12,000,000 willful penalty on Mr. Vinnik.[24]

On the Taxpayer Side

A U.S. person is generally required to file FinCEN Report 114 ("F.B.A.R.") if it has a financial interest in or signature authority over a bank, securities, or other financial account in a foreign country when the aggregate value of the foreign financial account(s) exceeds $10,000 at any given time during the reporting year. While no guidance has been issued yet, certain authors have argued that based on *U.S. v. Hom*[25] accounts holding virtual currencies may be subject to F.B.A.R. reporting obligations if all requirements are otherwise met.

In *Hom*, however, the taxpayer was involved in online gambling. For this purpose, he had opened three online accounts allowing him to use funds for online gambling purposes. His FirePay account was used to receive funds from his bank account and fund his online gambling accounts at PokerStars and PartyPoker. FirePay was an online financial organization that received, held, and paid funds on behalf of its customers. The U.S. District Court for the Northern District of California held that all three accounts were subject to F.B.A.R. reporting.

In reaching its decision, the court examined whether the four criteria for filing an F.B.A.R. were met:

- **U.S. Person**: The defendant was a U.S. citizen and thus the requirement was met.
- **Interest in a Bank, Securities, or Other Financial Account**: The court found that all three accounts were financial accounts because they were held by institutions that functioned as commercial banks.
- **Financial Account Is in a Foreign Country**: The financial institutions holding the account were outside the U.S. Therefore, the accounts were foreign, regardless of whether the foreign institution held the account owner's funds in U.S. accounts.
- **$10,000 Threshold**: This threshold was met in the facts under consideration.

The U.S. Court of Appeals for the Ninth Circuit upheld this decision only with regard to the FirePay account. In reaching its decision, the court stated, *inter alia*, that:

> Hom's FirePay account fits within the definition of a financial institution for purposes of FBAR filing requirements because FirePay is a money transmitter. . . .
>
> In contrast, Hom's PokerStars and PartyPoker accounts do not fall within the definition of a 'bank, securities, or other financial account.' PartyPoker and PokerStars primarily facilitate online gambling. Hom could carry a balance on his PokerStars account, and indeed he needed a certain balance in order to 'sit' down to a poker game.

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[24] U.S. Department of the Treasurey Financial Crimes Enforcement Network, in the Matter of BTC-e a/k/a/ Canton Business Corporation and Alexander Vinnik, Number 2017-03, July 26, 2017.

[25] *U.S. v. Hom*, 113 AFTR 2d 2014-2325 (N.D. Cal. June 4, 2014), aff'd, rev'd and rem'd, 118 AFTR 2d 2016-5222 (U.S. Court of Appeals, 9th Circuit), July 26, 2016.

> But the funds were used to play poker and there is no evidence that PokerStars served any other financial purpose for Hom. Hom's PartyPoker account functioned in essentially same manner.

As a result of the above, a U.S. person should have F.B.A.R. reporting obligations with regard to convertible virtual currency when that person holds (i) a convertible virtual currency account, with (ii) a non-U.S. (iii) exchanger or administrator that is (iv) a money transmitter under the BSA guidance, and (v) the value of all the person's accounts, whether in virtual or fiat currency, exceeds the $10,000 threshold in a given year.

Thus, U.S. taxpayers otherwise meeting the F.B.A.R. requirements and having accounts with non-U.S. cryptocurrency exchanges – such as, but not limited to, Binance,[26] Bitstamp,[27] Quoine,[28] and Bitfinex[29] – should disclose such accounts on their F.B.A.R.'s.

ONGOING EFFORTS

In the U.S.

U.S. authorities are continuously working to adapt the current legal framework to virtual currency.

- On September 21, 2016, the Treasury Inspector General for Tax Administration ("T.I.G.T.A.") issued a report recognizing the surge of virtual currencies in taxable transactions and the need for additional actions relating to taxpayer compliance.[30] In it, and pursuant to public comments on Notice 2014-21, T.I.G.T.A. identified three primary areas for which the public requested additional information:[31]

  - Keeping track of transactions associated with virtual currencies when they are used as property (including the appropriate valuation method)
  - Keeping track of the cost and payments related to mining Bitcoins
  - Determining how to ensure tax compliance of transactions involving virtual currencies

  It further recommended a revision of third-party information reporting documents to identify the amounts of virtual currency used in taxable transactions.[32] Adoption of its recommendations could lead to the end of anonymity

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26 Binance is a Shanghai-based digital asset exchange.

27 Bitstamp is based in Slovenia. It is not clear whether the exchange also has U.K. and U.S. presence.

28 Quoine is based in Singapore.

29 Bitfines is based in Taiwan (Republic of China).

30 T.I.G.T.A., "As the Use of Virtual Currencies in Table Transactions Becomes More Common, Additional Actions are Needed to Ensure Taxpayer Compliance," 2016-30-083, September 21, 2016.

31 *Id.*, p. 10.

32 *Id.*, p. 16.

for virtual currency holders.

- At a September 15, 2017, meeting of the Tax Section of the American Bar Association, I.R.S. Chief of Criminal Investigation Don Fort announced five areas of focus that included were virtual currencies and cryptocurrencies.[33] Mr. Fort described certain I.R.S. Criminal Investigation agents as the world's experts in this field.

- Proposed legislation was introduced in the House of Representatives that would prevent taxpayers from recognizing income when making virtual currency exchanges of less than $600. The bill, called the Cryptocurrency Tax Fairness Act, was introduced by Representative Jared Polis (D-CO) and Representative David Schweikert (R-AZ), who also spearheaded the formation of the Congressional Blockchain Caucus on February 1, 2017.

- The I.R.S. is focusing on individual taxpayers trading in virtual currency. On November 28, 2017, a U.S. District Court partially granted the government's petition to enforce an I.R.S. summons served on Coinbase, Inc., a U.S.-based virtual currency exchange.[34] Pursuant to the court order:

> Coinbase is ORDERED to produce the following documents for accounts with at least the equivalent of $20,000 in any one transaction type (buy, sell, send, or receive) in any one year during the 2013 to 2015 period:
>
> (1) the taxpayer ID number,
>
> (2) name,
>
> (3) birth date,
>
> (3) address,
>
> (4) records of account activity including transaction logs or other records identifying the date, amount, and type of transaction (purchase/sale/exchange), the post transaction balance, and the names of counterparties to the transaction, and
>
> (5) all periodic statements of account or invoices (or the equivalent).

Worldwide Examples

The European Union is currently working to regulate cryptocurrencies by applying anti-money laundering rules to cryptocurrency exchanges.[35]

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33 Alison Bennett, "New IRS Criminal Investigation Chief: Five Areas of Focus," *Daily Tax Report*, September 18, 2017.

34 *U.S. v. Coinbase, Inc.*, et al., Case no. 17-cv-01431-JSC, 11/28/2017.

35 Proposal for a Directive of the European Parliament and of the Council Amending Directive (EU) 2015/849 on the Prevention of the Use of the Financial System for the Purposes of Money Laundering or Terrorist Financing and Amending Directive 2009/101/EC; "In Boon for Bitcoin, UK to Regulate Digital Currency Exchanges," *Rueters*, March 18, 2015.

Japan has gone so far as to amended its laws to allow virtual currencies as a legal form of payment,[36] while other countries, such as Austria,[37] have published guidance on the tax treatment of cryptocurrencies.

CONCLUSION

While cryptocurrencies are undeniably booming, authorities worldwide are making efforts to regulate them. The anonymity provided by virtual currencies, such as Bitcoin, may be short lived given worldwide efforts to regulate them and subject their owners to reporting requirements. The ultimate aim is reach the correct balance between facilitating the legitimate use of virtual currency and preventing criminal activities enabled by its features.

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36 "Japan: A Forward Thinking Bitcoin Nation," *Forbes*, November 2, 2017.

37 See "Austrian Guidance on Taxation of Bitcoin and Other Cryptocurrencies," *Insights* 12 (2017).

THE NEW TRANSPARENCY REGISTER IN GERMANY

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Tags
Germany
Information Disclosure
Reporting Requirements
Transparency

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As of October 1, 2017, corporate entities (*i.e.*, companies and partnerships), other private law corporations (*i.e.*, private law foundations, co-ops, and associations), and trusts are required to report their beneficial owners to the newly-established German transparency register. The reports should have already been filed electronically.[1] The transparency register will be open to inspection from December 27, 2017.

With amendments to the German Anti-Money Laundering Act ("*Geldwäschegesetz*," hereinafter referred to as "GwG") the German Parliament has implemented the Fourth E.U. Anti-Money Laundering Directive, which directs all Member States to establish a national transparency register.[2] The purpose of this directive and the associated registers is to identify the beneficial owners of legal entities in order to prevent money laundering, in general, and terrorist financing, in particular.

FULFILLMENT OF REPORTING OBLIGATIONS

Legal representatives of legal entities and partnerships, trustees, and custodians are required to report beneficial owners or ownership to the transparency register.[3] The same applies for incorporated foundations, including charitable and private benefit foundations, each represented by their boards. Accordingly, practically all legal entities and partnerships, except for partnerships under the German Civil Code, are affected. However, the registration obligation does not apply to stock corporations that are listed on an organized (not an open) market.

Subsequent changes in ownership must be addressed and reported as well. The reporting party is required to review the completeness and correctness of all reported information at least once per year, and beneficial owners are required to provide reporting legal entities and partnerships with any relevant information.[4]

THE BENEFICIAL OWNER

For the purposes of the transparency register, beneficial owners are always and

1 Via this website.

2 Directive (E.U.) 2015/849 of the European Parliament and of the Council of May 20, 2015 on the prevention of the use of of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (E.U.) No. 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/E.C. of the European Parliament and of the Council and Commission Directive 2006/70/E.C.

3 Sec. 20 Para. 1 and Sec. 21 Para. 1 and 2 GwG.

4 Sec. 20 Para. 3 GwG.

exclusively individuals. In the case of a corporate entity, each individual who ultimately owns or controls more than 25% of the shares or votes, or exercises similar control, is considered a beneficial owner.[5] If a corporate entity has no beneficial owner that meets the aforementioned criteria, the legal representative, managing director, or partner will be recorded in the transparency register as the beneficial owner.

In the case of a fiduciary entity or trust, a beneficial owner is each individual that acts as a custodian of a fiduciary entity, or is appointed as a trustee or protector of a foreign trust. The same applies to beneficiaries of trusts and individuals who can control distributions of profits or exercise control over investment or administrative decisions. Trustees of dependent foundations must fulfill these reporting requirements only insofar as they administer private benefit foundations.

Concerning incorporated foundations, individual members of the foundation's board are always beneficial owners. There are no constraints with regard to possible control and influence of a single board member. Therefore, all board members must be reported. Settlors of foundations, however, should not automatically be treated as beneficial owners. In contrast to prior drafts, the final GwG amendments do not include settlors as beneficial owners.

Any beneficiary or group of beneficiaries of the foundation and any individual who can control distributions of profits or exercise control over investment or administrative decisions qualifies as a beneficial owner. At least in the case of charitable foundations or family foundations, it is in question which persons belong to the circle of (potential) beneficiaries and for whom reporting obligations have to be met.

INFORMATION SUBJECT TO NOTIFICATION

The following information needs to be reported for every beneficial owner:

- First name and surname
- Date of birth
- Place of residence
- Nature and extent of the economic interest (including the percentage of shares and voting rights)

German-resident trustees must also report the citizenship of the beneficial owners of the trusts they manage.

EXEMPTION FROM REPORTING

The reporting duties are deemed to be fulfilled if the respective information has already been published in the German commercial register or certain other public sources (*e.g.*, association register, register of cooperatives, etc.).

Hence, corporations with individuals as sole shareholders are not required to register due to the compulsory filing of the shareholder list with the commercial register.

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[5] Sec. 19 para. 2 GwG read in conjunction with Sec. 3 Para. 2 GwG.

In contrast, in the case of foundations, the German state registers of foundations are not considered to be sufficient, as they do not contain the complete information required.

INSPECTION OF ENTRIES

Relevant authorities are allowed to inspect the entries. The transparency register is open to public access only if a legitimate interest can be demonstrated. If the beneficial owner wishes to limit access to personal information, he or she must file a request showing that the interests worthy of protection prevail over the interests of access to the register. This requirement might be satisfied, for example, if the beneficial owners are minors.

CONCLUSION

If they have not done so already, legal representatives and beneficial owners should carefully assess their reporting duties as soon as possible, taking into consideration the specific circumstances of each case. If the required information has already been reported, it should be monitored for any changes, which then must be reported. Non-compliance with the reporting duties is a misdemeanor and administrative fines of up to €1,000,000 may be imposed.

BRAZIL 2017: TAX DEVELOPMENTS FOR BUSINESS TRANSACTIONS

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Brazil
B.E.P.S.
Digital Economy
Software
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INTRODUCTION

The year 2017 saw many important developments in Brazil regarding cross-border and intrastate business. This article focuses on three areas: B.E.P.S., categorization of software transactions to expand withholding tax exposure, and intrastate transactions.

BRAZIL AND THE B.E.P.S. ACTION PLAN

On May 29, 2017, Brazil formally requested entry to the O.E.C.D. Since 1994, Brazil has actively cooperated with the O.E.C.D., and it has been a key O.E.C.D. partner since May 2007 via an "enhanced engagement" program. Brazil already participates in 31 O.E.C.D. legal instruments, including the B.E.P.S. Action Plan, having signed the Declaration on B.E.P.S. in May 2013.

Brazilian tax legislation has evolved in the past few years in a way that often converges with international standards. This can be seen in the way Brazil has implemented most, but not all, B.E.P.S. actions and objectives.

B.E.P.S. Action 1: Addressing the Tax Challenges of the Digital Economy

No concrete measures were adopted. Nevertheless, Brazil has taken independent steps to address the way the digital economy is taxed, particularly with regard to B.E.P.S.

B.E.P.S. Action 3: Designing Effective Controlled Foreign Company ("C.F.C.") Rules

In November 2013, the Brazilian government published a provisional law that introduced new rules regarding the taxation of profits earned by branches and controlled or affiliate companies overseas.[1] The Brazilian provisions on profits earned overseas have broader reach than international standards, addressing all types of income earned by an foreign controlled or affiliate company.

B.E.P.S. Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

Brazil has introduced rules on thin capitalization[2] intended to prevent Brazilian companies from being funded by excessive debt held by related parties abroad. If the related lender is located in a country that is not a tax haven or is not subject to a

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1 Provisional Measure 627, later converted into Law 12,973/2014.

2 Law 12,973/2014.

privileged tax regime, the debt-to-equity ratio cannot exceed 2:1. If the lender is located in a tax haven or is subject to a privileged tax regime, the related-party debt cannot exceed 30% of the equity (*i.e.*, a 0.3:1 debt-to-equity ratio).

B.E.P.S. Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

B.E.P.S. Action 5 was implemented through two regulations issued by the Brazilian Federal Revenue Service:

- Normative Instruction 1658/2016 updates the list of tax havens and countries with privileged tax regimes, initially established under Normative Instruction 1037/2010, and introduces the concept of "substantive economic activities" for holdings in foreign subsidiaries.
- Normative Instruction 1689/2017 establishes procedures regarding the exchange of information between countries with which Brazil has in effect tax information exchange agreements covering matters such as transfer pricing and permanent establishments ("P.E.'s").

The Brazilian Federal Revenue Service system relies on the Public Digital Bookkeeping System ("SPED") and other systems to obtain information on taxpayers:

- SPED allows for a thorough online exchange of information between the Federal Revenue Service and taxpayers, providing great transparency and oversight.
- State and municipal authorities also have similar systems that allow local tax authorities to have access to the billing systems of businesses.
- Within Brazil, there are mechanisms allowing for a broad exchange of information involving the registration of vehicles, deeds, and service providers.
- Oversight of financial transactions is carried out on a regular basis by banking and tax authorities.
- Normative Instruction 1634/2016 sets forth the obligation to identify the beneficial ownership of companies.

This data is available to tax authorities in partner jurisdictions.

B.E.P.S. Action 7: Preventing the Artificial Avoidance of P.E. Status

So far, Brazil has not indicated that it intends to adopt Action 7 regarding the taxation of business profits. Questions regarding the P.E. concept are common among foreign companies interested in doing business in Brazil. Despite the absence of a formal P.E. concept in Brazil, several income tax rules[3] broadly reflect internationally accepted P.E. principles:

- Actual or *de facto* branches of foreign companies are regarded as legal entities for Brazilian tax purposes.[4] The existence of an independent division that trades or renders services on a regular basis through employees and

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[3] *E.g.*, Decree 3000/1999.

[4] Article 147 II.

“The Brazilian tax authorities have little experience with P.E. issues. As a result, the imposition of Brazilian tax on foreign companies without formal branches is rare.”

local management can result in the existence of a *de facto* branch that is subject to taxation in Brazil even if a formal branch is not registered.

- *Commissionaire* arrangements can result in branch taxation for the foreign principal. The law defines a *commissionaire* as a company or individual, holding independent status with regard to the principal, that acts in its own name but for the account of a principal when selling goods. The *commissionaire* is responsible for calculating the profits of the foreign principal that supplies the goods and collecting tax under the rules applicable to branches of foreign companies.[5]

- Agents resident in Brazil concluding direct sales in Brazil for foreign companies must compute profits and collect tax on behalf of principals. This rule does not apply when the agent is an independent party or a mere intermediary acting under a grant of authority that is limited to obtaining purchase offers that are forwarded to the principal. The law defines an agent as a person that represents another party in return for a fee. When an agent is involved in a sale, the agent does not conclude contracts in its own name.

  As is apparent, the Brazilian rule for independent agents is not dissimilar to the rule in the O.E.C.D. model. The agent must not have and regularly exercise the power to bind a foreign principal. Thus, an agent is not a P.E. of its principal when acting independently, without powers to bind the foreign principal, and without a pattern of activity in which it executes agreements on a regular basis.[6]

In practice, the Brazilian tax authorities have little experience with P.E. issues. As a result, the imposition of Brazilian tax on foreign companies without formal branches is rare. Even when an entity is characterized as a P.E., the Brazilian tax system may mandate taxation but does not provide the means for paying the tax. Moreover, the risk of P.E. characterization is extremely low for service providers because Brazil imposes very high withholding taxes on payments for the import of services. Tax authorities express greater interest in collecting withholding tax from payments to foreign service providers than in collecting net tax from the profits of an unofficial Brazilian branch. Even in the context of a P.E. and an applicable income tax treaty, Brazilian tax authorities tend to focus on collecting withholding tax when Brazilian enterprises pay service fees to Brazilian offices of foreign businesses.

B.E.P.S. Action 8, 9 and 10: Aligning Transfer Pricing Outcomes with Value Creation

If approved, Brazil’s membership in the O.E.C.D. could have a significant impact on the Brazilian transfer pricing rules in a few years. Brazil chose to adopt, as of 1997,[7] transfer pricing rules inspired by the O.E.C.D. Transfer Pricing Guidelines but mostly based on objective criteria. Although the application of these criteria is relatively straightforward, more often than not the result is not necessarily an arm’s length price, due to the use of predetermined profit margins (which can amount to 40% for certain activities).

5 Article 398.

6 Articles 399 and 539.

7 Law 9430/1996.

B.E.P.S. Action 12: Mandatory Disclosure Rules

No concrete action has been taken. Nevertheless, in 2015, the executive branch attempted to pass a bill to address mandatory disclosure of aggressive tax planning.[8] However, the Brazilian Congress vetoed significant portions of the legislation thereby eviscerating the proposal.

B.E.P.S. Action 13: Transfer Pricing Documentation and Country-By-Country Reporting

Country-by-Country reporting has been adopted.[9] However, legislation has not been enacted mandating the submission of master files and local files.

B.E.P.S. Action 14: Making Dispute Resolution Mechanisms More Effective

Procedures authorizing Brazilian participation in Mutual Agreement Procedures ("M.A.P.'s") related to Brazilian income tax treaties.[10] Brazil has in effect income tax treaties with the following countries:

- Argentina
- Austria
- Belgium
- Canada
- Chile
- China
- Czech Republic
- Denmark
- Ecuador
- Finland
- France
- Hungary
- India
- Israel
- Italy
- Japan
- Luxembourg
- Mexico
- Norway
- Netherlands
- Peru
- Portugal
- Philippines
- Russia
- Slovakia
- South Africa
- South Korea
- Spain
- Sweden
- Trinidad and Tobago
- Turkey
- Ukraine
- Venezuela

As can be seen from the list, Brazil does not have a comprehensive income tax treaty with the U.S. in effect.

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[8] Provisional Measure 685/2015.

[9] Normative Instruction 1681/2016.

[10] Normative Instruction 1669/2016.

B.E.P.S. Action 15: Multilateral Convention to Implement Tax Treaty Related Measures to Prevent B.E.P.S.

No concrete steps have been adopted. The tax authorities have stated that Brazil may opt to renegotiate each treaty bilaterally.

Final Note on B.E.P.S.

Overall, Brazil has been a pioneer in championing B.E.P.S. objectives, especially regarding the actions towards fiscal transparency and exchange of information. Although some actions and formalities have not yet been implemented, most have been addressed by Brazilian legislation. Once Brazil becomes a full member of the O.E.C.D., further implementation of the B.E.P.S. Action Plan is expected.

BRAZILIAN VIEW ON SOFTWARE TRANSACTIONS

In recent months, the General Tax Coordination ("C.O.S.I.T.") has issued several tax rulings regarding cross-border and domestic transactions involving software. Tax policy in this area is quite controversial due to the different levels of Federal units interested in collecting taxes (municipalities, States, and the Federal Union). Policy has not kept up with new technologies and developments in high-tech solutions offered in the market. As a result, rules are inconsistent and surprises are prevalent.

Payment for Off-the-Shelf Software

One example of inconsistent treatment relates to a previously resolved issue involving the taxation of standard software imports.[11] In the past, tax authorities understood that remittances made abroad for the licensing of standard software involving off-the-shelf products was not subject to Brazilian withholding income tax ("W.H.T."). This understanding was in line with Federal Supreme Court ("S.T.F.") case law, which established a rule treating a payment for standard software as the purchase of a product. As a result, the payment is not considered to be a royalty. Standard software is defined as multiple copies manufactured on a large scale, in a uniform manner, and intended for use by an undetermined number of users.[12] If standard software were considered as a product, its import would not subject to W.H.T., even if delivery is effected by download from the internet.

In its ruling,[13] C.O.S.I.T. reached the following conclusions:

- The licensing of the right to *sell and distribute* software, which is usually transacted between Brazilian distributors and foreign companies, differs from the licensing for the right to *use* the software. The latter is generally applicable to transactions between Brazilian distributors and end consumers.
- For cases involving licensing to sell and distribute software, the S.T.F. case law mentioned above is not applicable, as this precedent only refers to cases of licensing for the right to use the software. Thus, the characterization of standard software would be irrelevant to the commercial/distribution relationship between the Brazilian distributor and the foreign company.

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[11] C.O.S.I.T. Conflict Resolution Ruling 18/2017.

[12] Extraordinary Appeal 176.626-3.

[13] Conflict Resolution Ruling 18/2017.

- Payments made abroad by Brazilian companies for the right to sell the software fall under the concept of royalties, which are subject to (i) 15% W.H.T. (increased to 25% if the recipient is based in a tax haven) and (ii) 10% Contribution for the Intervention in the Economic Domain ("C.I.D.E.") in the context of a technology transfer. In a technology transfer, the source code of the software is provided, and the acquirer of the license is able to modify the program. The C.O.S.I.T. ruling stated that C.I.D.E. is not levied if a technology transfer does not occur.

As a result of the C.O.S.I.T. ruling, all taxpayers face greater tax exposure because the ruling is binding on all Federal tax authorities. Taxpayers caught by the ruling must be prepared to pursue review at administrative and judicial levels.

The position expressed in the C.O.S.I.T. ruling – that the payment has the character of a royalty – is applied to other Federal taxes, as discussed below. However, licensing of off-the-shelf software for local end users remains unaffected by the C.O.S.I.T. ruling.[14]

Software as a Service

In terms of new technologies, C.O.S.I.T has addressed the tax treatment of remittances made abroad for the provision of "Software as a Service" or "SaaS"[15] in a ruling involving a Brazilian company engaged in the sale, maintenance, and development of data processing systems.

In the ruling, a Brazilian company made payments to a foreign company for password authorization to access and use two different SaaS packages. One package was a utilities package protecting against computer viruses and spam. The other package was a virtual platform enabling database access and participation in conference calls, meetings, and training sessions. The Brazilian company subsequently provided access and authorization to Brazilian users.

In the ruling, C.O.S.I.T. concluded that the license to use a SaaS should be regarded as the provision of a technical service that was subject to W.H.T. and C.I.D.E. The rationale for the conclusion is as follows:

- The user did not acquire any software and did not have the software installed on its hardware. Rather, it paid periodic fees for access to the utilities package that was hosted in the cloud at an unknown location or locations.
- The Brazilian company was not allowed to modify the program's characteristics. Rather, the foreign company retained exclusive responsibility for management and maintenance of the software and provision of helpdesk services.
- The Brazilian company paid for access to a service, not for use and control of intangible property.
- The agreement between the Brazilian company and the foreign company provided that the payments were compensation for rendering a package of services.

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14 C.O.S.I.T. Ruling Request 303/2017.

15 C.O.S.I.T. Ruling Request 191/2017.

In sum, C.O.S.I.T. applied rules for the performance of technical services. Under Brazilian tax law, a broad definition is given to technical services, which is quite different from the concept adopted by most other countries. Once categorized as a service, remittances abroad were subject to the general 15% W.H.T. and 10% C.I.D.E. C.I.D.E. is a Federal tax levied (i) on the payment, credit, delivery, use, or remittance of amounts abroad related to a technology transfer (including licensing of patents and/or trademarks and technical assistance agreements and excluding software licensing, as long as the source code is not transferred) and (ii) on a payment abroad related to technical, administrative, and similar services, as well as any royalty payments. The taxpayer is the Brazilian legal entity.

Other taxes typically levied on imports of technical services were not analyzed by C.O.S.I.T. in the ruling.

Domestic Transactions Regarding Software

Imposto de Renda sobre Pessoa Jurídica ("I.R.P.J.") is the corporate income tax in Brazil. *Contribuição Social sobre o Lucro Líquido* ("C.S.L.L.") is one of the social insurance taxes that fund Brazilian social security. Brazilian legal entities may use the actual profit system or the deemed profit system to calculate the tax base for both taxes. The actual profit system computes the tax base by reference to actual results. In comparison, the deemed profit system computes the tax base by reference to percentages of the company's gross revenues. The percentage varies depending on the company's business activity.

To illustrate, the percentage applicable to the sale of merchandise is 8% for I.R.P.J. and 12% for C.S.L.L. For services, the percentage is 32% for both taxes. The taxable base is made up of deemed business profits using the applicable percentage, non-business actual income, and capital gains.

Under the deemed profit system, the sale of standard software can be treated as either a sale of a product or the provision of services. If only minimal modifications or adjustments are made to standard software, the activity is categorized as a sale of merchandise. On the other hand, if standard software is significantly altered and modified, the activity is categorized as a service.

The *Contribuição para os Programas de Integração Social e de Formulação do Patrimônio do Servidor Público* ("P.I.S.") and the *Contribuição Social para o Financiamento da Seguridade Social* ("C.O.F.I.N.S.") are taxes based on the turnover of companies. The P.I.S. is intended to finance the Brazilian unemployment insurance system and C.O.F.I.N.S. is used to fund social security. Next to I.R.P.J., C.O.F.I.N.S. raises the most revenue for Brazil.

With reference to domestic transactions, C.O.S.I.T. ruled on withholding obligations for I.R.P.J., C.S.L.L., and P.I.S./C.O.F.I.N.S. in the context of payments for professional services.

- In one ruling, the issue was whether certain activities should be regarded as professional services that are subject to taxation.[16] The ruling addressed three separate activities. The first was the sale of standard software and updates. The second was the sale of a permanent use or temporary use license related to general and nonexclusive software. The third was the performance of maintenance and technical support regarding the software.

16 C.O.S.I.T. Ruling 230/17.

C.O.S.I.T. ruled that the first two items were not considered to be services for purposes of I.R.P.J., C.S.L.L., and P.I.S./C.O.F.I.N.S. On the other hand, the provision of maintenance and of technical support services was considered to be the performance of services. Consequently, payments made for the performance of maintenance and support activities were subject to C.S.L.L. and P.I.S./C.O.F.I.N.S.

- In another C.O.S.I.T. ruling, the performance of technical services focused on maintenance activities for the proper functioning of a computer program. The ruling concluded that the revenue must be characterized as arising from the provision of services, even if the activity is not expressly covered in the agreement.[17]
- In a third C.O.S.I.T. ruling, the resale of permanent and temporary licenses of standard software through download was categorized as the sale of merchandise by a Brazilian company for purposes of the Special Tax Regime for Small Businesses.[18] This ruling is consistent with case law in Brazil.
- Finally, C.O.S.I.T. ruled that partial or total updates on standard software acquired through physical support or through download is properly categorized as a sale of merchandise for the purposes of the levy of Social Security Contributions on Gross Revenues.[19]

“Courts have been asked to decide which level of São Paulo’s government is competent to impose tax on transactions with software related to download and cloud computing.”

<u>State V.A.T. (“I.C.M.S.”)</u>

Another important topic relates to State V.A.T. (“I.C.M.S.”), where software is potentially subject to taxes on services and on products. To illustrate, the State of São Paulo, for example, recently ruled that I.C.M.S. is levied on transactions with non-customized or tailor-made software involving electronic transfers of data, regardless of whether it is by means of download or through cloud computing.[20] However, this levy is currently suspended. At the same time, the city of São Paulo ruled that a Municipal Tax on Services (“I.S.S.”) should be levied on the download of any kind of software, standard or customized, when the transaction involves electronic data transfer.[21]

Courts have been asked to decide which level of São Paulo’s government is competent to impose tax on transactions with software related to download and cloud computing. Is it a service or the sale of a product? It is possible that each level of government has the authority to categorize the transaction as it wishes (in which case the answer will be that both have competency to impose and collect the tax)?

RECENT CHANGES IN STATE BENEFITS RELATED TO I.C.M.S.

Supplementary Law 160/2017 was recently enacted to address a tax war between the Brazilian states. The Brazilian Constitution establishes that a supplementary

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17 C.O.S.I.T. Ruling 235/2017.

18 C.O.S.I.T. Ruling 231/2017.

19 C.O.S.I.T. Ruling 18/2017.

20 Normative Decision CAT 4/2017.

21 *Id.*

law should define how I.C.M.S. incentives would be granted – Brazil has 26 states, plus a Federal district, with competence to collect this state tax. In the Brazilian legal system, a supplementary law implements a provision set forth in the Constitution and must be approved by a two-thirds majority in both legislative houses, the Senate and the House of Representatives. Thus, the Brazilian Constitution should be seen to establish the policy, and the supplementary law addresses the details.

Supplementary Law 24/1975 established that all tax exemptions, benefits, remissions, amnesties, and tax or financial incentives should be approved by the National Council of Tax Policy ("C.O.N.F.A.Z."), composed of the 27 state treasury secretaries and the finance minister, who represents the Federal government. The quorum for a C.O.N.F.A.Z. meeting is the presence of a majority of C.O.N.F.A.Z. members. All decisions regarding the grant of a tax benefit require a unanimous vote. C.O.N.F.A.Z. decisions authorizing states to grant benefits are formalized by means of a covenant that must be ratified by the respective state's legislative branch.

In spite of a provision stating that benefits granted without the detailed approval process are null and void – meaning the tax remains due and payable, notwithstanding the act of a state – many states have ignored this rule when granting tax incentives. As a result, other states have begun to deny credits where a transaction benefitted from a tax incentive that was not approved by C.O.N.F.A.Z. In addition, several S.T.F. rulings have determined that unilaterally granted state tax benefits are unconstitutional.

Supplementary Law 160/2017 was passed to overcome the uncertainty around established. Its main provisions are as follows:

- States should list all the normative acts granting tax benefits and register them with C.O.N.F.A.Z.
- By means of a covenant executed by C.O.N.F.A.Z.,[22] the states and the Federal district can reinstitute tax credits related to unilaterally granted tax benefits.
- The approval of the covenant will require a quorum made up of two thirds of the states and consisting of at least one third of each region of the five regions of Brazil.
- Approval should occur by the beginning of February 2018.
- After that target date, the term of each incentive may be extended by the governors for up to 15 years for most economic activities, with reduced timelines of eight, five, three, and one year for other activities listed in the covenant.
- It is also possible for governors to grant incentives to other taxpayers located in their states, extending existing incentives under the same terms.
- A state may enact the same tax benefits granted by other states of the same Brazilian region.
- These rules have retroactive effect forbidding states from collecting past tax credits related to tax benefits.

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[22] Supplementary Law 24/1975.

- The granting of other tax benefits that are not consistent with Supplementary Law 24/1975 will subject the states to penalties provided under the Fiscal Responsibility Law, such as the prohibition on receiving voluntary transfers, as well as credit restrictions.

Once the covenant is approved, past tax liabilities connected to the lawfulness of the benefits will be settled. Although discrepancies between state tax incentives will continue for up to 15 years, companies can be sure that past situations will not trigger tax assessment notices drawn up by different states.

CONCLUSION

The year 2017 can be categorized as a typical year in Brazil. The country took steps to adopt internationally accepted norms regarding cross-border taxation. At the same time, taxpayers continued to encounter inconsistently applied tax rules and bureaucratic conflicts.

AN AMERICAN IN LONDON: DUE DILIGENCE OBSERVATIONS

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Tags
Due Diligence
M&A
United Kingdom

INTRODUCTION

U.S. business owners and professionals performing due diligence on potential merger or acquisition candidates are all too familiar with the trials and tribulations of arriving at a fair valuation for the acquirer. They often stress over the quality of the target's financial information, potential hidden liabilities, financing, and the like. Now, imagine that the due diligence exercise is occurring outside of the U.S. because the target is based abroad. Adding to the stress is a different culture as well as different finance and legal terminology, laws, and accounting principles. How is one to manage?

The silver lining, in my experience, is that when the due diligence involves a non-listed (*i.e.*, privately-held) U.K. company, financial information is much more accessible than it is in the U.S. One can purchase information on a possible target and see the reported operating results, ownership group, and directors. The information is provided in a required government format, as will be discussed. However, this does not guarantee that the information is accurate. Normal due diligence skepticism still applies.

This article will provide information on some sources of information, forms of financing, and director responsibilities that are typical in the U.K. This is not a "how to" on M&A due diligence, but rather an overview of the types of financial information, financing, and other business practices relevant to acquiring a privately-held company. It is based on the author's experience garnered from several due diligence exercises in the U.K. for potential acquirers based in the U.S.

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FINANCIAL INFORMATION

In the U.S., we are accustomed to receiving various forms of financial statements in accordance with Generally Accepted Accounting Principles ("G.A.A.P."). In the U.K., there are also Generally Accepted Accounting Principles. However, they are known as U.K. G.A.A.P. Financial statements are often prepared in accordance with these principles. In addition, financial statements may also be prepared pursuant to International Financial Reporting Standards ("I.F.R.S."). The latter is usually reserved for listed (*i.e.*, publicly-traded) companies.

In the U.K., public and private companies are governed by the Companies Act 2006 (the "Act") as amended. The Act sets forth the requirements for operating public and private corporations and limited companies, including director responsibilities and reporting requirements to Companies House, the keeper of all financial statements. Generally, non-listed companies are required to report their financial information within nine[1] months after the fiscal year-end, listed companies within six months.[2] Penalties are assessed for lateness and may indicate financial or operating issues to be cognizant of during the due diligence process.

Now that we have context, the financial information must be acquired from Companies House. The information can be accessed by following this link. Here, one can access free information, select documents, or subscribe to the Companies House information service. Personally, I commence my due diligence with a request for the financial statements.

> ***"Too often we tend to put more credibility in audited financial statements than other levels of financial statement preparation such as internal management reports or tax returns."***

Contained in the financial statements are statements and exhibits we, in the U.S., are unaccustomed to seeing for non-public companies. One such exhibit is the section on "Company Information." Company Information contains a listing of the company's directors, registered number (the equivalent of an E.I.N. in the U.S.), registered office business address, auditor, and bankers, if any.

I use this information to begin some of my preliminary due diligence. I call business associates and colleagues to see what I may uncover in casual conversation based on knowing the players. I also conduct internet searches to determine lawsuits, sanctions, or other adverse actions taken against the company or its directors, as well as the professionals retained by the company.

While on the topic of financial and accounting data, I want to emphasize the importance of skepticism when evaluating the data. Too often we tend to put more credibility in audited financial statements than other levels of financial statement preparation such as internal management reports or tax returns. On more than one occasion, my due diligence has uncovered questionable accounting principles. These questionable principles were not developed to facilitate the transaction but rather were used and adopted over years.

As one banker friend once said to me, "I don't understand G.A.A.P., but I know if the business cash flows." This tactic is important when conducting due diligence in the U.K. Americans will not know all of the U.K. G.A.A.P. differences, but we can develop cash flow models proving or disproving the operating results. After all, it is all about business.

BANKING

Banking in the U.K. is vastly different from banking in the U.S., both in process and diversity of product – some better and some worse. For this reason, it is useful to understand the more common forms of bank financing one will encounter in the U.K. In my experience, the most common forms are bank sales financing, overdraft facility, trade financing, and bank guarantees.

Bank Sales Financing ("B.S.F.")

B.S.F. is asset-based financing. Similar to the practice in the U.S., B.S.F. can be secured by accounts receivable ("debtor accounts") or inventory ("stock"). The advance rate will be similar to what we are accustomed to seeing in the U.S. – 80% of eligible accounts receivable. Incorporated into the agreement will also be ineligible

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1 "Filing Accounts," GOV.UK, last updated July 25, 2017.

2 *Id.*

accounts (*e.g.*, cross-aged receivables greater than 90 days old, concentrations, or accounts receivable with right of offset). Accounts receivable with right of offset occurs frequently when the business sells to a vendor. The bank is very concerned with not realizing 100% of its collateral in the event of a bankruptcy ("receivership"). The bank therefore limits its exposure through additional advance rate restrictions, perhaps 50% or less for accounts with rights of offset. The disadvantage of this financing vehicle is that the company is limited to the accounts receivable at a given point in time. This means if the business is seasonal, there will be insufficient working capital for the business, and the business may need Trade Financing, discussed below.

Finally, the reporting is more cumbersome than in the U.S. Monies received from customers are immediately swept against the outstanding balance. From my experience, the finance team of the target company must be competent and on the ball with their reporting or this facility will prove to be problematic.

Overdraft Facility

An overdraft facility is known as a line of credit in the U.S. It operates in much the same manner. However, in my experience, banks in the U.K. do not extend this type of financing to privately-held companies, least of all U.K. companies owned by a U.S. entity or individual. There are ways around it, if one is willing to post a Letter of Credit. However, the bank may still refuse overdraft facility in lieu of lending using a B.S.F. secured by a Letter of Credit.

Trade Financing

Trade financing, commonly referred to as import/export financing, enables the business to finance its inventory, thereby overcoming seasonality as it relates to product. The bank will typically request a list of the company's suppliers. If the bank is not comfortable with a supplier, it will not fund the P.O. The terms are typically 120 days from the date of shipment. Upon presentation of appropriate shipping documents, the payment is made to the supplier. Problems do arise when the customers do not pay timely or when there are delays in shipments to customers. In my experience, the bank is usually willing to extend the date of repayment.

Bank Guarantee

A bank guarantee is exactly what it implies. It can be used as a performance bond to ensure the company performs as intended under a contract. It is also used for the Value Added Tax ("V.A.T.") Duty Deferment Scheme when goods are imported to the U.K. It is given to Her Majesty's Revenue and Customs ("H.M.R.C.") – the U.K. equivalent of the I.R.S. – to ensure the company can meet the cost of all duty and V.A.T.

Other

Some other terms to be aware of as you go through the due diligence process are "bank support" and "comfort letter." Bank support is a euphemism for work out. This will require more work on the business's part and more monitoring by the bank. If you hear the words "business support," I would not hold out hope that the bank will assign the financing to a new owner. With that said, the bank may be interested in working with the new owner and request a comfort letter that states the foreign owner in the U.S. company will provide resources in support of the U.K. entity. The resources expected will be cash. The bank will present this as a non-binding document, but legal advice I have obtained in the U.K. has always cautioned against signing the comfort letter.

EMPLOYMENT

Perhaps more than any other area of due diligence, U.K. employment norms are difficult for Americans to comprehend.

In the U.S., we are accustomed to employment at will – a concept in employment law whereby an employer can dismiss an employee for any reason without warning. This concept does not exist in the U.K.

Generally, only senior executives have employment agreements in the U.S. This is not true in the U.K. In the U.K., all employees have employment ("service") agreements, which set forth hours of work, vacation time ("holiday"), benefits, grounds for termination, and payment once terminated. It is important to review these agreements carefully, especially for senior executives of the target company.

In my experience, employees in the U.K. can be terminated ("made redundant"). However, one must follow the procedures established in the employment agreement. For example, I was involved in the termination of a senior financial professional. The terms of her employment agreement were such that she was entitled to six months' pay after termination (referred to in the U.K. as "Garden Leave"). For a period of time, this company was paying terminated employees a nice sum while, in some cases, also employing their replacements.

A by-product of having an employment agreement is that U.K. employees take their responsibilities very seriously. They will generally work the hours required in their agreements but not longer, or at least not on a consistent long-term basis, as is common in the U.S.

The mistake many Americans make is to presume that the target company's workforce will abide by American standards – working on weekends, working for more than eight hours daily, limiting vacation time to two weeks. I have unsuccessfully tried to impart this aspect of American work culture. It does not work.

During your due diligence, you must begin to think through which employees you will keep, the cost involved for terminating the others, and how you intend to manage them from 3,000 miles away. A sure-fire way to encourage significant turnover is to have an American present in the U.K. from the onset or to insist on American work habits. If that is the intent of the acquirer, let me save you time, money, and aggravation. Pass up the opportunity. This is the one area that cannot be overcome with money alone. There must be a plan and cultural sensitivity. Even with such a plan, it will not go smoothly and a great deal of patience will be required.

OFFICE LEASES

Office leases in the U.K. operate in a similar fashion to those in the U.S. There is one major difference: the concept of "dilapidations." As many an attorney can attest, dilapidations constitute the disrepair for which a tenant is liable upon vacating the premises (*e.g.*, repairs, redecoration, and reinstatement of alterations). In other words, the tenant must leave the premises as it was provided.

Obtain the target company's leases and review the language. In the U.K., it is unlikely that a lease does not contain language as to dilapidations. Financial Reporting Standard 12 ("F.R.S. 12") and International Accounting Standard 37 ("I.A.S. 37") set forth the requirements to accrue the amount. If you have company with audited financial statements, the financial statements should provide for a dilapidations reserve, which will be described in the footnote under "Provisions for Liabilities." This will indicate the amount included in the financial statements but not the actual total liability, as the accrual usually occurs ratably over the life of the lease. Read the lease agreement carefully and speak with experts. The last thing an advisor or business owner wants to see is a lease expiring in the near term costing the business hundreds of thousands of pounds sterling for the privilege of leaving the premises.

DIRECTOR RESPONSIBILITIES

It may seem odd to include director responsibilities in a document on due diligence. However, this is a serious consideration as it bestows rights, obligations, and liability on an individual.

Prior to becoming a director of a privately-held U.K. company, I had the usual American view when it came to the housekeeping for a corporation. How many of you or your clients maintain corporate minutes, meeting agendas, resolutions, and the like? Most in the U.S. first give consideration of the requirements when the company is put up for sale or when bank financing requires up-to-date resolutions, minutes, etc.

A private company director in the U.K. is expected to follow the rules of the articles of association, keep company records, report changes, and file the company's accounts and tax return. The responsibility is greater, more along the lines of a director of a publicly-held company in the U.S., as can be seen in the following examples.

Example 1

> A director has responsibility if a company overtrades. This occurs where a company requires more resources either in people, working capital, or other circumstances than is available and the company runs the risk of not meeting its obligations. Most people would consider start-ups at risk, but in my experience, most privately-held companies in the U.K. are thinly capitalized. If this is the case, one will hear terms such as "trading within our means."

Example 2

> Another area where a director can be held responsible is with regard to health and safety. Health and safety deals with anything involving the people who work for the company. Examples of health and safety concerns include electrical cords not being properly adhered to the floor causing a danger for falls, employees speeding in company cars, or multiple tickets for speeding received by employees. If there is a serious accident and the company cannot demonstrate that it sent the employee to driver training, the director can be held responsible.

Arguably, these are items where the executives and directors can be held liable in the U.S., as well. But can a director in the U.S. be held criminally responsible? In the U.K., a director most certainly can.

For the reasons mentioned above, it is imperative to determine who will be a director post-closing. It will also be imperative that the entity will be appropriately managed to ensure the various laws and responsibilities are carried out properly to reduce exposure for the individuals involved. As a director, I travel, phone, and review internal financial information to ensure I am carrying out my fiduciary responsibility. In addition, there is an agenda for each board meeting. A standing item on the agenda is health and safety.

"Those that prove successful take the cultural differences seriously and are sensitive and respectful of those differences."

MORE THOUGHTS ON FINANCIAL INFORMATION

As I have covered, U.K. directors have responsibility and liability for their companies. Consequently, the attitude towards financial reporting is more sensitive when it comes to overtrading and profitability. There is a desire to ensure the company is profitable, and accounting principles are often used to achieve this end, especially if there is bank financing involved. Therefore, be wary of significant prepaid assets, or even fixed assets, for that matter.

In the course of a manufacturing company due diligence, I found designs capitalized. I am not referring to molds. I am referring to wages capitalized for designing patterns on the basis the patterns would be reused. As I analyzed the data and recast the capitalized assets as expenses, the company went from marginally profitable to significantly unprofitable. In another due diligence, I was presented with various refinancings of debt through government programs. The U.K. has some interesting programs for small and midsize enterprises ("S.M.E.'s"). However, in this case, the programs were used to mask cash flow problems and kick the repayment problem down the road. Potential buyers beware.

FINAL OBSERVATIONS

The information presented can be considered a quick start as to finding documents, overcoming terminology, and understanding financing.

As professionals, we get too caught up in the data. Keep in mind that the items making due diligence in the U.K. more difficult are not only the regulations and banking, but also the cultural differences. The cultural differences are huge. Do not be surprised if you tell a British manager to stay out of an area and she actually steps aside. Also do not be surprised if this same manager has a solution but does not proactively come forth with it.

Having worked for many years with colleagues in the U.K., there is a saying I have heard time and again: "The Americans have landed." It is not flattering, but meant to imply we are here to save the day and know what to do to save it. Indeed, we have arrived, and bringing this cultural awareness with us is important. After all, the due diligence is being conducted to acquire and/or merge the U.K. operation into the U.S. operations of the acquirer. Significant dollars and effort have been expended, and the difference between success and failure is a simple understanding of what makes us different.

I do not have any empirical data to support the following assertion, only anecdotal evidence in speaking with friends and colleagues who have worked for U.K. companies post-acquisition by American companies. Those that prove successful take the cultural differences seriously and are sensitive and respectful of those differences. Those that are not sensitive and respectful of the cultural differences can expect to waste years trying to get the business to run smoothly and profitably. Remember what George Bernard Shaw said in 1910: “England and America are two countries separated by a common language.” In my experience, what was true then is even more true now.

DOUBLE DUTCH: DIVIDEND TAX REFORM EXTENDS EXEMPTION, YET TACKLES ABUSE

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INTRODUCTION

In the Netherlands, the third Tuesday of September is known as Princes' Day (*Prinsjesdag*). This event clearly has two sides: Traditionally, it is the annual occasion for the Dutch to show their loyalty to the monarchy (and for the ruling family of Orange to show its royalty to the people in return). Politically, it marks the opening of the new parliamentary year, with the presentation of the budget proposals for the next year. In this regard, it is the Dutch equivalent of the U.K.'s Budget Day.

In line with this double-sided character, this year's budget contains a proposed dividend tax reform that has two sides as well. First, the legislative proposal provides for a significant extension of the existing exemption from withholding tax by introducing a unilateral exemption applicable to corporate shareholders based in treaty countries, such as the U.S. At the same time, it tightens the current system by bringing cooperatives used as holding vehicles within the scope of the dividend withholding tax rules and making the new exemption subject to stringent anti-abuse rules.

These new rules are scheduled to enter into force as per January 1, 2018. When effective, the Dutch government aims to reinforce the position of the Netherlands as the jurisdiction of choice for setting up holding companies that function within business structures with genuine economic activities. In taking these steps, the Dutch government must heed the calls coming from Paris, where the O.E.C.D. is rolling out its B.E.P.S. Action Plan, and Brussels, where the European Commission continues to pursue E.U. Member States that grant illegal State Aid. Together, they bode ill for structures set up primarily for tax reasons. As will be discussed in this article, the proposed legislation attempts to forge an attractive holding company tax system without creating harmful tax regimes. Finding the right balance will require a deft touch by the Dutch government.

EXTENSION OF DIVIDEND AND GAIN EXEMPTIONS

Historically, the Dutch dividend withholding tax regime provides for exemptions in certain domestic situations. Where one Dutch company owns at least 5% of the nominal share capital of another Dutch company, the shareholder is eligible, in principle, for benefits granted under the Dutch participation exemption. The exemption applies to dividends received from a 5% or greater subsidiary. Where the exemption is applicable to the shareholder, a subsidiary distributing a dividend is not required to withhold tax.

Upon implementation of the Parent Subsidiary Directive ("P.S.D.") back in the early 1990's, a similar exemption was introduced for corporate shareholders based in E.U. Member States. Even though the P.S.D. contains a higher threshold for exemption, based on case law from the European Court of Justice, the qualifying ownership percentage for exemption in intra-E.U./E.E.A. situations may not exceed the domestic threshold.

The proposed legislation extends the scope of the existing exemption for corporate shareholders based within the E.U./E.E.A. to any jurisdiction that has concluded a tax treaty with the Netherlands containing a clause governing taxation of dividends. Consequently, a tax information exchange agreement ("T.I.E.A.") that merely provides for exchange of tax information is not covered by the proposed legislation. The contents of the applicable dividend clause are not relevant. The new unilateral exemption will apply where the treaty provides for a reduction of the statutory domestic withholding rate.

"The proposed legislation extends the scope of the existing exemption or corporate shareholders . . . to any jurisdiction that has concluded a tax treaty with the Netherlands containing a clause governing taxation of dividends."

As an example, the unilateral exemption will apply to qualifying Canadian-resident companies under the Netherlands-Canada Income Tax Treaty even though the treaty provides only for a reduced withholding tax rate of 5%. Similarly, the unilateral exemption will apply to qualifying Chinese-resident companies under the Netherlands-China Income Tax Treaty that reduces withholding rates on dividends to 5% in some circumstances and 10% in others. It will apply also to qualifying U.S.-resident companies under the Netherlands-U.S. Income Tax Treaty when those companies do not qualify for the exemption provided under the treaty.

Because the proposed legislation contains its own test for qualification and is a unilateral provision requiring no concurrence by a treaty partner, the exemption can apply even though the recipient of the dividend fails to meet any of the tests under the limitation on benefits ("L.O.B.") clause of the treaty between the Netherlands and the shareholder's country of residence. This may make the Netherlands an attractive location for a European holding company owned by a group based in the U.S. or Japan, where the relevant income tax treaties contain detailed L.O.B. clauses that are not always easy to meet. Clearly, a unilateral exemption that applies irrespective of reduced treaty rates and specific treaty requirements significantly improves the position of the Netherlands as a European "hub" for multinational enterprises headquartered in the world's largest economies – and important trading partners – such as Canada, China, Japan, and the U.S.

With a view on the simultaneous introduction of a withholding obligation for "holding" cooperatives (see below), going forward the exemption will also be applicable to distributions to "qualifying members" of such cooperatives. In other words, while the new rules may bring holding cooperatives within the scope of the dividend tax, in principle these cooperatives should not be affected if and to the extent their members are corporations established in a treaty country. That said, in these situations normally there would be no Dutch tax benefit in using a cooperative anymore, meaning that existing holding cooperatives might just as well be converted into companies.

Lastly, the new unilateral exemption will apply subject to domestic anti-abuse rules. These rules are discussed in greater detail below. Essentially, they codify the principle purpose test ("P.P.T.") as laid down in the new multilateral instrument ("M.L.I."), which has been developed by the O.E.C.D. within the context of the B.E.P.S. Action Plan. As the M.L.I. is adopted worldwide, it may be expected that the P.P.T. will gradually become part of bilateral tax treaties, meaning that more and more tax treaties will contain similar anti-abuse rules. While dividend clauses in tax treaties currently may overrule anti-abuse rules as codified in domestic legislation, over time anti-abuse rules laid down in domestic law and relevant tax treaty provisions will merge in scope for countries that have signed the M.L.I. and revised treaties with other countries.

The key likely will not be in the standard that is adopted but in the application of that standard. It may turn out that the Dutch application of the P.P.T. may not be sufficiently rigid to satisfy the European Commission. As further discussed below, Dutch anti-abuse rules are not just meant to codify the P.P.T. as laid down in the M.L.I. but also to implement the G.A.A.R. as included in the recently amended P.S.D. Any perceived failure to implement the P.S.D. in a correct manner may lead the European Commission to take legal action against the Netherlands.

INCLUSION OF HOLDING COOPERATIVES

Under current law, as a rule, cooperatives are not within scope of Dutch dividend tax. This has been a deliberate choice; in fact, today's government policy in the Netherlands still maintains that "real" cooperatives must not be bothered with an obligation to withhold dividend tax when distributing profits to their members. As a result, the Dutch legislator has created a clear distinction between a cooperative and other business entities or arrangements such as a public company ("N.V."), a private company ("B.V."), the contractual form of an "open" limited partnership that is not transparent ("C.V."), and a mutual fund ("F.G.R."). In principle, the latter group of business entities or arrangements are obliged to withhold dividend tax on their profit distributions.

The background to this distinction is that the cooperative is traditionally used for certain collective activities (*e.g.*, purchases or sales) that are closely connected with – and supportive to – the individual businesses of its members. For this reason, it is felt that no fiscal obstacles should hinder the distribution of profits to members of cooperatives.

Pursuant to the Dutch Civil Code, the legal purpose of a cooperative is "to serve the economic interests of its members." This definition is generally accepted as being rather broad and is not restricted to any specific activities or industries. Even though cooperatives are traditionally used for collective activities within the agricultural and banking sectors, nothing on the face of the law prevents investors or companies from using cooperatives for other purposes, as long as the relevant activities serve the economic interest of a member. Consequently, holding and finance activities qualify just as well from a legal point of view.

In the course of the past decade, the use of Dutch cooperatives became quite popular within the domain of international tax planning. Although it goes without saying that such popularity was mainly caused by the absence of an obligation to withhold tax on distributions at source, it follows from the above that this was not caused by any change of law. The law always provided for that treatment. Rather, the sudden rise of the Dutch cooperative as an international holding vehicle resulted when tax advisers "discovered" the cooperative as an appropriate vehicle for structuring international investments. Particularly in relation to private equity, using a cooperative did not just create a tax benefit. It offered a nice "add-on" by reason of the flexibility it provides from a legal point of view in structuring the arrangement. This is because a cooperative is much less governed by mandatory provisions of law than a company.

Inevitably, systems in nature tend to revert to stasis, and the rise of the cooperative lead to its partial downfall once its popularity attracted the attention of the tax authorities, both in the Netherlands and abroad. It became clear that Dutch cooperatives could be used as an exit route from the E.U. to tax haven jurisdictions. This is generally considered undesirable, particularly where membership interests are held as a passive investment and members are not actively involved in the management of the cooperative and its investments, as is normally the case with private equity funds.

Under some pressure from the international community, the Netherlands introduced a withholding obligation for cooperatives in 2012 that was designed to be applicable in specific circumstances. This provision however was formulated as an exception to the rule. Hence, it was aimed at certain abusive structures only. With a view to implementing the general anti-avoidance rule ("G.A.A.R."), as laid down in the amended P.S.D., into Dutch law, the wording of the relevant legislation was amended with effect from 2016, but nothing of substance changed.

Then, in July 2016, the European Commission published a notice on illegal State Aid that set the stage for the present change in law. In its notice, the European Commission reasoned that where cooperatives are used for similar purposes and activities as companies, there would be no justification for a difference in tax treatment and any deviation from the general legal framework as it applies to companies might be construed as offering a selective advantage, which in turn may result in illegal State Aid. Considering the broad definition of their statutory purpose, Dutch cooperatives can be used for similar purposes and activities as companies, from a legal point of view. Apparently, the European Commission expressed the view that, from an illegal State Aid perspective, cooperatives should be subject to the same type of taxation as companies.

Essentially, this is what the proposed legislation aims to achieve. By introducing the concept of a holding cooperative that differs from other types of cooperatives, a cooperative that is predominantly engaged in holding and group finance activities will be brought within scope of collecting dividend withholding tax and therefore become – more or less – subject to the same type of taxation as other entities and arrangements that are customarily required to withhold tax on dividend distributions. This treatment will apply when holding and group finance activities comprise at least 70% of all activities engaged in by a cooperative. Where a cooperative is significantly engaged in activities other than holding and group finance, it remains outside the scope of the dividend tax. This will occur when other activities comprise more than 30% of the total activities of a cooperative. Consequently, cooperatives with real economic activities should not be affected by the new rules, except in unusual circumstances. Accordingly, for dividend withholding tax purposes, a cooperative will be afforded comparable treatment to a company if it is predominantly engaged in holding and finance activities.

Whether a cooperative qualifies as a holding cooperative depends on its activities over the financial year preceding a profit distribution. While in principle the composition of its balance sheet should be decisive, other factors may also be taken into account – such as allocation of turnover and the type of activities carried on by its employees. Even though the aggregate book value of participations in group companies and group loans may comprise over 70% of the asset side of a balance sheet, a cooperative may still not be regarded as a holding cooperative if it performs a headquarter function with active involvement in the management of its participations, provided that a sufficient number of employees perform management tasks of substance.

Where a cooperative has a significant number of members based in non-treaty jurisdictions such as the British Virgin Islands or the Cayman Islands, it cannot rely on the new domestic exemption from dividend withholding tax in relation to profit distributions to those members. Particularly in those situations, it seems worthwhile to consider a restructuring (*e.g.*, by making the cooperative sufficiently active through hiring employees, renting office space, and the like. Also, private equity structures with sufficient employees at the level of the cooperative and active involvement at the level of its portfolio companies may be out of the scope of withholding tax obligations. Again, the substance of the employee activities will likely be determinative, not titles and activities that occur sporadically.

Pursuant to the legislative proposal, the dividend withholding tax treatment of cooperatives remains different from companies where profit distributions are made to a member owning an interest of less than 5% in the cooperative. The withholding tax obligation on dividend distributions applies solely to qualifying members that are entitled to at least 5% of either annual profits or liquidation proceeds. For this purpose, membership interests that are directly or indirectly held by related parties or by a "cooperating group" must be aggregated. Since "real" cooperatives often have many members, this provision effectively functions as an "escape clause" since it ensures that even though they may qualify as holding cooperatives, these cooperatives are not affected – and thus bothered – by the new rules.

INTRODUCTION OF ANTI-ABUSE RULES

As already mentioned above, application of the new domestic exemption is subject to anti-abuse rules. These rules are basically a combination of the P.P.T. as advocated by the O.E.C.D. in B.E.P.S. Action 6 and the G.A.A.R. as recently inserted in the P.S.D.

The wording of the new anti-abuse rules is essentially based on existing Dutch domestic corporate income tax rules. Under specific circumstances, dividends distributed to members and capital gains from the sale or other disposition of a membership interest may be taxed in the hands of a foreign shareholder or member. Under the legislative proposal, this provision will be aligned with the new dividend tax provisions. Consequently, the exemption is denied if the following conditions are met:

- The shareholder or member (the "direct owner") holds its participation in the company or holding cooperative (the "Dutch entity") and one of the main purposes of that holding is the avoidance of Dutch dividend tax (the "subjective test").
- The shares or membership rights (the "participation") are part of an artificial structure or the profit is distributed through an artificial transaction or a series of artificial arrangements or transactions that lack valid business reasons reflecting economic reality (the "objective test").

Thus, the new legislation establishes the following obligations:

- Under the subjective test, management of the company or the cooperative must determine whether the direct shareholder or member has a main purpose of avoiding Dutch dividend tax. This is generally the case if the Dutch entity would be required to withhold more dividend tax on its distributions had the direct owner not been inserted into the structure, meaning that one must be able to rely on the objective test, as discussed below, in the event the subjective test produces negative results. Note that Dutch dividend tax avoidance need not be the main purpose for the investment under the subjective test.

- Under the objective test, one must assess whether the structure is artificial by itself or in conjunction with a series of artificial arrangements or transactions that lack valid business reasons reflecting economic reality. Essentially, this the mantra formulated by the European Court of Justice in its ruling in the *Cadbury Schweppes* case.

Where the direct owner conducts an active business to which its participation in the Dutch entity is attributable, valid business reasons reflecting economic reality are generally present. In comparison, if the direct owner is considered to hold its participation as a passive portfolio investment rather than an active business asset, profit distributions by the Dutch entity would be subject to withholding tax.

Where the direct owner is merely an intermediary holding company, the assessment is more complicated. In any event, its shareholder (*i.e.*, the indirect owner of the Dutch entity) must conduct an active business enterprise, whilst the intermediary holding company must function as a link (*schakelfunctie*) between its shareholder and the Dutch entity. In that case, "valid business reasons reflecting economic reality" are still considered to be present if the intermediary holding company meets a number of the new relevant substance requirements in its own jurisdiction. Most of these criteria resemble existing minimum substance requirements applicable to certain Dutch-based entities and are rather straight forward. However, with the new anti-abuse rules, two additional substance requirements are introduced for intermediary holding companies:

- The intermediary holding company must incur salary costs equal to at least €100,000 for employees performing the activities that function as a link between the indirect owner and the Dutch entity. These employees may be hired from group companies through a salary-split arrangement. However, the part-time employees must perform their activities for the intermediary holding company in the jurisdiction where that company is established.

- The intermediary holding company must also have its own office space at its disposal and that space must be equipped and actually used for the performance of such activities for at least 24 months.

Since it is recognized that time will be required to meet the two additional requirements, a three-month window is provided for identifying employees and arranging facilities. Everything must be in place by April 1, 2018.

OTHER MATTERS

Existing structures with intermediary holding companies may run afoul of the new domestic anti-abuse rules if the relevant substance requirements are not met, notably the requirements to (i) pay at least €100,000 annually in salaries and (ii) rent and equip office space for at least 24 months. This would also apply to intermediary holding companies established within the E.U./E.E.A. or in a treaty jurisdiction such as Luxembourg. Even though, in these situations, Dutch dividend tax may currently still be mitigated under an applicable tax treaty, this might change once the P.P.T. is inserted in the treaty at the time of implementation of the M.L.I.

Tax rulings will terminate as from January 1, 2018, if the intermediary holding company does not meet the relevant substance requirements in a timely manner. In certain situations, having an intermediary holding company in place may no longer be necessary, as a result of the introduction of the domestic exemption.

"Current dividend tax provisions would remain in force until the date of abolition, albeit the contemplated withholding tax exemption for distributions to treaty country residents may still be implemented."

CONCLUSION

In recent years, the Netherlands has relinquished its historic role as the premier location for a European holding company for a multinational group based in Canada, China, Japan, and the U.S. With the adoption of an exemption from withholding tax for Dutch entities, business arrangements, and cooperatives, the "bloom" may be returning to the "tulip."

P.S. – NEW COALITION GOVERNMENT INTENDS TO ABOLISH DIVIDEND TAX

On Tuesday October 10, 2017, following a negotiation period of almost seven months (a new record) from the date of the last general elections, it was announced that a coalition of four political parties will form a new Dutch government. That same day, the new coalition presented their political agreement to the Dutch Parliament. Amongst other (tax) topics, the agreement addresses the coalition's intention to completely abolish the Dutch dividend withholding tax, effective January 1, 2019, or ultimately by January 1, 2020.

In light of this outcome, the recent legislative proposal that is the subject of this article may not pass after all. This would imply that current dividend tax provisions would remain in force until the date of abolition, albeit the contemplated withholding tax exemption for distributions to treaty country residents may still be implemented, effective January 1, 2018. More clarity on this topic is expected in the coming weeks.

SWISS FEDERAL COUNCIL OPENS CONSULTATION PROCESS ON TAX PROPOSAL 17

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INTRODUCTION

Swiss voters rejected the Corporate Tax Reform Act III ("C.T.R. III") in a referendum on February 12, 2017. But Swiss tax reform was not derailed, only delayed. This article addresses events that took place in September of this year that are intended to move the process forward. This article provides an overview of the most important aspects of tax reform that are under consideration currently.

T.P. 17

Recommendations regarding the implementation of a modified corporate tax reform were presented to the Swiss Federal Council on June 1, 2017, under the title Tax Proposal 17 ("T.P. 17"). At its meeting on September 6, 2017, the Federal Council presented a new version of the project.

The proposal provides for the abolishment of existing cantonal tax privileges, as agreed with the E.U. Additionally, the Federal Council proposes the following compensation measures: (i) mandatory introduction of a patent box by all cantons and (ii) voluntary introduction of additional deductions for research and development ("R&D") expenses by the cantons. Further, the proposal provides for the possibility of a tax-neutral realization (*i.e.*, a step-up in basis) of hidden reserves that were created under the old tax regimes or before immigration to Switzerland. The previously-proposed notional interest deduction is no longer part of the reform package. In order to finance T.P. 17, the privileged taxation of dividends from qualifying participations will be limited to 30% (currently: 40% on the Federal level and usually up to 50% on the cantonal level).

General reductions to cantonal corporate income tax rates are not part of the proposal because the cantons may independently decide on reductions. In order to provide the cantons with more fiscal flexibility, the proposal provides for an increase of the canton's share in income from the direct Federal tax.

ABOLITION OF CANTONAL TAX PRIVILEGES

With the Federal Act on T.P. 17, the existing legal basis for cantonal tax privileges available to holding, domicile, and mixed companies will be abolished. As soon as it is definitive that T.P. 17 will be implemented (*i.e.*, once it is clear that there is no referendum against T.P. 17 or once T.P. 17 has been accepted in a referendum by the Swiss voters), the cantons will have until the time T.P. 17 comes into force to adapt the cantonal tax laws to the new Federal requirements. The cantons are free to abolish the cantonal tax privileges before the whole T.P. 17 comes into force.

When the cantonal laws come into force, companies that benefit from cantonal tax privileges will be subject to ordinary taxation. T.P. 17 provides for a five-year transition period during which the realization of hidden reserves established during the old regime are taxed separately. Alternatively, hidden reserves of a tax-privileged company may also be realized tax-neutrally in the course of giving up the privileged tax status before the new rules come into force. Such realization of hidden reserves may then be amortized over the following years (the so-called previous-law step-up). Further, special practices regarding the tax allocation of principal companies and finance branches will be abolished by the Swiss Federal Tax Administration.

Pursuant to a statement by Federal Counselor Maurer, Switzerland agreed to abolish cantonal privileges by 2019. Since the Dispatch for T.P. 17 will only be provided to the Federal Council by the Federal Department of Finance in the spring 2018, the new law may not come into force until 2020 at the earliest, and therefore, abolishment of the tax privileges by 2019 is impossible. It is conceivable that this may entail sanctions by the O.E.C.D. or unilateral anti-avoidance measures by individual states.

"Abolishment of the tax privileges by 2019 is impossible. It is conceivable that this may entail sanctions by the O.E.C.D. or unilateral anti-avoidance measures by individual states."

Further, it should be noted that information on tax rulings regarding privileged tax regimes that are still applicable on January 1, 2018 may be spontaneously exchanged with other jurisdictions in the course of the spontaneous exchange of information.[1] Even if the respective rulings are retracted before January 1, 2018, the privileged taxation may still be claimed by the taxpayer until the cantonal tax laws are changed or until tax-privileged status is given up by the taxpayer, provided that the requirements for the privileged tax status are still fulfilled.

PATENT BOX

A patent box will be introduced under T.P. 17 and will be mandatory for all cantons. This patent box provides that taxable income derived from patents and comparable rights is taxed with a reduction of up to 90% upon request. At the Federal level, such profits are taxed without a reduction.

The patent box regime fulfills the requirements provided by the O.E.C.D. (the so-called modified nexus approach). Pursuant to this modified nexus approach, income from qualifying rights may only be subject to a privileged regime in proportion to the extent overall R&D expenses are allocable to the taxpayer. Allocable R&D expenses consist of expenses for R&D performed by the taxpayer in Switzerland, expenses for R&D performed by third parties, and expenses for R&D performed by group companies in Switzerland.

ADDITIONAL R&D DEDUCTIONS

The cantons are authorized in T.P. 17 to provide an additional deduction from the cantonal corporate income tax base for R&D that is performed in Switzerland. This additional deduction must not exceed 50% of the qualifying R&D expense.

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1 See "Spontaneous Exchange of Tax Rulings – The Swiss Angle," *Insights* 9 (2017).

LIMITATION ON TAX RELIEF

As was the case with C.T.R. III, T.P. 17 proposes the introduction of a limitation on tax relief. The limitation on tax relief provides that at least 30% of the taxable profit of a company must be subject to tax before the application of any special regimes, such as the patent box and the additional R&D deductions. In addition, no losses may result from the application of the special regimes.

INCREASED DIVIDEND TAXATION

T.P. 17 proposes that dividend taxation for individuals with qualifying participations should be increased to at least 70% at the Federal and cantonal levels. Currently, only up to 60% of such dividends is taxed on the Federal level and only up to 50% is taxed in most cantons. This measure is intended to finance the tax deficits connected with T.P. 17 and the cantonal tax rate reductions.

INCREASED CANTONAL SHARE IN DIRECT FEDERAL TAX

To the extent possible, T.P. 17 aims at keeping Switzerland fiscally attractive for mobile activities. However, the tax incentives of T.P. 17 affect only certain kinds of mobile income. The profits not covered by these incentives are subject to the ordinary corporate income tax rate after the abolishment of the current tax privilege system. In order to prevent Swiss companies that currently enjoy tax privileges from moving aboard, the cantons must reduce – in certain cases drastically – their corporate income tax rates. This is illustrated in the chart at the end of the article. In order to provide the cantons with more flexibility in this regard, T.P. 17 provides for an increase of the cantonal share of income from direct Swiss Federal tax. The reduction of the cantonal corporate income tax rates, which is made possible by this measure as well as the revision of the inter-cantonal financial equalization, is by far the most important part of T.P. 17.

RELIEF FOR CAPITAL TAXES

Companies benefitting from a privileged tax regime currently pay capital tax at a reduced rate. T.P. 17 proposes that the cantons should provide appropriate compensation measures to maintain their attractiveness once the privileged tax regimes are abolished.

REALIZATION OF HIDDEN RESERVES

T.P. 17 provides for a tax-neutral realization of hidden reserves upon relocating to Switzerland and tax-effective amortization in the following years. This produces a symmetry with the tax treatment of a relocation abroad, which triggers the taxation of hidden reserves.

It should be noted that the hidden reserves are not realized on the tax balance sheet but are instead determined by the tax administration through decree.

CANTONAL TAX RATE REDUCTIONS

The reduction of cantonal corporate income tax rates is not directly part of T.P. 17. With regard to the planned implementation under C.T.R. III, most of the cantons that did not already have low tax rates planned to implement rate reductions. Various cantons developed different strategies based on facts and circumstances unique to each canton. The cantons of Vaud and Geneva, for example, propose to implement compensation measures only to a limited extent while substantially reducing the general tax rates. Other cantons, like Zurich, would reduce the tax rate by a relatively small amount and make more extensive use of compensation measures.

It is assumed that the announced proposals at the cantonal level will not fundamentally differ at the time of implementation of T.P. 17. Furthermore, with an increase in the cantonal share in the income from the direct Swiss Federal tax and changes in the inter-cantonal financial equalization, cantons will be able to proceed with tax rate reductions in a more or less fiscally neutral manner.

TRANSPOSITION

T.P. 17 further provides that all sales of participation rights to a company in which the seller holds an interest of at least 50% will be subject to tax, to the extent the consideration for such transfer exceeds the sum of share capital and capital contribution reserves. This applies also if several people act in concert with regard to the transfer and collectively fulfill the 50% requirement.

A tax-free private capital gain is therefore no longer possible under T.P. 17 with regard to a transfer of participation rights to a controlled company. This is to be compared to the current provision, which provides that only transfers of at least 5% to a controlled company are subject to taxation.

TIMING FOR IMPLEMENTATION

The Federal Council's Dispatch on T.P. 17 is expected in the spring of 2018, hence the new provisions cannot come into force before 2020. Afterwards, the cantons must adapt their cantonal tax laws to the new provisions of the Federal Act on the Harmonization of Cantonal Taxes. Current tax privileges are therefore expected to continue for several years.

CONCLUSION

Within a relatively short period of time, a compromise has been achieved politically regarding tax reform. T.P. 17 contains the most important points of the C.T.R. III in a hopefully majority-backed proposal. Nonetheless, the absence of a notional interest deduction in T.P. 17 is troubling. It would have been an important tool for Switzerland to attract group financing activities. Whether this will be corrected in the course of parliamentary consultation remains to be seen.

CHART

Standard Corporate Income Tax Rates by Canton (incl. Federal)		
Canton	**Current**	**Under T.P. 17**
Aargau	18.6%	Open
Appenzell Ausserrhoden	13.0%	Open
Appenzell Innerrhoden	14.2%	Open
Basel Country	20.3%	14.0%
Basel City	22.2%	13.0%
Berne	21.6%	16.4 – 17.7%
Fribourg	19.9%	13.7%
Geneva	24.2%	13.5%
Glarus	15.7%	14.2%
Grisons	16.1%	Below 15%
Jura	20.9%	Open
Lucerne	12.3%	No Reduction
Neuchâtel	15.6%	Open
Nidwalden	12.7%	No Reduction
Obwalden	12.7%	Open
St. Gall	17.4%	14.0%
Schaffhausen	16.0%	12 – 12.5%
Schwyz	15.3%	Open
Solothurn	21.5%	12.9%
Thurgau	16.4%	13.0%
Ticino	20.7%	17.5%
Uri	15.1%	Open
Valais	21.6%	15.6%
Vaud	22.1%	13.8%
Zug	14.6%	~ 12%
Zürich	21.2%	18.2%

SPONTANEOUS EXCHANGE OF TAX RULINGS – THE SWISS ANGLE

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Rulings
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INTRODUCTION

For the past few years, the spontaneous exchange of information – and tax rulings in particular – has been a major focus of the O.E.C.D. With many countries, including Switzerland, now adopting implementing legislation, the initiative has reached the final phase before first actions will be taken.

For the uninitiated, the term "spontaneous" means that the tax authority discovering the information sends the information to another country's tax authority on its own volition. It is neither automatic nor requested. Spontaneous exchange is one of three types of information exchange introduced during the last year by means of the O.E.C.D. Convention on Mutual Administrative Assistance in Tax Matters ("C.M.A.A.T."). Namely, the types are (i) information exchange upon request, (ii) automatic exchange of information, and (ii) spontaneous exchange of information.[1]

Switzerland introduced the spontaneous exchange of tax rulings as of January 1, 2017, on the basis of the C.M.A.A.T. Qualifying tax rulings that were confirmed after January 1, 2010, and are still applicable on January 1, 2018, will be subject to spontaneous exchange by the tax authorities.

LEGAL BASIS

Swiss tax treaties and tax information exchange agreements ("T.I.E.A.'s") in their current form do not provide for the spontaneous exchange of information. The legal basis for spontaneous exchange of information is contained in the C.M.A.A.T. as approved in December 2015 by the Swiss legislator. As Switzerland made certain reservations to the C.M.A.A.T., the spontaneous exchange is limited to tax rulings concerning (i) income (of both individuals and corporations), (ii) capital/net wealth (again of individuals and corporations), and/or (iii) withholding tax. Tax rulings covering *inter alia* V.A.T., inheritance or gift taxes, stamp duties, or social contributions will not be exchanged spontaneously, nor on request, as they would not be covered by tax treaties[2] or T.I.E.A.'s.

In order to provide a specific legal basis allowing for spontaneous exchange of tax information, the Swiss Act on International Administrative Assistance in Tax Matters and its respective ordinance required amendments, which came into effect on January 1, 2017.

1 See C.M.A.A.T. arts. 5, 6, and 7.

2 Switzerland has nine tax treaties covering inheritance tax, but they do not contain information exchange clauses.

TAX RULINGS

In General

Switzerland boasts a longstanding and reliable tradition of providing advance rulings to taxpayers. Although Swiss legislation does not provide a formal legal basis for the practice,[3] the binding effect of tax rulings was initially derived from constitutional law (*i.e.*, the protection of good faith) and later cemented by case law.

In accordance with Swiss jurisprudence, a tax ruling is binding under the following conditions:

- The ruling was provided by the competent authority or a confirming authority, which the taxpayer could assume is competent.
- The ruling was made with respect to a specific set of fully disclosed facts.
- The ruling was not made subject to reservations.
- The ruling was not obviously incorrect.
- Specific dispositions were made based on the ruling.
- The law did not change since the ruling was granted.

Spontaneous Exchange of Tax Rulings

For the purpose of spontaneous exchange of information, Swiss law contains a definition of tax rulings that must be exchanged spontaneously. (See below regarding the so-called *de minimis* clause.)

Pursuant to that definition, a tax ruling is "an information or confirmation concerning tax consequences on the basis of the facts outlined by the taxpayer, received from the tax authority and the taxpayer relies on the confirmation/information received."

The form in which a tax ruling was granted is irrelevant with regard to its possible exchange, meaning a ruling may be exchanged whether it was granted in writing or orally (although the latter would clearly be the exception).

Nor is the granting of a tax ruling related to a subsequent implementation of the tax ruling (*e.g.*, execution of a specific transaction). This may result in a tax ruling being exchanged although the taxpayer never implemented the envisaged structure or transaction described in the ruling.

In order to avoid the exchange of rulings, whether regarding an implemented transaction or one that never occured, the advice is generally to file a request to withdraw the tax ruling prior to December 31, 2017.

Types of Rulings to Be Exchanged

In accordance with current legislation, Swiss tax authorities will not exchange all types of tax rulings on a spontaneous basis. Those subject to spontaneous

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[3] The V.A.T. Act is the only Swiss legislation that provides a specific legal basis for tax rulings.

exchange are listed in B.E.P.S. Action 5 and specified for Swiss purposes in the domestic law ordinance.

Even though Article 7 of the C.M.A.A.T. may also cover rulings relating to individuals, the Swiss provisions, as currently drafted, seem to mainly affect Swiss corporations. Under the Swiss provisions, the following types of rulings are subject to exchange:

- **Rulings Relating to Preferential Corporate Tax Regimes.** *E.g.*, rulings about holding, mixed, or domiciliary company regimes, principal companies, I.P. boxes, or finance branches are subject to exchange. Although these regimes will most likely be abolished in the course of the ongoing corporate tax reform ("C.T.R."), existing rulings will still be subject to exchange.
- **Unilateral Transfer Pricing Rulings.** *E.g.*, transfer pricing rulings granted by the Swiss tax authorities without the involvement of other concerned states are subject to exchange.
- **Rulings Reducing Taxable Profit Without Reflection in the Financial Statement.** As the Swiss tax liability of a company is tightly connected to its financial statement, divergences between the profit in accordance with the financial statement and the taxable profit are rare under current legislation. However, as, for example, C.T.R. may introduce an excess deduction for research and developement, this type of rulings may become more relevant in future.
- **Rulings on Permanent Establishments ("P.E.'s").** *E.g.*, rulings about the recognition of a P.E. or profit allocation to a P.E. are subject to exchange.
- **Rulings on Conduit Structures.** *E.g.*, rulings on hybrid structures are subject to exchange. This category applies to circumstances where the structure leads to non-taxation or under-taxation.

"Tax rulings are to be exchanged only if the rulings (i) were granted after January 1, 2010, and are still in force on January 1, 2018, or (ii) are granted after January 1, 2018."

The above types of tax rulings are to be exchanged only if the rulings (i) were granted after January 1, 2010, and are still in force on January 1, 2018, or (ii) are granted after January 1, 2018.

De Minimis Clause

Tax rulings need not be exchanged if they are of minor importance to the receiving states due to the tax amounts involved or if the amounts to be paid are disproportionate to the administrative effort of the tax authorities.

PROCEDURE

The cantonal tax authorities have begun issuing information letters to taxpayers whose rulings fall under one of the above categories. In principle, taxpayers have three options to proceed prior to the end of 2017:

- If the taxpayer wishes to rely on the tax ruling after December 31, 2017, an electronic registration and description of the tax ruling is required to be submitted on a template provided by the O.E.C.D. The template, and not the tax ruling, will be exchanged with the receiving state(s).

- If the taxpayer does not intend to rely on the tax ruling after December 31, 2017, the tax ruling can be withdrawn.
- If the taxpayer wishes to rely on the tax ruling after 2017 but is of the opinion that the tax ruling is not subject to spontaneous exchange, the taxpayer is invited to make his or her case.

If the taxpayer fails to act altogether or within the requested deadline (in principle, prior to December 31, 2017, at the latest), the cantonal authorities will send the tax ruling to the Federal tax authority ("F.T.A."). The F.T.A. will then decide if the tax ruling is subject to spontaneous exchange. If so, the F.T.A. will inform the taxpayer accordingly. At that point, the taxpayer has the option to appeal. In a case where advance notification may jeopardise the purpose or success of an exchange, the F.T.A. may inform the taxpayer after the information has been delivered. Legal appeals can be filed once the information is delivered.

The templates will be exchanged by category to states entitled to receive the information, provided that the receiving state has implemented rules for the spontaneous exchanges of tax information. In all of the above tax ruling categories, the state where the direct controlling and top holding company (*i.e.*, headquarters) has its tax residence will receive the information. In the case of a P.E., the state where the P.E. is located will receive the information too.

For tax rulings confirmed after January 1, 2018, the taxpayer is requested to complete the O.E.C.D. template within 60 days following the confirmation of the tax ruling.

CONCLUSION – TO KEEP OR WITHDRAW?

It is sensible for Swiss taxpayers, and international companies in particular, to analyse any Swiss tax rulings and assess whether the rulings are subject to spontaneous exchange. In cases where information exchange is likely to result in adverse foreign tax consequences, it may be sensible to opt for a withdrawal of the tax ruling.

Additionally, since spontaneous exchange of information is intended to be reciprocal, Switzerland is expected to receive information from other states regarding tax rulings issued to Swiss taxpayers. Therefore, it is also advisable for Swiss taxpayers to review tax rulings granted by other states.

Considering the wealth of information that will become available as a result of spontaneous exchange, it is expected that the number of information exchanges upon request will increase.

LEGAL AND PRACTICAL STRATEGIES FOR MANAGING TAX DISPUTES IN INDIA

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Tags
B.E.P.S.
India
Multilateral Instrument
Tax Controversy
Transfer Pricing

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In an era of globalization, where foreign entities are looking at rapid expansion and turning to newer markets such as India, entities may find themselves exposed to unexpected tax risks and disputes in jurisdictions with unfamiliar tax systems. A tax dispute can potentially have serious long-term ramifications with respect to both the profitability of the entity and the reputation of the business enterprise. In the Indian context, the last decade has seen an upsurge in tax disputes, with a number of high-profile cases currently being contested at various levels. Multinational companies such as Vodafone, Nokia, Shell, Aditya Birla, and NDTV are all cases in point.

The main causes for the rise in tax disputes are as follows:

- Recent efforts on the part of the Indian tax authorities to widen the country's tax base by emphasizing source-based taxation
- Taxpayers implementing "creative" structures to achieve a tax-effective structure or transaction
- Confusion resulting from lack of clarity on new provisions exacerbated by aggressive interpretations by both taxpayers and tax authorities
- Conflicting rulings pronounced by different appellate forums or authorities across the country contributing to delays or multiplicity of tax disputes

The following high-profile tax disputes and controversies in India have gathered attention in the recent years:

- The $11 billion *Vodafone* case wherein the question of taxability of indirect transfer of Indian assets was decided by the Supreme Court of India
- The *Nokia* case, which involved taxation of royalty payments from Nokia India to its Finnish parent company, wherein the Income Tax Department issued a notice to Nokia's subsidiary in India and froze its assets
- The *Shell India* and *Vodafone* cases involving the application of transfer pricing provisions regarding the issue of shares and the alleged under-valuation of shares to avoid tax in India[1]
- The Aditya Birla-AT&T deal involving the question of an "indirect transfer" of Indian assets and the application of the India-Mauritius Income Tax Treaty
- The recent *NDTV* case where the Income Tax Appellate Tribunal ("I.T.A.T.") collapsed the entire multi-jurisdictional corporate structure created by NDTV and taxed certain amounts received by it as unexplained income

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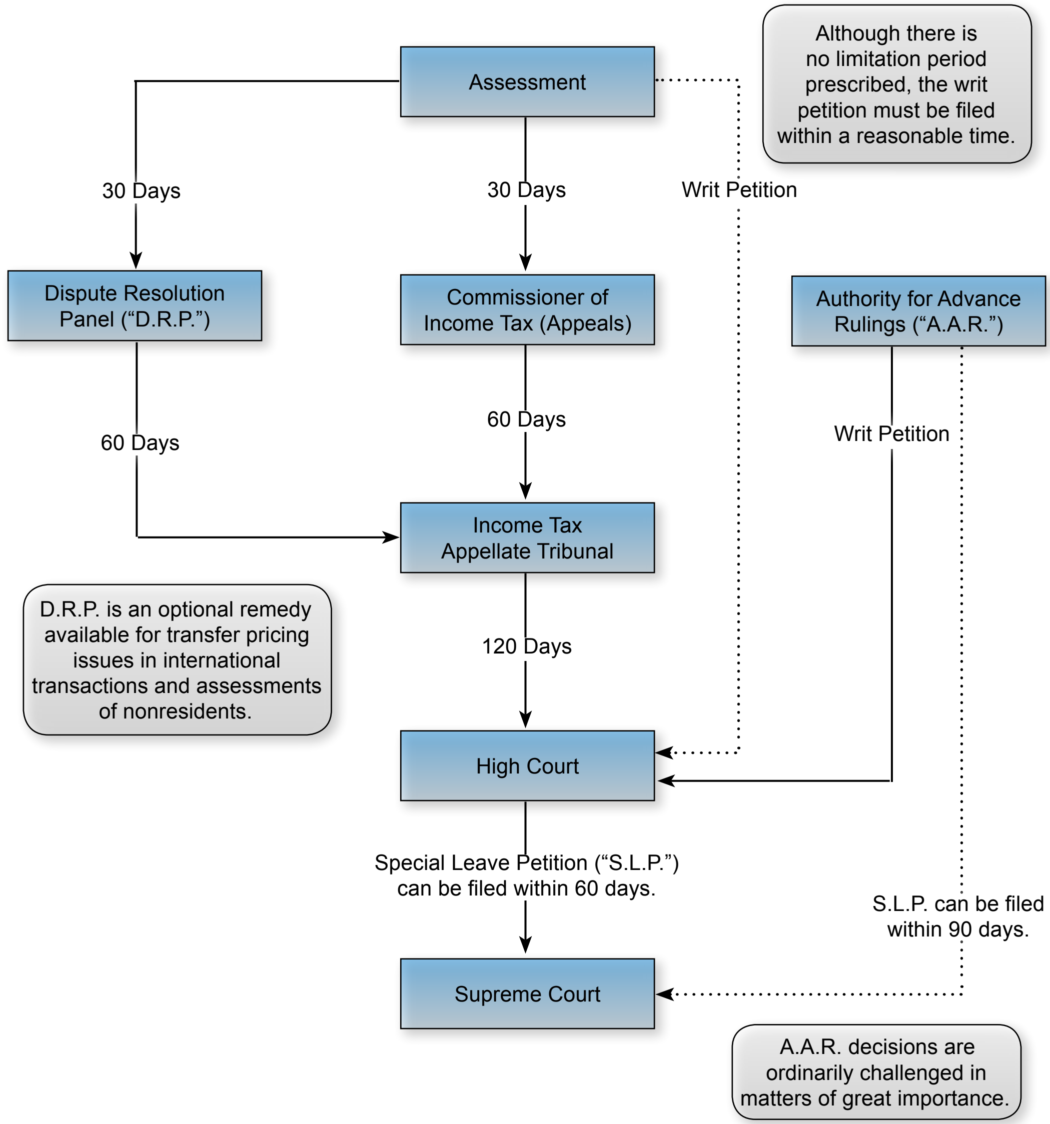
[1] This issue has been resolved following the Bombay High Court's decision in *Vodafone* and the Indian government's support for the decision.

The diagram below provides an overview of the appeals process in India and the timelines for filing such appeals or objections:



> ***"The last decade has seen an upsurge in tax disputes, with a number of high-profile cases currently being contested at various levels."***

DEVELOPING PROPER STRATEGIES FOR EFFECTIVE HANDLING OF TAX LITIGATION

The importance of enlisting sound tax counsel to develop effective legal strategies and mitigate tax disputes cannot be overemphasized. Such strategies can be beneficial both before and after a transaction is effected. Unless handled properly, litigation can be a long-drawn and expensive affair in India.

Preventing Tax Disputes

Some of the key steps that could help avoid tax litigation are set out below:

- Vet transactions from an income tax perspective to ensure compliance with all applicable laws and legal "do-ability."
- Appropriately draft legal documents and vet prospective structures from tax

perspective to avoid unnecessary litigation or disputes going forward. With the introduction of the General Anti Avoidance Rules ("G.A.A.R."), it is important that the commercial intent behind each transaction is immaculately captured in the transaction documents.

- When undertaking a transaction such as an acquisition, merger, slump sale, [2]or share sale, ensure that all relevant documents and evidence are preserved, including supporting evidence with respect to the valuation of the assets involved.

- Take a proactive approach by making the best use of the forums available for speedy dispute resolution (*e.g.* approach the Authority for Advance Ruling ("A.A.R.") for a determination on the taxability of a transaction).

- Make appropriate disclosures in tax returns at the outset to bring relevant facts and legal documents on record and lay the foundation for a strong defense of the taxpayer's position. This can also help to avoid the application of penalties, if the taxpayer's claim is not accepted in a tax assessment.

- When undertaking international transactions with related parties, a taxpayer should make a reasoned determination of how it will handle transfer pricing aspects of the transactions. Choices include (i) preparation of a competent transfer pricing study prior to undertaking the transaction, rather than as an afterthought, (ii) utilization of the Advance Pricing Agreement ("A.P.A.") mechanism, as discussed in detail below, or (iii) adherence to the prescribed safe harbor rules.

- Consider obtaining a "tax insurance policy" to safeguard against any potential future tax demands.

Handling Tax Disputes

When tax disputes arise, it is critical that the taxpayer arrange for proper and effective representation before the tax and appellate authorities and that all key facts, arguments, supporting evidence, and relevant documentation are put forth in a comprehensive manner. It should be noted that the High Courts and the Supreme Court generally decide on questions of law and not questions of fact. Further, they do not routinely permit the introduction of additional evidence. There should also be timely compliance with official procedures and follow up to push for speedy resolution of disputes.

UTILIZING FORUMS THAT FACILITATE DISPUTE RESOLUTION

Under Indian income tax laws, the following forums facilitate dispute resolution.

A.A.R.

This forum is primarily available to nonresidents and foreign companies. An advance

[2] A slump-sale involves the transfer of one or more undertakings as a result of the sale for a lump-sum consideration without values being assigned to the individual assets and liabilities.

ruling can be obtained for a completed transaction as well as for a proposed transaction, but not for a hypothetical transaction. An A.A.R. ruling is binding on the tax authorities and the applicant. Consequently, it provides certainty regarding the tax position in India for a nonresident or foreign company. However, in several instances, the High Courts and the Supreme Court have entertained challenges against advance rulings by way of a writ petition or a special leave petition ("S.L.P.") under the Constitution of India.

It may be noted that the prerequisite for filing an application before the A.A.R. is that the question raised by the applicant must not be pending before any income tax authority, appellate tribunal, or court.

The benefit of approaching the A.A.R. is that potential proceedings before a tax officer are usually put on hold from the date of the application until the date of the ruling. Consequently, the tax authorities may not assert, or demand payment of, a tax liability while A.A.R. proceedings are under way.

While the provisions prescribe a time limit of six months, within which the A.A.R. will pronounce its ruling, of late the A.A.R. has been taking between two or four years to issue its ruling. Factors contributing to this delay include a vacancy in the office of the chairman and a backlog of cases. One hopes that this situation will soon improve and the A.A.R. will revert to the prescribed timeframe.

A.P.A.'s for Transfer Pricing Matters

Globally, as well as in India, transfer pricing disputes account for a major portion of all tax litigation. With a view to reduce such litigation, the Indian government has introduced a framework for A.P.A.'s between the tax authorities and certain specified taxpayers who enter, or propose to enter, transactions with associated enterprises outside India. An A.P.A. is an agreement between a taxpayer and the tax authority on an appropriate and mutually agreed upon transfer pricing methodology for a set of transactions over a fixed period of time.

An A.P.A. will be valid for the period of years specified in the agreement, subject to an upper limit of five consecutive tax years. A rollback provision is also available, so that the A.P.A. is applicable to past years as well. The A.P.A. is binding only with respect to the specified transaction. The A.P.A. ceases to be binding if there is any change in law or facts bearing on the subject matter of the A.P.A.

An A.P.A. provides the following benefits to the taxpayer:

- Certainty with respect to the international transactions covered in the agreement
- Low annual reporting costs
- Flexibility in developing pragmatic and workable solutions for complex transfer pricing issues owing to the joint endeavors of the taxpayer and the tax authorities
- Excellent returns on the time and effort invested in negotiating the original A.P.A. when the agreement is renewed
- Reduction in risks and costs associated with transfer pricing audits and litigation over the term of the A.P.A.

As of July 31, 2017, the tax department entered into 171 A.P.A.'s, which include 12 bilateral A.P.A.'s and 159 unilateral A.P.A.'s.

Withholding Tax Authorization

An action taken with the consent of the tax authorities is generally protected from litigation going forward.

If a payor or a recipient believes that a proposed payment is not taxable in India, or is taxable at a reduced rate, the tax authorities may be approached for authorization. Where the tax authorities issue a reduced rate or zero tax withholding certificate, the payment can be effected without deducting tax or with tax deducted at a reduced rate.

This mechanism can reduce the possibility of later disputes. However, the withholding certificate is not a conclusive determination of the recipient's tax position. The tax authorities usually reserve the right to make a final determination when assessing the taxpayer's return for the relevant period.

Dispute Resolution Panel ("D.R.P.")

The D.R.P. is another mechanism formulated by the Indian government to facilitate expeditious resolution of tax disputes. The D.R.P. consists of a collegium of three commissioners of income tax who adjudicate matters concerning adjustments proposed by the tax officer in tax assessments of foreign companies and cases involving transfer pricing adjustments.

A taxpayer who objects to adjustments proposed in a tax assessment may submit those objections to the D.R.P. The D.R.P. considers the objections and, after hearing both sides, gives necessary directions to the tax officer, who is obliged to frame the tax assessment based on the directions of the D.R.P. The D.R.P. is required to provide its directions in a timely manner.

Mutual Agreement Procedure ("M.A.P.") Under Tax Treaties

This is a special mechanism for dispute resolution provided under Indian's multilateral tax treaties. The M.A.P. applies to cases where an action or a proposed action leads to double taxation of income or to tax that is not in accordance with the relevant tax treaty. On receipt of a taxpayer's application for the M.A.P., the competent authority of the taxpayer's country of residence will take up the disputed matter with the competent authority of India to discuss the issues and attempt to arrive at a resolution.

Resolution under the M.A.P. and resolution under domestic laws can be carried out simultaneously, and the taxpayer may choose to accept or decline the resolution reached by the competent authorities.

TRIGGERING LITIGATION – TAXPAYER BEWARE!

G.A.A.R.

One cannot discuss Indian income tax provisions without examining the impact that will arise from the introduction of G.A.A.R. Moving to a "substance" over "form" approach, the introduction of G.A.A.R. from April 1, 2017, is expected to change the landscape of taxation in India.

G.A.A.R. may be invoked by the tax authorities where the main purpose of an arrangement is to obtain a tax benefit. The G.A.A.R. provisions empower the tax authorities in India to declare any such arrangement as an "impermissible avoidance arrangement." On this basis, it may disregard entities in a structure, reallocate income and expenditures between parties to the arrangement, alter the tax residence of entities and the legal situs of assets, and treat debt as equity or vice versa. By doing so, the tax authorities may even deny tax benefits conferred under a tax treaty.

Accordingly, taxpayers must ensure that there is commercial substance behind every transaction or structure in order to mitigate risks. A taxpayer may also approach the A.A.R., for determining whether a particular proposed transaction would be free from attack under the G.A.A.R. provisions.

Transfer Pricing

Transfer pricing has always been a subject of heavy litigation in India – the controversies in the *Vodafone* and *Shell* cases being only recent examples.

Indian transfer pricing provisions are fast evolving as the Indian government endeavors to protect the country's tax base. Along these lines, Finance Act 2017 introduced two international practices to the Indian tax landscape: thin capitalization norms and secondary adjustments.

"Moving to a 'substance' over 'form' approach, the introduction of G.A.A.R. from April 1, 2017, is expected to change the landscape of taxation in India."

Even with risk mitigation and dispute resolution mechanisms such as A.P.A.'s and safe harbor rules, India has experienced a substantial increase in transfer pricing disputes in recent years. As India's role in the global economy and presence of the international stage continues to grow, a further increase in transfer pricing related disputes is expected.

"Indirect Transfer" Tax Provisions

The indirect transfer tax provisions were introduced in 2012 with retrospective effect, to negate the effect of the Supreme Court's ruling in *Vodafone*. Under the indirect transfer tax provisions, gains on a transfer of an interest in entity (which includes a foreign corporation) are liable to tax in India if the foreign entity derives "substantial value" from assets situated in India, subject to benefits available under tax treaty, if any.

For the purpose of determining whether a foreign entity derives substantial value in India, certain threshold limits are provided, based on the values of the asset and the foreign entity. Consequently, tax disputes are anticipated with respect to the application of the indirect transfer tax provisions to specific transactions.

Place of Effective Management

In 2016, the test for corporate residency of foreign companies moved from control and management being situated wholly in India to place of effective management ("P.O.E.M.") in India. The determination of P.O.E.M. is a factual determination, based on substance over form, taking a holistic approach on a year-to-year basis. Considering the subjective nature of the guidelines issued for determining P.O.E.M., disputes are likely to arise.

Valuation Norms

By reason of recently introduced provisions, a minimum fair market value test is to be fulfilled by the acquirer of assets situated in India, as well as the transferor of equity shares in India. The fair market value of equity shares is to be computed by a hybrid mechanism based on the asset composition of the company. For the purpose of valuing equity shares, the fair market value of any downstream investments, onshore or offshore, are also to be taken into consideration.

In addition, ambiguity exists with respect to the application of accepted valuation norms to instances such as the conversion of instruments or a bonus issue of shares. Considering the complexities that may arise in obtaining a valuation of this nature and the ambiguity surrounding the application of these provisions, taxpayers should seek sound legal advice prior to entering into any such transaction.

Implementation of B.E.P.S. Provisions

Over the past few years, India has begun adopting provisions under the O.E.C.D.'s B.E.P.S. initiative, including the equalization levy and thin capitalization norms. It is expected, that India will steadily adopt many concepts under the B.E.P.S. Action Plan, leading to further changes in the Indian tax regime.

India has already signed the O.E.C.D.'s Multilateral Instrument ("M.L.I."), in line with the B.E.P.S. Action Plan. The M.L.I. seeks to amend the existing network of more than 3,000 bilateral tax treaties between the signatory countries. With the ratification of the M.L.I. by each new country, existing tax treaties between India and the signatory jurisdiction will stand amended. The potential impact of the M.L.I. will require careful study, and advice should be sought prior to entering any transaction.

CONCLUSION

Given the adversarial nature of tax assessments and the costs involved in tax dispute resolution, it is preferable to conduct one's business so as to ensure that cause for a dispute does not arise in the first place. However, litigation may become inevitable owing to the nature of the transaction, the stakes involved, or the conflicting views of the tax authorities.

The government has the responsibility to ensure that disputes are addressed with a sense of urgency and without delayed or frivolous appeals. This may be accomplished through the creation of stringent guidelines to ensure pro-taxpayer rulings are challenged only if they are demonstrably perverse or apparently erroneous. Additionally, the government may establish a mechanism to hold tax authorities accountable for frivolous or vexatious tax demands. The merits of a case should be the guiding factor in determining if a tax dispute moves forward, not merely the quantum of tax or the stakes involved in the matter.

In this challenging, high-stakes environment, the best possible strategy for managing tax disputes involves maintaining proper and robust documentation, capturing the commercial substance of the transaction in legal documents, carefully drafting legal submissions to the judicial authorities, bringing all the relevant facts to the fore at the first possible instance, and acquiring effective and persuasive legal representation.

CAVEAT DOMINUS: A COMPARISON OF POST-EMPLOYMENT ENTITLEMENTS IN THE U.S. AND ITALY WHEN EXECUTIVE EMPLOYMENT IS TERMINATED WITHOUT CAUSE

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Cross-Border Business
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INTRODUCTION

Management of a U.S.-based multinational is often shocked by what it hears when seeking advice from a European labor lawyer regarding employee rights in connection with the termination of a European executive. Simply put, the rules in Europe are quite different from the rules in the U.S., and unlike the in U.S., they do not favor the employer. To assist businesses and executives based in one country and doing business, or contemplating doing business, on the other side of the Atlantic, this article discusses the differences in what management and executives can expect when the employment relationship is terminated in the U.S. and Italian contexts.

EXECUTIVE RIGHTS AT TERMINATION IN THE U.S.

The general, indeed historic, rule of U.S. employment law is that, without a specific contract of employment, U.S. executives are, like most other employees, considered employees "at will" – meaning the will of the employer. This rule, by itself, is often re-stated to mean that an employer can terminate an executive "for any reason (except a prohibited reason), at any time, or for no reason at all" unless a written contract exists that provides for rights upon termination.

Legal Issues at Termination

Legal issues may arise where either of the following conditions are met:

- The executive receiving the notice of termination has a contract with the employer – usually a written (*i.e.*, express) contract or, much less often, an implied contract as the result of statements, promises, or representations by the employer or the employer's agent.[1]
- The reason for the executive's termination is a prohibited reason.

In the U.S., most prohibited reasons fall under one of the many forms of illegal discrimination. Overriding U.S. Federal law prohibits "employment actions" – including termination – motivated by discrimination based on gender, sexual harassment, age, race, ethnicity, religion, national origin, physical or mental disability, or retaliation for being a "whistleblower" or engaging in other protected conduct. Moreover,

[1] The differences between express and implied employment contracts are beyond the scope of this article. The following discussion of executive employment agreements presumes a written agreement that is negotiated between the executive and the employer with the assistance of legal representation and customarily entered into at the commencement of the employment relationship.

each state and many localities have separate laws prohibiting discriminatory employment actions against persons in even broader categories of protected status, quality, or identity, such as *inter alia* sexual orientation, marital or domestic partner status, family responsibility, and caregiver status. With respect to new and different protections under state and local laws, the list keeps growing as each year passes.

Entitlements for Termination Without Cause

For the purpose of focusing this discussion on possible entitlements that a U.S. executive can expect when he or she is terminated by the employer "without cause,"[2] the following discussion assumes that (i) the U.S. executive is being terminated without cause (*e.g.*, the employer has decided that someone else can do a better job or the position is being eliminated) and (ii) the executive's termination is otherwise lawful and does not reflect discrimination or otherwise legally prohibited conduct by the employer.

"It is so important for executives in the U.S. to obtain a carefully negotiated agreement when they enter into employment . . . without any such agreement, the executive's legal entitlements are modest indeed."

Under these circumstances, the key issue is to determine what, if anything, the terminated executive is entitled to receive. The detailed answer varies according to the executive's particular situation, but the general answer is that the executive is entitled to whatever is provided *by the explicit terms of his or her contract* or as part of *the employer's overall company policy*, plus a *few extra entitlements under the law* regardless of what the contract says, even if there is no contract.

Limited Benefits under Law or Customary Practice

Considering these extra-contract legal entitlements, such as they are, will easily demonstrate why it is so important for executives in the U.S. to obtain a carefully negotiated agreement when they enter into employment, since without any such agreement, the executive's legal entitlements are modest indeed. They include the following:

- Up to a certain number of weeks – rarely surpassing 20 weeks – of unemployment compensation from the government, administered through a type of insurance plan into which U.S. employers are obligated to make periodic contributions
- The ability to remain on the employer's health benefits plan, at the cost of the employee, for up to 18 months (so-called C.O.B.R.A. benefits, an acronym that refers to the title of the Federal legislation that created this entitlement)
- If the employer has a generally applicable severance pay plan or policy, the

[2] Also beyond the scope of this article is a discussion of termination for cause. The definition of "cause" is a carefully negotiated term in most executive contracts, and accordingly, differs from contract to contract. It typically centers on the notion that the executive has performed an act that so egregious, anti-social, or against the letter and spirit of the employment relationship that the employer is justified in immediately terminating the executive's employment with little or no further entitlement. Examples include the following: (i) The employee has committed a crime or an act of moral turpitude or violated a material term of the employment contract or the employer's trust, or has performed an act likely to cast the employer into public disrepute; (ii) in the specific industry of the employer, the employee has broken a rule or regulation; (iii) the employee breaches the terms of employment by virtue of total or substantial non-performance of one's job duties after having been notified of this failure and given an opportunity to cure the defective performance.

number of weeks of continuing pay provided for by that plan or policy (customarily, an amount based on a formula such as one or two weeks of pay for every year of service, sometimes commencing after a fixed number of initial years of service)

- A "roll over" into another plan of portable *vested* retirement benefits under a savings, deferred compensation, or retirement or pension plan maintained by the employer (while *unvested* benefits generally disappear upon termination)

Front-End Planning for Back-End Benefits

This list of legally mandated entitlements is rather small. Accordingly, U.S. executives and their employment attorneys know that before an executive accepts employment, the focus must include termination rights and entitlements, which must be negotiated carefully with the employer pursuant to a written contract.

The most prominent of such "negotiated" entitlements are the following:

- Severance. This covers a continuation of salary in order to bridge the transition to a new position. As the trend in the U.S. is for executive contracts to be "at will" rather than for a set term of years, the executive's written employment agreement (or binding offer letter) must contain a specification of precisely what severance the executive will receive from the employer if the executive is terminated "without cause." Six months of base compensation is a minimum. Depending on the executive's level of seniority and the care with which the executive's agreement has been negotiated, severance pay amounting to a full year of the executive's base compensation (or even more) is not uncommon.

- Continuing Health Benefits. Because without a contract it is the executive, not the employer, who has the legal obligation to pay the premiums to continue health insurance coverage under C.O.B.R.A., an executive's contract should allocate payment responsibility to the employer during the severance period.

- Bonuses. Without a specific contractual entitlement, many executives, as a purely legal matter, will forfeit bonuses upon termination without cause before the date on which the bonus is to be paid, even if they have worked an entire year. The executive's contract should address this as well and provide for the payment of a bonus, or a meaningful portion of it, depending on the date of termination. This becomes especially important in those industries, such as the financial services industry, where executive compensation frequently involves a modest base salary and a far larger annual bonus.

- Accelerated Vesting of Equity Interests and Other Incentives. Similarly, without a contractual provision providing that in the event of a termination without cause, all future incentive benefits, including the right to stock or stock options, shall become vested (and thereafter payable to the executive on some agreed-on future date), the executive must assume that all *unvested* incentives and equity interests will be forfeited upon the end of his or her employment.

The foregoing should be sufficient to convince the reader that without a good written employment agreement, negotiated by a knowledgeable executive employment attorney, *none* of these items are automatic legal entitlements in the U.S. upon an executive's termination. For an executive in the U.S. to be certain of these enhanced entitlements, he or she must negotiate *an individual written agreement before accepting employment*.

EXECUTIVE RIGHTS AT TERMINATION IN ITALY

Generally speaking, and especially when compared with the situation in the U.S., Italy is very protective of employees. Individuals tend to stay with an employer, rather than move from one company to another, and it is very difficult to terminate employment agreements.

Non-executive employees may only be terminated (i) for cause, (ii) for a justified subjective reason such as serious nonperformance, or (iii) for a justified objective reason such as an internal reorganization that results in redundancy. Until 2012, companies with more than 15 employees were obligated to reinstate an unlawfully terminated employee and to pay damages for the unlawful termination. For years, this was an obstacle to job creation and the growth of the Italian economy. In 2012 and 2015, legislative reforms were passed, which limited the circumstances for re-instatement, reserving this measure only for the most serious cases of unlawful termination. In all other cases, the remedy is limited to payment of an indemnity for damages incurred by the employee.

The foregoing protections apply only to non-executive employees who, as a rule and with certain exceptions discussed below, are excluded from the legal framework that limits individual dismissals. Executives, on the other hand, are granted substantial protections with regard to termination of their employment under collective bargaining agreements.

<u>Legal Framework</u>

In Italy, the rights of an executive in relation to an employment agreement are ruled by the law and, most of all, by collective bargaining agreements (*Contratti Collettivi Nazionali di Lavoro* or "C.C.N.L.'s"). Although theoretically possible, employment relationships that are not ruled by a C.C.N.L. are very rare.

It is therefore uncommon for executives to enter into a proper employment agreement or to provide for the consequence of a termination. Rather, it is common to be hired by a simple letter indicating the main conditions of the employment, such as salary, title, and main duties, with all other rights and duties provided under the applicable C.C.N.L.

Italian law provides its own set of protections beyond the scope of the C.C.N.L.'s in cases of (i) discriminatory dismissal based on gender, age, religion, and other similar items; (ii) dismissal based on an illegal motivation, such as a retaliatory dismissal); or (iii) other motives considered illegal by the law. To illustrate, the executive must be reinstated in his or her position, which means that the working relationship continues. However, the executive may instead choose an indemnity amounting to 15 months' salary. In addition, the executive may claim an indemnity in the amount corresponding to the salary not received during the period of wrongful termination from the date of dismissal to the date of reintegration.

As with all other employees, the executive is entitled to a notice period, unless the dismissal is for cause. The duration of the notice period is determined by the applicable C.C.N.L. The most important C.C.N.L.'s are those applicable to the industrial and commercial sectors.

The duration of the notice period depends on seniority. In the above mentioned C.C.N.L.'s, the notice period ranges between a minimum of six months' and a maximum of 12 months' salary. The higher range applies for executives whose employment has exceeded 15 years.

It is common to substitute the notice period for an indemnity that is equal to the salary that would have been paid during the notice period and to exonerate the executive from a continuing obligation to work for the company. Bonuses or other variable remuneration may also be included. Thus, the amount involved in the indemnity may be high.

Health Insurance

All Italian residents are covered by social security, which includes access to public health care for a reduced amount, depending on income. Most executive employment packages include additional coverage that reimburses all or part of private health care. Such coverage normally continues during the notice period, even if the executive is not required to work during that time.

Vesting of Equity Interest and Other Incentives

There is no specific rule regarding the acceleration of stock options or other incentives that are generally ruled by the provisions of the incentive plan and the company policy in this regard; these aspects are often included in negotiations following termination.

Additional Indemnity

The C.C.N.L.'s also provide for the right of the executive to receive an additional indemnity when the dismissal is not justified. The range of motives for dismissal that have been considered as justified by the courts is quite wide. It includes all motives that may jeopardize the relationship between the employer and the executive.

The amount of the additional indemnity provided by the C.C.N.L.'s is based on duration of employment, age, and other case-specific facts. The most recently renewed C.C.N.L.'s reduced the number of months for which the additional indemnity may be payable to less senior executives. The minimum is now two months' salary, and the maximum can reach 24 months' salary.

T.F.R.

T.F.R. stands for *Trattamento di Fine Rapporto* (*i.e.*, severance pay), which is an amount of money that each employer must hold for all his or her employees until they leave the company or job. It is not a redundancy payout, since it is paid even in the case of voluntarily resignation, but rather a kind of compulsory savings plan.

N.A.S.P.I.

N.A.S.P.I. (*Nuova Assicurazione Sociale per l'Impiego*) is a governmental institution acting as unemployment insurance. It may provide compensation for unemployed persons, including executives, for a maximum period of 24 months.

The period of eligibility begins after the end of the notice period and its duration will depend on the amount paid by the company and the duration of the employment.

In any case, the maximum monthly amount payable by N.A.S.P.I. is currently €1.3 million (approximately $1.45 million).

Practically Speaking

In Italy, it is common for executives and their employers to negotiate a "termination package" – within the range provided by the applicable C.C.N.L. When a complaint is filed before a labor court, it is generally done in order to provide additional leverage in negotiations.

CONCLUSION

Italian employment law provides greater legal rights to a terminated executive than U.S. law. In the U.S., benefits are derived from a well-drafted employment agreement. In Italy, as in much of Europe, benefits are derived from employment law and industry-wide collective bargaining agreements. As a result, U.S. businesspersons and their attorneys are often surprised by the differences between a typical Italian employment contract and those in the U.S. The surprise is even greater when it is discovered that an employment agreement with an Italian executive is subject to a set of mandatory provisions of law and industry-wide agreements that provide significant termination rights notwithstanding the absence of a detailed agreement or any agreement at all. More importantly, these rights cannot be bargained away by the employee in an employment agreement. *Caveat Dominus!*

"Italian employment law provides greater legal rights to a terminated executive than U.S. law."

CIRCULAR LETTER NO. 17/E CLARIFIES SPECIAL TAX REGIME FOR ITALIAN "NEW RESIDENTS"

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Tags
Italy
Non-Domiciled Taxation
Pre-Immigration Planning
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INTRODUCTION

On December 7, 2016, the Italian Parliament approved the 2017 Budget Law, which entered into force on January 1, 2017. Article 1, paragraphs 152 through 159 of the law introduce a new tax regime for individuals who transfer their tax residence to Italy (the "New-Resident Regime"). This regime is meant to make the transfer of tax residence to Italy appealing and, in particular, to attract wealthy individuals and families. The Italian New-Resident Regime offers preferential tax treatment, which consists of a yearly lump-sum payment of €100,000 on any foreign income and gains, and exclusion from inheritance and gift tax on foreign assets, departing from ordinary treatment under Italian tax law.

The Italian tax authority (*Agenzia delle Entrate*) released Protocol No. 47060, the initial implementing rules, on March 8, 2017. Then, on May 23, 2017, it released Circular Letter No. 17/E (the "Circular"), which provides several clarifications and additional guidance for application of the regime.

WHO CAN APPLY?

The New-Resident Regime is reserved for individuals with citizenship abroad or in Italy who meet the following two conditions:

- They transfer tax residence to Italy.
- With regard to Italy, they have had nonresident status for tax purposes for nine out of the ten preceding taxable years.

As general rule, individuals are deemed to be resident in Italy if they meet any of the following conditions on 183 days or more during the tax year (184 or more days in case of leap years):

- The individual is registered in the Civil Registry of the Resident Population.
- The individual is domiciled in Italy pursuant to the Italian Civil Code.
- The individual is resident in Italy pursuant to the Italian Civil Code.

In order to prevent an abusive exercise of the election, the *Agenzia delle Entrate* has published a checklist to identify a series of factual circumstances that may be indicative of tax residence in Italy based on the individual's center of vital interests. Among the factors to be considered are the tax residence of a spouse or children in Italy and the availability of movable and real property assets in Italy. In addition, individuals who have never withdrawn themselves from the Italian Civil Registry of the Resident Population cannot apply for the regime.

When the two requirements are met, an individual may apply for the benefits of the New-Resident Regime and take steps to become registered in the Civil Registry of the Resident Population. According to the Circular, enrollment in the Civil Registry of the Resident Population is sufficient to qualify for benefits, although appropriate verification procedures may be carried out to prevent abuse.

Protocol No. 47060 clarifies that the regime is also available from 2017 for those who transferred their tax residence to Italy in 2016, provided that the nine-year residency requirement is met.

THE NEW-RESIDENT REGIME

Beginning with the 2017 fiscal year, the New-Resident Regime provides for lump-sum taxation of €100,000 per year on non-Italian-source income and gains. This payment is in lieu of the tax that would be applied ordinarily. Such income and gains are not subject to any additional income taxation, even if remitted to Italy. However, all Italian-source income and gains remain subject to ordinary tax rules under the Italian personal income tax regime.[1]

The New-Resident Regime can be extended to family members by paying an additional €25,000 per year, per relative. The family members who can benefit from the regime include spouses, sons and daughters (including sons-in-law and daughters-in-law), parents (including parents-in-law), and brothers and sisters. If the new resident does not have any sons or daughters, the direct closest descendants can benefit in their places. The New-Resident Regime may be extended to family members at different points in time. Consequently, each family member can access the regime at a later date if they remain resident abroad after Italian residence is established by the principal applicant.

The taxpayer may elect to apply the New-Resident Regime to income earned in all foreign countries or only selected countries ("cherry picking"). No tax credit is granted for taxes paid in countries for which the new resident has elected to be covered by the €100,000 Italian tax payment.

In general, income is deemed to be foreign sourced and is consequently covered by the lump-sum tax if any of the following conditions is met:

- The income is derived from assets located abroad.
- The income is derived from activities performed abroad.
- The payer is resident abroad.

In accordance with Italian law, certain foreign financial assets produce foreign income, even if they are held with Italian banks. Such foreign income is covered under the lump-sum tax. Consequently, a taxpayer utilizing the New-Resident Regime should advise the Italian bank of the election in order to avoid the application of domestic withholding tax to these financial assets. Where a bank has collected

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1 With reference only to Italian-source income and foreign income that is subject to Italian personal income tax ("I.R.P.E.F."), some deductions are granted (*e.g.*, for social security and welfare contributions, health care contributions (up to €3,615.20), and donations to certain qualifying religious organizations and universities).

withholding tax from income produced by these assets notwithstanding the income's foreign character, the withholding tax may be used to offset other Italian taxes pursuant to Article 17 of Legislative Decree no. 241 of 1997 or be recovered by submitting a claim for refund within the terms of Article 38 of D.P.R. n. 602 of 1973.

In some cases, the benefit of the New-Resident Regime is also granted to foreign-source income derived from assets held through a foreign or Italian subsidiary. In this regard, if the entity (*e.g.*, a trust, foundation, or company) is disregarded for Italian tax purposes, foreign income arising from the underlying assets is covered by the lump-sum tax. In comparison, if Italian movable or immovable assets are held through a foreign interposed entity, income arising from those assets is subject to ordinary Italian taxation.

Where an individual benefitting from the New-Resident Regime is a director in a company formed outside of Italy, the Circular clarifies that such entities are not considered to be tax resident in Italy, provided that a majority of the board of directors are not Italian resident individuals who do not benefit from the New-Resident Regime. Moreover, the Italian Controlled Foreign Companies rules do not apply to non-Italian-resident companies held by individuals benefitting from the New-Resident Regime unless the direct shareholder of the nonresident company is itself an Italian company.

In order to prevent abusive situations, the exercise of the election will not prevent the imposition of capital gains tax on foreign substantial participations ("Qualified Participations") generated in the first five years of residence under the New-Resident Regime. During that period, the gains will be subject to ordinary taxation in Italy. Pursuant to Italian law, a shareholding is a Qualified Participation when the shares meet either of the following thresholds:

- The shareholding represents a percentage of voting rights in the company's ordinary shareholders' meeting that exceeds 2% for listed shares or 20% for unlisted shares.
- The shareholding represents a participation in the share capital exceeding 5% for listed shares or 25% for unlisted shares.

Thus, if capital gains are derived on Qualified Participations during the first five years of Italian tax residence under the New-Resident Regime, the ordinary I.R.P.E.F. regime and a tax rate of roughly 25% will be applicable. However, a step up in basis is regularly available for Qualified Participations in unlisted companies provided that a charge is paid based on the fair market value of the company. Through June 30, 2017, the charge was imposed at the rate of 8%.

The five-year period starts from the first tax period of Italian tax residence. As such, if an individual transfers his or her tax residence during the 2017 fiscal year and applies for the New-Resident Regime from 2018, capital gains arising from the disposal of foreign qualified shareholdings will be out of the scope of the substitute tax through the close of the 2021 tax year.

The value of the Qualified Participation must be reported on Form RW of the Italian tax return during the first five years of Italian residence. For disposals within the initial five-year period, capital gain is calculated as follows:

- If, upon a move to Italy, the former country of residence imposed a departure tax, the value used by that country to compute taxable gain becomes the tax basis for Italian tax purposes. In all events, the basis is capped at the fair market value of such shareholdings, as determined under principles of Italian tax law.

- If, upon a move to Italy, the former country of residence did not impose a departure tax, the tax basis for Italian tax purposes is the original purchase price.

Aside from Qualified Participations, the New-Resident Regime grants exemption from the following aspects of Italian tax law:

- Reporting obligations in relation to foreign assets (Form RW)
- Payment of wealth taxes on real estate properties and financial assets held abroad (respectively, I.V.I.E. and I.V.A.F.E.)
- Inheritance and gift tax on rights and assets held abroad

Italian tax residents are normally liable for gift tax and inheritance tax on transfers of assets by way of gift or at the time of death, whether the asset is located in Italy or abroad. In cases of foreign donors or deceased residents, the foreign assets are out of the scope of Italian gift tax or inheritance tax with regard to assets located abroad. Individuals who elect to be taxed under the New-Resident Regime, and the family members who accompany them in benefitting from the New-Resident Regime, will be exempt from gift tax and inheritance tax on transfers of assets located outside Italy regardless of the residence of the recipient or heirs. No cap is placed on this benefit. In comparison to this favorable treatment, "non-donor" acts (*liberalità indirette*) and deeds establishing restrictions on use (*atti di costituzione di vincoli di destinazione*) of property located in Italy will be subject to gift tax.

As mentioned above, an individual may elect out of the New-Resident Regime on a cherry-picking basis. This may allow the individual to benefit from certain tax treaties that might not otherwise apply to Italian residents benefitting from the New-Resident Regime. Where an individual opts out with regard to a country, Form RW must be filed and wealth taxes (*i.e.*, I.V.I.E. and I.V.A.F.E.) must be paid with respect to assets held in that country.

Individuals benefitting from the New-Resident Regime can add additional "excluded States" each year. However, once a jurisdiction has been excluded, it cannot be covered by the substitute tax in the following tax periods. The Circular also clarifies that where the individual has opted out of the New-Resident Regime with regard to income and gains realized in one or more foreign countries, the election is extended to inheritance and gift tax, also.

PROCEDURE AND TIMEFRAME

The election for the New-Resident Regime must be made on the personal income tax return related to either the tax period in which the individual transferred residence to Italy or the following tax year.

It is possible to obtain prior approval from the *Agenzia delle Entrate* by filing a ruling (a so-called *interpello*), although the request for a ruling is not mandatory. The ruling can be filed even if the taxpayer has not yet transferred tax residence in Italy. In this case, the taxpayer must also submit a "checklist," which contains several questions related to the personal, social, and economic situation of the taxpayer and the taxpayer's family. The checklist published by the *Agenzia delle Entrate* is intended to identify factual circumstances that may indicate the absence of tax residence in Italy in nine of the ten years preceding the exercise of the election. If the taxpayer decides to exercise the option without filing a ruling request, the information requested in the checklist must be included on the Italian tax return in which the option is exercised.

"The lump-sum tax must be remitted in a single payment, due by June 30, each year and cannot be deducted from other taxes."

A response to a ruling request must be issued within 120 days, which can be extended by an additional 60 days under certain conditions. If the *Agenzia delle Entrate* does not reply within the above deadline, a positive reply is deemed to have been issued.

The taxpayer must indicate in the ruling request, or in the Italian tax return where the option is exercised, the jurisdiction or jurisdictions where residence was maintained prior to acquiring Italian residence. The *Agenzia delle Entrate* will exchange information with the tax authority of each such jurisdiction.

Once the New-Resident Regime is elected, special tax treatment is allowed for up to 15 years. During this period, entitlement to benefits is automatically renewed annually, unless an early withdrawal or reason for loss of entitlement occurs. The New-Resident Regime ceases to apply in the case of omitted or partial payment of the substitute tax or in the case of a transfer of tax residence to another country. In addition, the taxpayer, or accompanying family member, may revoke the election at any time. In any event, if the principal taxpayer withdraws from the New-Resident Regime, withdrawal will apply to the accompanying family. However, a family member to whom the regime has been extended can exercise an option to remain subject to the New-Resident Regime for the remaining tax period. In any event, if the principal taxpayer revokes the election or loses status under the New-Resident Regime, or if a family member opts in and then opts out of continued status under the New-Resident Regime, the loss of status is final and cannot be reversed.

The lump-sum tax must be remitted in a single payment, due by June 30, each year and cannot be deducted from other taxes. The New-Resident Regime cannot be combined with other tax relief related to the transfer of residence to Italy.

TAX TREATY RELIEF

When making an election for coverage by the New-Resident Regime, it is important to gage the effect of the election on treaty benefits with regard to income from sources outside Italy as well as capital, gifts, and inheritances involving property located outside of Italy.

The Circular clarifies that individuals benefitting from the New-Resident Regime are considered as Italian resident for the purposes of the double tax treaties entered into by Italy, since such individuals are taxed in Italy on their worldwide income and foreign income is subject to the lump sum substitute tax. Nonetheless, it is the view of the tax authorities in countries other than Italy that could be problematic. Consequently, entitlement to benefits from double tax treaties should be verified on a case-by-case basis.

In broad terms, the O.E.C.D.'s Model Tax Convention on Income and on Capital (the "Convention") defines the term "resident of a contracting state" as any person who, under the law of that state, is liable to taxation therein by reason of their domicile, residence, place of management, or any other similar criterion. However, some treaties contain a specific "subject to tax" condition that must be met for someone to be considered a resident of a contracting state. For example, the double tax treaty between Switzerland and Italy establishes that an individual will be deemed not to be resident in either country if the individual is not subject to the taxes generally levied on all the income in the state of purported residence.

With respect to inheritance in Italy, double tax treaties exist with the following countries: the U.S., Sweden, Greece, the U.K., Denmark, Israel, and France. Notably, only the treaty stipulated with France concerns both inheritance and gift taxes. Focusing on the double tax treaty between Italy and France, Article 4 states that the term "person domiciled in a contracting state" does not include persons whose inheritance or donation is subject to tax in a state only for the properties which are situated therein. Thus, an individual who elects to apply the New-Resident Regime, generally speaking, is not considered a resident for the purpose of this treaty.

NEW INVESTOR VISA

The new flat-tax regime is accompanied by changes to Italian immigration laws designed to make it possible for individuals who are not nationals of an E.U. Member State to avoid restrictions that usually apply to the acquisition of Italian residence. Article 1, paragraph 148 of the 2017 Budget Law introduced a special two-year "visa for investors" regime, which aims to attract foreign investors and high-net-worth individuals to Italy.

The newly introduced investor visa is for foreign investors who intend to meet one of the following thresholds:

- The individual will invest at least €2 million in bonds issued by the Italian government, and maintain that investment for at least two years.
- The individual will invest at least €1 million in an Italian company, or €500,000 in an "innovative start-up" Italian company, registered with the special section of the Italian Chamber of Commerce, and maintain that investment for at least two years.
- The individual will make a philanthropic donation of at least €1 million in support of an Italian project of public interest in the field of culture, education, immigration, or scientific research.

To request and obtain the investor visa, foreign investors must (i) demonstrate beneficial ownership of the sufficient liquid sums that can be readily transferred to Italy, (ii) submit a written statement committing to make the investment or gift within three months of entering Italy, and (iii) demonstrate expected income of an amount higher than the minimum level for the exemption from healthcare contributions (*i.e.*, €8,500).

The exact application procedure for the investor visa is yet to be determined. The Italian Ministry of Economic Development, Ministry of Internal Affairs, and Ministry of Foreign Affairs and International Cooperation will issue a joint decree setting out the procedure and appointing the authority responsible for processing the application and issuing the clearance to authorize the consulate to release the visa. It is likely that the individual will be expected to submit the required documentation through a web platform. The Financial Intelligence Unit will be tasked to ascertain the lawful source of an applicant's funds. Finally, an applicant will likely be required to (i) present a copy of a passport or travel document with an expiry date that exceeds the required visa by a minimum of three months, (ii) provide proof of financial resources, (iii) provide self-certification of the legitimacy of the source of funds, and (iv) provide a clear and detailed description of the investment and its intended beneficiary.

If approved, the designated authority will send clearance to the relevant diplomatic or consular representative, who will issue the investor visa. As indicated above, the investor visa will grant the right to a two-year residence permit, which can be extended for an additional three-year period. In any event, the visa is revocable if a donation is not made within three months of the date of entering Italy or if an investment is disposed of before the two-year expiry date of the visa. After legally staying in Italy for five years, a foreign national can apply for permanent residency, provided the eligibility requirements have been met. Family members will also be allowed to join the foreign investor in Italy and receive a stay permit for family reasons.

Finally, it should be noted that specific criminal penalties are to be applied in the case of providing false documents or untrue certification regarding the lawful source of funds.

PANCAKE DAY – END TO PERMANENT NON-DOMICILE STATUS AND CHARGING NON-DOMS I.H.T. ON U.K. RESIDENTIAL PROPERTY[1]

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In Sweden, it is traditional on Thursdays to lunch on a split pea soup followed by pancakes, jam, and cream. Before the Reformation, when Sweden was a Catholic country, it answered the need for a hearty meal before Friday fasting.

In Westminster Hall on Tuesday July 11 Peter Dowd, the Shadow Chief Secretary, was hungry. "Why are we waiting for the Finance Bill?" he asked. "We have waited and waited for the Finance Bill. I hope we get it this side of Christmas—we might get it next Pancake Thursday."

On Thursday July 13, the U.K. government came with pancakes and there was jam and cream. In written statements to both Houses of Parliament ministers confirmed that a Finance Bill will be introduced as soon as possible after the summer recess and that provisions previously announced, which were intended to take effect from April 2017, will take effect from that date. H.M. Treasury and H.M. Revenue and Customs then followed by publishing updated draft provisions for the second 2017 Finance Bill.

Hopefully the government will find an opportunity to get the bill to the floor of the House of Commons in September. At Question Time on Tuesday July 18, the Chancellor of the Exchequer and other ministers at the Treasury answered questions addressed to the Chancellor by members of the House of Commons. One, in reference to non-domiciled ("Non-Dom") status and offshore trusts, drew a response from the Financial Secretary to the Treasury Mel Stride, who confirmed that it is the government's intention to "legislate further, making it harder for non *doms* to avoid tax on funds withdrawn from trusts." Otherwise, nothing was said to add to the prior week's written statements.

The written statement to the House of Commons on July 13 was delivered by Mel Stride. He reminded the House that at the point at which a number of changes to the tax legislation were withdrawn from the Finance Bill introduced in March 2017, including changes to the tax treatment of the non-domiciled, his predecessor had stated that there was no policy change.

The statement to the House of Commons reads:

> Where policies have been announced as applying from the start of the 2017-18 tax year or other point before the introduction of the forthcoming Finance Bill, there is no change of policy and these dates of application will be retained. Those affected by the provisions should continue to assume that they will apply as originally announced.

[1] The author would like to acknowledge the contributions of James Badcock and Peter Daniel, also of Collyer Bristow LLP, in the preparation of this section.

> The Finance Bill to be introduced will legislate for policies that have already been announced. In the case of some provisions that will apply from a time before the Bill is introduced, technical adjustments and additions to the versions contained in the March Bill will be made on introduction to ensure that they function as intended. To maximise certainty about the exact provisions that will apply, the Government is today publishing updated draft provisions.[2]

Two of the supporting documents for the second 2017 Finance Bill relate to the end to the permanent Non-Dom status and charging Non-Doms inheritance tax ("I.H.T.") on U.K. residential property and can be found here.

The policy paper "Deemed Domicile: Income Tax and Capital Gains Tax - Updated Legislation," published on July 13, 2017, introduces the new rules for deeming individuals domiciled in the U.K. for tax purposes from April 2017.

The policy paper "Inheritance Tax on Overseas Property Representing UK Residential Property – Updated Legislation" introduces the new rules to ensure that individuals deemed domiciled under the new deeming provisions will be subject to I.H.T. on their worldwide income and gains.

The news story that the government will legislate for all policies that were included in the pre-election Finance Bill had been already foreshadowed in the background briefing notes published by Cabinet Office and the Prime Minister's Office on the occasion of the opening of Parliament on Wednesday June 21, 2017. The government said at the time that it intended that all those policies originally announced to start from April 2017 would be effective from that date. The justification for this was that the bill would implement budget decisions: The Queen's speech and background notes can be found here.

On Friday July 14, the government published a list of provisions that those affected "should continue to assume that they will apply as originally announced" – the list can be found here.

The budget decisions to which the briefing notes refer are the budget resolutions that were passed by the House of Commons at the close of the Spring Budget 2017 debate "on all of which a Bill is to be brought in." However, the motions passed related to the provisions contained in the first 2017 Finance Bill, then printed and introduced into Parliament, which only had legal effect insofar as they were brought in by the Finance Act 2017.

In the April wash up negotiations between the government and the opposition, the government agreed to drop the deemed domicile changes. Consequently, a motion from the chair that those provisions be given up was carried by the House of Commons on April 25 at the Third Reading of the Bill. The effect of that, and subsequently the dissolution of Parliament on May 3, is that the budget resolution decisions that had not been brought into law lapsed. In summary, the spring budget decisions announced by the government and accepted by the last Parliament were enacted by the first Finance Act 2017. Similarly, those rejected will be implemented by this Parliament, just as if they had been accepted by the previous one.

It has been said that:

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[2] U.K. Parliament, "Finance Bill: Written Statement," July 13, 2017, HCWS47.

> The rule of law stands for the view that decisions should be made by the application of known principles or laws. In general such decisions will be predictable, and the citizen will know where he is. On the other hand there is what is arbitrary. A decision made without principle, without any rules. It is therefore unpredictable, the antithesis of a decision taken in accordance with the rule law.[3]

It has also been said that:

> Whatever one thinks of this practice of backdating Budget legislation, one must concede that it does not drastically upset expectations. The law is merely enacted as was promised by prior public announcement, with effect from that date and no earlier. What is of more concern is legislation made retroactive prior to the announcement date, such that it could not have been expected, let alone acted upon, by the taxpaying public.[4]

In March 2002, then Solicitor-General Harriet Harman described the approach taken by the government of the time to retrospective legislation:

> The Government's policy before introducing a legislative provision having retrospective effect is to balance the conflicting public interests and to consider whether the general public interest in the law not being changed retrospectively may be outweighed by any competing public interest. In making this assessment the Government will have regard to relevant international standards including those of the European Convention for the Protection of Human Rights and Fundamental Freedoms which was incorporated into United Kingdom law by the Human Rights Act 1998.

Each year, at the Second Reading, the Chancellor of the Exchequer states under section 19(1)(a) of the Human Rights Act 1998, that in his view the provisions of the Finance Bill are compatible with the convention rights.

The government would presumably argue that it is in the public interest to have tax policy for the year implemented in line with the expectations at the time of the budget and that the taxpayer had due warning of this. Indeed many taxpayers will have arranged their affairs according to what was previously announced. If changes are only implemented from some future date, such as April 2018, these taxpayers may be disadvantaged. On the other hand, taxpayers will suffer tax that they would not have suffered if the changes were not introduced retrospectively. One might question whether the estates of individuals who died between April 6 and July 13 should be chargeable to I.H.T. on assets that were not chargeable to tax when they died.

Parliament rose for the summer recess on Thursday July 20. The Houses do not return again until September 5. Parliament will then rise again for the conference recess on September 14 before returning on October 9. If the bill is not debated before October, it seems unlikely that it will reach the statute book long before the end of November.

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3 Geoffrey Marshall, "The Franks Committee: Report on Administrative Tribunals and Enquiries," (1957) 35 *Public Administration*.

4 Geoffrey T. Loomer, "Taxing Out of Time: Parliamentary Supremacy and Retroactive Tax Legislation," *British Tax Review* 1 (2006).

It is now two years since the release of Summer Budget 2015[5] and the announcement of a change of policy in the fiscal treatment of those not U.K. domiciled. A change that was intended to create a fairer system while protecting the ability of the U.K. to continue to attract individuals to come to the U.K. and invest. What message does it send abroad about our constitutional principles that Parliament will be debating in September or October whether estates for which I.H.T. accounts were returned in April should be posthumously taxed?

The government's need to make the legislation retrospective (to the time of a previous parliament) typifies the wholly unsatisfactory way in which these changes to the taxation of Non-Dom individuals have been introduced – a manner that has been hugely damaging to the U.K.'s reputation for stability and reliability.

So, what's not to like? Too little jam and too little cream.

"So, what's not to like? Too little jam and too little cream."

[5] Summer Budget 2015 can he found here.

HIGH-SPEED TAX REFORM: THE U.K. DIVERTED PROFITS TAX & RESTRICTIONS ON CORPORATE INTEREST DEDUCTIONS

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INTRODUCTION

Over the past 24 months, the U.K. has seen significant changes to its corporate tax system. Two of the most notable changes concern the introduction of the new diverted profits tax ("D.P.T.") and restrictions to the U.K.'s previously generous tax relief for corporate interest payments.

The speed at which the U.K. has introduced these wide-sweeping changes is unprecedented – D.P.T. was first announced in November 2014 and came into force on April 1, 2015 – and is driven by the U.K. government's desire to combat unacceptable tax avoidance. This desire has been influenced by political pressure within the U.K. and from the international community.

The international focus on preventing corporate tax avoidance has been seen most notably through the O.E.C.D.'s Base Erosion and Profit Shifting Project (the "B.E.P.S. Project"). The B.E.P.S. Project aims to combat the artificial shifting of profits within a multinational group from high-tax jurisdictions to low-tax jurisdictions and the exploitation of mismatches between different tax systems that result in little or no tax being paid on a global basis.

Following international recognition that the global tax system requires a complete overhaul in order to prevent B.E.P.S., the G-20 asked the O.E.C.D. to recommend possible solutions. In July 2013, the O.E.C.D. published an action plan proposing 15 actions designed to combat B.E.P.S. at an international level, which included recommendations to restrict tax relief on corporate interest payments.

This article briefly considers both D.P.T. and the new restrictions on U.K. tax relief for corporate interest payments.

DIVERTED PROFITS TAX

D.P.T. is a U.K. tax aimed at multinationals operating in the U.K. that artificially syphon profits out of the U.K. or try to avoid maintaining a taxable establishment by playing the complexities of the global tax system. It is primarily an anti-avoidance measure and was introduced in the Finance Act 2015.

It will be of particular interest to non-U.K. taxpayers because the usual double tax treaty relief provisions, which one would expect to override D.P.T. and take taxpayers outside the charge, do not apply. The U.K.'s revenue service, HM Revenue & Customs ("H.M.R.C."), takes the view that since D.P.T. is not income tax or corporation tax, it does not fall within the ambit of any of the U.K.'s current treaties. Some U.K. advisers to multinational groups expect that as individual treaties are updated, treaty partner jurisdictions will insist that the U.K. extend treaty protection to D.P.T. Others are more skeptical, believing that the B.E.P.S. Project changed the expectations regarding the purpose of an income tax treaty. Preventing double non-taxation is now as important as preventing double taxation. In any event, treaty renegotiation is a process that will take years to come to fruition. Consequently, the intention of H.M.R.C. is that multinationals that do not have a U.K. permanent establishment ("P.E.") under a treaty are subject to U.K. tax as a measure to prevent unacceptable tax planning.

The current rate of D.P.T. is 25% of the diverted profit. D.P.T. is charged at a rate of 55% on ring-fenced diverted profits and ring-fenced notional profits in the oil sector. Given that the rate of U.K. corporation tax is currently 19% (and set to be reduced further to 17% from April 1, 2020), it is expected that companies affected by D.P.T. will seek to restructure operations so as to derive profits in the U.K.

When Does D.P.T. Apply?

D.P.T. applies to diverted profits arising on or after April 1, 2015. Apportionment rules are provided for accounting periods that straddle that date.

Broadly, D.P.T. applies in two circumstances:

- A group has a U.K. subsidiary or P.E. and there are arrangements between connected parties that "lack economic substance" in order to exploit tax mismatches. (One example of this would be if profits are taken out of a U.K. subsidiary by way of a large tax-deductible payment to an associated entity that is located in a tax haven and lacks the capability to perform an actual function that justifies the payment.)
- A non-U.K. trading company carries on activity in the U.K. in connection with supplies of goods, services, or other property. The activity is designed to ensure that the non-U.K. company does not create a P.E. in the U.K. and either (i) the main purpose of the arrangement is to avoid U.K. tax or (ii) a tax mismatch is secured such that the total profit derived from U.K. activities is significantly reduced. (This is referred to as the "avoidance of a U.K. taxable presence.")

Generally, in practice, D.P.T. should not apply to small- and medium-sized companies ("S.M.E.'s"). If a company has less than 250 employees and either its turnover is no more than €50 million or its assets are no more than €43 million, it should qualify as an S.M.E. However, when calculating whether a company is an S.M.E., it may be necessary to aggregate the number of employees and turnover/assets of certain linked companies.

Companies or P.E.'s Lacking Economic Substance

Where companies or P.E.'s lack economic substance, there are two tests that must be considered:

- The insufficient economic substance condition
- The effective tax mismatch condition

If either test is met, a D.P.T. charge will be payable.

“Where a transaction has been designed to ensure the avoidance of a U.K. taxable presence, a D.P.T. charge may arise.”

The insufficient economic substance condition will apply where (i) the tax benefit of the transaction is greater than any other financial benefit and (ii) it is reasonable to assume that the transactions were designed to secure the tax reduction.

Alternatively, it will apply where (i) a person is a party to one or more of the transactions, (ii) the contribution of economic value by that person is less than the tax benefit, and (iii) it is reasonable to assume that the person’s involvement was designed to secure the tax reduction. Broadly, this condition will not be met if there are real people engaged in activities that perform a real function that justifies the financial benefit.

There will be an effective tax mismatch if the transaction gives rise to a tax reduction for one party and the tax payable by the other party is less than 80% of the tax reduction obtained by the first party. There is an exemption for tax reductions arising solely from payments to registered pension schemes, charities, and persons with sovereign immunity, and payments to certain offshore funds or authorized investment funds.

Avoidance of a U.K. Taxable Presence

Broadly, where a transaction has been designed to ensure the avoidance of a U.K. taxable presence, a D.P.T. charge may arise where either (i) both the insufficient economic substance condition and the effective tax mismatch condition are satisfied or (ii) the tax avoidance condition is satisfied.

The tax avoidance condition will apply if arrangements are in place in connection with supplies of goods or services in the U.K. and the main purpose, or one of the main purposes, of the structure is the avoidance or reduction of a U.K. corporation tax charge.

Avoidance of a U.K. taxable presence does not exist if the U.K. activity is undertaken by someone acting as an agent of independent status or for the purposes of alternative finance arrangements.

There are also specific exceptions from a D.P.T. charge if, in a 12-month accounting period, U.K.-related sales are below £10 million or U.K.-related expenses are below £1 million.

Calculation of the D.P.T. Charge

Calculating the D.P.T. charge is complex, and various rules must be considered. Broadly, it will be necessary to consider profits that would have arisen if the company had made a full transfer pricing adjustment. It will also be necessary to determine the amount of profit that would have arisen from an alternative transaction that would have reasonably taken place if a tax reduction had not been relevant to the parties.

H.M.R.C. has stated that no taxable diverted profits should arise if, in the relevant transactions, the company made transfer pricing adjustments that put it in the same tax position as if arm’s length pricing had been used.

The main difficulty when calculating D.P.T. is likely to be the assumption that it is relatively easy to determine an appropriate alternative transaction that would have reasonably taken place if a tax reduction had not been relevant.

What Happens if D.P.T. Applies?

Notification

D.P.T. has its own specific rules for assessment and payment. D.P.T. is not self-assessed; rather, companies must notify H.M.R.C. if they are potentially within the scope of D.P.T. and do not satisfy any of the exemptions. Usually, this notification must be given within three months after the end of the company's accounting period.

Preliminary Notice

Following notification, if H.M.R.C. believes that a company may be liable for D.P.T., it will issue a preliminary notice to the U.K. company or P.E. This notice must outline the grounds on which H.M.R.C considers D.P.T. to be payable and calculate D.P.T. based on certain simplified assumptions. H.M.R.C. is also entitled to disallow up to 30% of the relevant tax-deductible expenses of the company, where it finds that these expenses are higher than they would have been if the transaction had been carried out on arm's length terms.

H.M.R.C. must issue a preliminary notice within two years of the end of the accounting period in which the D.P.T. charge arose. A company or P.E. has 30 days to contact H.M.R.C. to correct obvious errors in the notice, which might include arithmetical errors or errors regarding the company's status as an S.M.E. However, there is no right to appeal the preliminary notice.

The test for whether a D.P.T. charge applies relies heavily on questions of fact. Therefore, it is vital that taxpayers engage with H.M.R.C in the period after making a notification of potential chargeability, during which H.M.R.C will consider whether to issue a preliminary notice.

Charging Notice

Within 30 days of receiving any representations, H.M.R.C must either issue a charging notice stating the amount of D.P.T. payable by the U.K. company or P.E., or notify the recipient that no D.P.T. is payable. The recipient then has 30 days from receipt of the charging notice to pay any D.P.T. due. There is no right to appeal the preliminary notice or charging notice prior to payment, and there are no grounds for delaying payment.

Appeals

Following payment, H.M.R.C. has 12 months to review the charge to D.P.T. During this time, the charge may be reduced or increased. The company or P.E. can appeal a D.P.T. charge only after the 12-month review period has ended. An appeal is heard by the Tax Tribunal. If no appeal is made, the D.P.T. charge becomes final.

The fact that there is no right of appeal until 12 months after payment of any D.P.T. charge will mean that companies that are ultimately successful on appeal will suffer a significant cash flow disadvantage.

Clearances

There is no formal clearance procedure for D.P.T., although it may be possible to obtain a written opinion from H.M.R.C. on the likelihood a D.P.T. notice will be issued.

However, H.M.R.C. has cautioned that it will not be able to provide a view on whether transactions are likely to fall within the scope of D.P.T. in every case where an opinion is sought.

Expected Impact of D.P.T.

Although originally flagged to the market as a pure anti-avoidance measure that would be used only in exceptional cases of egregious tax planning, D.P.T. is expected to have a significant impact on multinationals and how they structure their businesses. In September 2016, H.M.R.C announced that it had identified almost 100 multinationals as being potentially within the scope of the new tax and was expecting many of them to dispute the charge.

Indeed, in November 2016, H.M.R.C. released figures showing that the amount of U.K. tax potentially underpaid by big businesses due to shifting profits to other jurisdictions has increased by 60% in the last year, to £3.8 billion.

This substantial increase suggests that H.M.R.C has opened a significant number of new inquiries over the last 24 months, focusing on intra-group, cross-border transactions. It has been suggested that D.P.T. could be one of the factors driving the increased amount of tax under consideration by H.M.R.C., and it is certainly the case that a threat of a D.P.T. charge is being used by H.M.R.C. as a weapon in transfer pricing disputes to force taxpayers to re-allocate taxable profit to the U.K.

It is clear that the scope of D.P.T. is wide and that extensive resources are being given to H.M.R.C to assess D.P.T. issues. Multinationals operating in the U.K. should expect H.M.R.C. to explore in depth whether a D.P.T. charging notice should be issued. Since the conditions for D.P.T. rely heavily on questions of fact, it is vital that companies engage in full fact finding and present evidence to H.M.R.C in as cogent a way as possible to support their arguments. It is also essential that companies have proper transfer pricing benchmarking measures both in place and appropriately evidenced, since this is a key way of avoiding a D.P.T. charge.

RESTRICTIONS TO CORPORATE INTEREST EXPENSE DEDUCTIONS

On April 1, 2017, the U.K. government introduced new rules restricting tax deductions for corporate interest payments. The draft legislation for inclusion in Finance Bill 2017 was published in full on March 20, 2017. However, following the U.K. prime minister’s decision to hold a general election on June 8, 2017, the draft provisions for the new rules were removed from the Finance Act 2017, which received royal assent (thereby becoming law) on April 27, 2017.

At the time of writing, it is uncertain whether the draft legislation will be enacted in a second finance bill this year and will still have effect from April 1, 2017. Depending on the outcome of the general election, it is possible that the draft legislation could be included as part of a second Finance Bill in summer 2017, or its enactment could be deferred further. Although such things are never certain, irrespective of the outcome of the general election, it is probable that the legislation will eventually be enacted in something like its current form, since it is rare for a measure so far advanced (and so lucrative for the U.K.’s Treasury) to be abandoned.

Previous U.K. Interest Deductibility Rules

Prior to April 1, 2017, the U.K. had generous rules in relation to tax relief on corporate interest payments. Generally, interest paid on debt financing was deductible from a company's U.K. corporation tax profits and therefore a company's liability to U.K. corporation tax was reduced.

In theory, interest payments could be used to reduce U.K. corporation tax payments. This form of tax relief was often invaluable, particularly to those corporations operating in the energy, real estate, and infrastructure sectors, which are heavily reliant on debt financing when embarking on new projects.

A range of anti-avoidance provisions existed to restrict excessive interest deductions, although there was no general limitation rule. Nevertheless, there was concern that the U.K.'s generous rules were open to abuse. For example, it was often cited that the U.K. interest deductibility rules enabled multinationals to load up U.K. companies with high levels of debt to reduce taxable profits, whilst shifting business profits to lower-tax jurisdictions that are tax havens.

"Under the new U.K. rules, tax relief for interest and certain other financing costs will be limited to 30% of tax-E.B.I.T.D.A."

However, given that the U.K. has extensive anti-avoidance rules to prevent such abuse, these concerns did not really carry any weight until the advent of the B.E.P.S. Project, which was the main driver for change.

Background to the New Rules – the B.E.P.S. Project

In July 2013, when the O.E.C.D. published its plan proposing 15 actions designed to combat B.E.P.S., Action 4 focused on limiting B.E.P.S. via interest deductions and, specifically, whether a general rule should be introduced to restrict the availability of tax relief on interest payments, regardless of the purpose of the debt or the party it is with.

In October 2015, the O.E.C.D. published its final recommendations in relation to Action 4. It recommended the introduction of a general interest limitation rule that should operate by restricting interest deductions by reference to a fixed ratio of a company's earnings before interest, taxes, depreciation, and amortization ("E.B.I.T.D.A."). The O.E.C.D. did not specify the level of this ratio; rather, it advocated that countries should choose an E.B.I.T.D.A. ratio of between 10% and 30%.

The O.E.C.D. recommended that there should be an optional exclusion for interest on loans used to fund public benefit projects. The rationale for this is that certain public benefit projects are considered to have a low tax avoidance risk.

The O.E.C.D. also recommended introducing several safeguards to address any potential volatility that the rule may create. These included a *de minimis* threshold for low risk entities and carry forward provisions, whereby disallowed interest deductions can be carried forward and deducted in a future accounting period.

The O.E.C.D. also suggested that jurisdictions should consider introducing suitable transitional rules, particularly to enable existing third-party debt to be excluded or "grandfathered" from the ambit of the new restrictions.

Overview of the New U.K. Rules

Under the new U.K. rules, tax relief for interest and certain other financing costs will be limited to 30% of tax-E.B.I.T.D.A., which will broadly be profits chargeable to corporation tax, excluding interest, increased by (i) tax depreciation such as capital allowances, (ii) tax amortization and relief for losses brought forward or carried back, and (iii) group relief claimed or surrendered.

When applying the rule, groups will generally need to work out the tax-E.B.I.T.D.A. of each U.K.-resident member company and each U.K. P.E., and add them together. The limit on deductible interest will be 30% of that figure.

There will be a *de minimis* allowance of £2 million per annum, which means that groups with a net interest expense below this threshold will be unaffected by the fixed ratio rule.

A company will be able to carry-forward *indefinitely* interest expenses that have been restricted under the rule. The interest carried forward may then be treated as a deductible interest expense in a subsequent period if there is sufficient interest capacity in that period. Additionally, if a group has spare interest capacity for an accounting period it will be able to carry this forward and use it as additional interest capacity in subsequent periods, although it will expire after five years.

The new restrictions will apply to interest on existing loans as well as new loans, although limited grandfathering will be available in certain circumstances (see below).

Group Ratio Rule

The new rules will include a group ratio rule ("G.R.R."), based on the net interest to group E.B.I.T.D.A. ratio for the worldwide group, and will allow deductions up to the net interest to group E.B.I.T.D.A. ratio for the worldwide group if this exceeds the fixed ratio. This is intended to help groups with high external gearing for genuine commercial purposes, by substituting the G.R.R. for the fixed ratio rule if it produces a better result for the group.

The G.R.R. will be calculated by dividing the net *qualifying* group interest expense by the group E.B.I.T.D.A. When calculating the G.R.R., whilst net interest is essentially calculated in the same way as for the fixed ratio rule, the worldwide group-E.B.I.T.D.A. is an accounting measure – it broadly equals the consolidated profit before tax of the worldwide group, adjusted for depreciation and net interest.

The G.R.R. will be used as an alternative to the 30% fixed ratio rule. The amount of deductions available under the G.R.R. will be capped at 100% of tax-E.B.I.T.D.A.

Interest on related-party loans, perpetual loans, and result-dependent loans will not be included in the calculation of the G.R.R.

Earlier drafts of the legislation provided that a third-party loan guaranteed by a related party would constitute related-party debt, which would have resulted in many commercial loans being ineligible to be used as part of the G.R.R. However, following extensive lobbying from industry, the draft legislation has been revised and now provides that a loan will not be treated as having been made by related parties where (i) a guarantee is provided by a member of the debtor's group, (ii) financial assistance is only provided in relation to shares in the ultimate parent entity, or loans to a member of the group, or (iii) financial assistance is a non-financial guarantee. Limited grandfathering is also now available for guarantees provided prior to April 1, 2017.

Public Infrastructure Exemption

To maintain investment in the U.K.'s infrastructure sector, there will be an exclusion for interest paid on public infrastructure projects, known as the Public Infrastructure Exemption ("P.I.E."). Infrastructure projects tend to be highly geared, and their viability is often dependent on the availability of debt financing. Without a specific exclusion, many infrastructure projects would not get off the ground due to lack of affordable debt financing and difficulty raising equity finance.

The P.I.E. will only be available if an election is made and will only apply to companies where all, or significantly all, their income and assets relate to activities involving public infrastructure assets.

Meaning of Public Infrastructure Assets

For this purpose, public infrastructure assets will include the following assets:

- Tangible U.K. infrastructure assets that meet a "public benefit test"
- Buildings that are part of a U.K. property business and are let on a short-term basis to unrelated parties

The public infrastructure asset must also have, or be likely to have, an expected economic life of at least ten years and must be shown in a balance sheet of a member of the group that is fully taxed in the U.K.

An asset will meet the public benefit test if it is procured by a relevant public body (such as a government department, local authority, or health service body) or will be used in the course of an activity that is or could be regulated by an "infrastructure authority." This second leg of the definition should be wide enough to include projects relating to airports, ports, harbors, waste processing, energy, utilities, electric communications, telecoms, roads, and railways.

Companies will qualify for the exemption if they provide a public infrastructure asset or carry on activities that are ancillary to, or facilitate the provision of, a public infrastructure asset. The exemption will also apply to activities relating to the decommissioning of a public infrastructure asset.

Any building may be a "qualifying infrastructure asset" if it is part of a U.K. property business and intended to be let on a short-term basis to persons who are not related parties. "Short-term basis" means having an effective duration of less than 50 years and not being considered a structured finance arrangement. Buildings that are sublet are included in the definition.

Third-Party Debt Requirement

The P.I.E. will only apply to interest paid to third parties where the recourse of the creditor is limited to the income, assets, shares, or debt issued by a qualifying infrastructure company, which need not be the borrower.

Guarantees from parent companies or non-infrastructure companies within the group could prevent the exemption from applying. However, guarantees provided before April 1, 2017, and certain non-financial guarantees (relating to providing the services) will now be ignored.

Grandfathering Provisions

Originally, no grandfathering was proposed. However, there were significant concerns that grandfathering was required to prevent existing infrastructure projects from going into default, particularly those with shareholder debt, such as many existing P.F.I.-type projects, which may find it difficult to restructure. Examples include infrastructure projects involving U.K. schools and hospitals that are highly geared for genuine commercial reasons and where viability of a particular project is dependent on the tax deductibility of the project's interest expenses. These projects may have commenced ten years prior to enactment and may still have 20 or more years left to run – a restriction on tax relief could be catastrophic to the continued viability of such projects.

After much lobbying by industry, grandfathering was introduced for these projects. Although the new restrictions will apply to interest on existing loans, limited grandfathering will be available for infrastructure companies within the P.I.E. if the following conditions are satisfied:

- The loan relationships were entered into on or before May 12, 2016.
- At least 80% of the total value of the company's future qualifying infrastructure receipts for a period of at least ten years were highly predictable by reference to certain public contracts.

A transitional provision also applies in the first year to enable groups to restructure to fall within the P.I.E.

Administration of the New Rules

The new rules operate by assessing the level of interest in the worldwide group and therefore any restriction on the deductibility of interest cannot be processed through a company's normal U.K. corporation tax return. U.K. companies will now need to file a new interest restriction return.

The return contains basic information about the composition of the worldwide group, the key figures from the group interest level computation, and the allocations of any disallowances.

A short-form interest restriction return can be completed by companies claiming that the £2 million *de minimis* threshold applies. If a company elects to complete the short-form interest restriction return, it will not be able to use its interest allowance in a later period, although it will have 60 months to revoke its election and submit a full return.

Groups must appoint a reporting company to make the return. This is a company that is not dormant and was a U.K. group company or a group member subject to U.K. corporation tax for at least part of the relevant period to which the return relates.

Expected Impact of the New Interest Restriction

The exact impact of the new restrictions is not yet certain since the draft legislation, although far advanced, did not reach its final form at the time of the Finance Act 2017. However, multinationals can expect to undergo an extensive year-by-year compliance procedure to determine how much of the current U.K. interest deductions will become disallowable retroactively. A period of uncertainty will likely exist during which corporate restructuring of U.K. sub-group debt-to-equity ratios may take place as if the new rules will be applicable.

SUMMARY

Both D.P.T. and the new restrictions on corporate interest deductions could have a significant impact on the structuring of U.K. corporate transactions involving significant levels of debt financing and entities located in multiple jurisdictions. Although both measures are predominately aimed at preventing aggressive forms of tax avoidance, they will unwittingly affect genuine commercial transactions. As with much U.K. tax legislation, both sets of rules are very complicated and can be difficult to navigate. Therefore, U.K. tax advice should always be sought before trying to apply the rules.

"Multinationals can expect to undergo an extensive year-by-year compliance procedure."

NEW PROPOSAL FOR SWISS CORPORATE TAX REFORM

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Tags
Corporate Tax
Notional Interest Deduction
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INTRODUCTION

Following up on our recent article on Swiss corporate tax reform,[1] the Steering Committee representing the cantons and Swiss Federation issued its recommendation regarding the implementation of a modified corporate tax reform to the Swiss Federal Council on June 1, 2017. The corporate tax reform has been renamed the Tax Proposal ("T.P. 17") and is, in general, based on the Corporate Tax Reform III ("C.T.R. III"), which was rejected on February 12, 2017, by Swiss voters.

The Steering Committee met representatives of cities, municipalities, political parties, business associations, and labor unions in order to achieve a more balanced, transparent, and politically accepted corporate tax reform. Compared to the C.T.R. III, the package has been adjusted and now also includes a social component. As expected, the preferred tax regimes provided by Swiss law will be abolished and the main goals of the reform remain the same (*i.e.*, to maintain Switzerland as an attractive and competitive business and tax location, to be in line with international best practices, and to generate sustainable tax revenues). This article summarizes the most important differences between the C.T.R. III and T.P. 17.

PROPOSED ADJUSTMENTS

Notional Interest Deduction

While the C.T.R. III included a deemed interest deduction on excessive shareholder's equity – known as a notional interest deduction ("N.I.D.") – this measure is not included in the new proposal. Since this measure was one of the most debated items in the C.T.R. III, the exclusion was expected. Swiss finance branches (*i.e.*, branches of a foreign company providing finance services to group members) will face higher corporate income tax rates, since they will be subject to ordinary taxation on a cantonal/municipal level and no additional deduction for extra equity will be granted.

Patent Box

The introduction of a cantonal/municipal level intellectual property ("I.P.") or "Patent Box" regime, based on the O.E.C.D. nexus approach, is also included in the new proposal. Compared to the C.T.R. III the Patent Box will, however, not include patented software. Therefore, software companies will not be able to benefit fully from tax relief granted by the Patent Box regime.

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[1] See Peter von Burg and Natalie Peter, "Swiss Corporate Tax Reform Postponed," *Insights* 2 (2017).

Deduction for Research and Development

In addition to the Patent Box regime, the C.T.R. III provided for an optional deduction of 50% for research and development ("R&D") costs incurred in Switzerland. This optional deduction is included in the T.P. 17 as well. However, the Steering Committee emphasized that the deduction should be limited to personnel expenses. Fees to contract research organizations may not generate the enhanced tax benefit.

Introduction of an Overall Limitation of Tax Reduction at the Cantonal Level

The measures provided for by the C.T.R. III would have allowed for up to an 80% reduction of taxable profits at the cantonal/municipal level. However, the T.P. 17 has restricted the reduction. Provided a company will be able to benefit from multiple measures of the new proposal, the total reduction will be limited to 70%. Hence, such companies will face slightly higher corporate income tax rates.

Income Tax Rates

As under the C.T.R. III, it will still be at the discretion of the cantons to decrease cantonal/municipal corporate income tax rates. However, the minimum taxation of qualifying dividend income earned by individuals must be at least 70% under the T.P. 17, whereas under the C.T.R. III the minimum taxation was 60%. This increased taxation of dividend income earned by individuals will mainly impact owners of small- and medium-sized entities ("S.M.E.'s") and will lead to a slightly higher total income taxation.

Family Allowance

The minimum amount for the family allowance will be increased to CHF 230 for child allowance and CHF 280 for education allowance. Most of the cantons will need to raise payments to comply with the new minimum standards. This measure introduces a social component into the reform that was not part of C.T.R. III.

OUTLOOK

In general, the need for tax reform is undisputed, and it is expected that, following discussion by the Federal Council and the Swiss parliament, the above-mentioned proposals will be included in the final bill. As mentioned above, the removal of the N.I.D. should not generate further discussion, and the N.I.D. most likely will not be included in the final reform. The other proposals discussed above include only small changes to the reform proposals of C.T.R. III and some adjustments may be made after discussion by the Federal Council and the Swiss parliament. Finally, the proposal to increase the family allowance may be questioned by center or right-wing parties, since it is not connected to corporate taxation.

The step-up mechanism – imposing a tax on the realization of undisclosed hidden reserves and self-generated goodwill at a special low tax rate during a transitional period – is not explicitly addressed by the T.P. 17. However, it is anticipated that this mechanism will still be applied for a transitional period.

The T.P. 17 is only in its initial stage. The expected timeline provides that the Federal Council will confirm or adjust the T.P. 17 in June. It is further expected that the Swiss Federal Department of Finance will prepare the draft bill, which will undergo consultation by the end of this year. If all goes well, the Swiss parliament will adopt the bill in the spring of 2018. Subject to the consensus among all parties, no additional voting on the reform is likely, provided that sufficient signatures to a request for referendum are not gathered. Because the cantons must join the Federal government through the adoption of the proposals under cantonal law, it is expected that the reform will come into force on the 1st of January 2020 or 2021.

"The T.P. 17 is only in its initial stage. . . . If all goes well, the Swiss parliament will adopt the bill in the spring of 2018."

ECONOMIC NEXUS THROUGH OWNERSHIP AND USE OF INTELLECTUAL PROPERTY

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Tags
Intangible Assets
Intellectual Property
Nexus
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INTRODUCTION

The key issue in determining whether a corporation is subject to income tax in a particular state is whether nexus exists to that state. It is often prudent for a corporation to be proactive and diligent in in this analysis because each mistake with regard to a state in which some form of activity or connection exists could prove costly. If a corporation is found by state tax authorities to have the requisite nexus to that state and it has failed to file a tax return, the corporation will be exposed to additional taxes and penalties for noncompliance. That is why corporations that are subject to disclosure of high risk tax positions in their financial statements under ASC 740 -10 (the codification to FIN 48 in the accounting world) find that issues of possible nexus are closely monitored by the financial statement auditors.

However, managing nexus as part of annual or quarterly tax planning can also serve as a state and local tax saving opportunity. Under certain circumstances, a corporation may be able to use nexus statutes to shift profits from a high-tax state to a low-tax state.

DOING BUSINESS

An out-of-state corporation is subject to tax in a particular state only if the corporation engages in business in the state and the business activities are sufficient to establish nexus. The definition of "doing business" varies from state to state, but typically includes buying or selling services or property, executing contracts, enforcing contract rights, maintaining a place of business, and hiring employees in the state. However, nexus can also arise from less obvious transactions.

Public Law 86-272 limited the rights of states to tax out-of-state corporations with respect to the solicitation of sales within the state. Its application is limited to sales of tangible personal property. This limitation benefits out-of-state retailers of hard goods but provides little benefit to companies selling a digital product that is delivered over the internet.

Under Public Law 86-272, if an out-of-state corporation merely solicits orders in a state, and nothing more, the corporation does not have nexus with the state for tax purposes. Solicitation includes actual requests for purchases and ancillary activities that have no independent business purpose apart from the solicitation of orders. Examples of solicitations and ancillary activities that do not give rise to nexus include minor or incidental advertising, the display of free samples of a product, or the training or meeting of sales representatives on a periodic basis.

Nonetheless, the scope of nexus is broad, and some states and courts have expanded the definition of nexus to include "economic nexus," including nexus arising from the ownership and use of intellectual property ("I.P.") within a state.[1]

WHAT IS ECONOMIC NEXUS?

States have increasingly extended the definition of nexus to include an out-of-state corporation's ownership and use of I.P. within the state. I.P. typically includes copyrights, patents, trademarks, trade names, trade secrets, service marks, and know-how that are used within a state.

"A foreign corporation could be subject to tax in a particular state despite being exempt from income tax on the Federal level due to reliance on a tax treaty."

Thus, a corporation can have economic nexus with a state solely by executing a licensing agreement that earns the corporation royalties from that state, even if the corporation itself has no presence in the state. This greatly expands the concept of nexus for state tax purposes, and can be a trap for out-of-state corporations that are unaware of such provisions. It is important that any corporation leasing I.P. outside of its home state becomes familiar with the nexus laws of any state in which it enters into a licensing agreement.

This is particularly important for non-U.S. corporations (frequently referred to by state law as "alien corporations") that do not otherwise engage in business in the U.S. As with their domestic counterparts, alien corporations can be swept up in a state's broad nexus provisions. Because tax treaties between the U.S. and foreign countries are not necessarily binding on states, a foreign corporation could be subject to tax in a particular state despite being exempt from income tax on the Federal level due to reliance on a tax treaty.

From the viewpoint of a state tax administration, a corporation formed and headquartered in another state is considered to be a "foreign corporation" but not an "alien corporation." Alien corporations and foreign corporations are afforded similar treatment. Hence, income tax treaties are often ignored for state income tax purposes.

For example, the Massachusetts Department of Revenue issued a directive in 1996[2] (the "Directive") advising that a foreign corporation's I.P. used within the state subjects that corporation to income tax if (i) the I.P. generates or is otherwise a source of gross receipts within Massachusetts for the corporation, including through a license or franchise; (ii) the activity is purposeful (such as through a contract with a company in the state); and (iii) the corporation's presence in Massachusetts is more than *de minimis*.

The Directive provided several examples of I.P. giving rise to nexus in Massachusetts:

- A dress shop in Wisconsin licenses its name to a Massachusetts company for use in connection with the sale of the Massachusetts company's clothing line in the state, pursuant to which the dress shop receives royalties from the Massachusetts company's sales in the state.
- A Delaware company located in Alabama develops and patents technology

[1] Revenue earned from the performance of services is not protected by P.L. 86-272 and may form the basis for nexus. This article, however, is limited to a discussion of I.P. that does not have a physical presence within the state.

[2] D.O.R. Directive No. 96-2.

for a motor scooter, then licenses the patent to a Massachusetts company for use in its manufacture and sale of scooters in Massachusetts, pursuant to which the Alabama company receives an upfront fee for the right to use the patented technology and a royalty on the sale of scooters.

- A Delaware fast food franchiser located in New Jersey franchises the rights to one of its restaurants to a New Hampshire resident for a location in Massachusetts, and the terms of the franchise agreement require the franchisee to use various items of I.P. owned by the franchiser, pay a monthly franchise fee, and pay a royalty charge based on sales proceeds.

These examples illustrate that nexus exists in Massachusetts whenever an out-of-state corporation enters an agreement to license certain I.P. and receives a royalty payment based on in-state sales of the licensee. Even a Japanese corporation licensing trade secrets and know-how on automobile radar devices would have a corporate income tax liability in Massachusetts.

In 2011, New Jersey issued Technical Advisory Memorandum 2011-6, which provided that taxpayers performing services and domiciled outside the state who solicit business within the state or derive receipts from sources within the state may have corporate nexus with the state.

While taxpayers have attempted to claim that economic nexus violates the due process clause and the commerce clause, courts have largely rejected these arguments and have found economic nexus properly exists based on the use of intangibles in the state.

"Unlike nexus for sales and use tax, which requires physical presence, courts have consistently held that such actual presence is not required for states to tax corporate income generated from the use of I.P."

ECONOMIC NEXUS REPLACES PHYSICAL PRESENCE

Unlike nexus for sales and use tax, which requires physical presence,[3] courts have consistently held that such actual presence is not required for states to tax corporate income generated from the use of I.P. Courts have emphasized that physical presence is not required if the corporation has an economic connection to the state.

For example, in *Geoffrey, Inc. v. Commr. of Revenue*,[4] the Massachusetts Supreme Judicial Court rejected the taxpayer's claim that it lacked nexus with Massachusetts because it did not have physical presence in the state. The court upheld the state's authority to tax out-of-state corporations due to their ownership and use of I.P. in the state because Geoffrey made "purposeful efforts to reap economic benefits" from Massachusetts' retail marketplace. The court held that collecting royalties based on net sales pursuant to a licensing agreement gave rise to "substantial nexus" in the state and that the imposition of tax upon a foreign corporation without a physical presence in Massachusetts did not violate the commerce clause.

In the case, Geoffrey was engaged in the business of licensing trademarks for the Toys "R" Us logo that were used in retail stores throughout the U.S. It had no employees and owned no tangible property in Massachusetts, and its sole activity in

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[3] See *National Bellas Hess v. Department of Revenue of I.L.*, 386 U.S. 753 (1967).

[4] *Geoffrey, Inc. v. Commr. of Revenue*, 899 N.E. 2d 87 (M.A. Sup. Jud. Ct. 2009).

the state was its licensing of trademarks to stores in the state in exchange for royalty payments on net sales. Nonetheless, the court emphasized the fact that the agreements afforded Geoffrey the continued right to regulate use of the trademarks and access to courts in Massachusetts to protect its I.P. rights. Interestingly, Geoffrey did not exercise the latter privilege.

The Massachusetts court's decision closely resembled the holdings of courts in several other jurisdictions, including South Carolina, which had also determined that Geoffrey's receipt of royalties in the state gave rise to economic nexus.[5] The Supreme Court of South Carolina held that since Geoffrey was engaged in the business of owning and licensing I.P., its decision to license trademarks for use in many states evidenced a purposeful intent to seek the benefit of economic contact with those states. The court also noted that Geoffrey could have prohibited the use of its intangibles in the state, and it did not elect to do so.

In both cases, Geoffrey relied on the U.S. Supreme Court's decision in *Quill Corp. v. North Dakota*,[6] which held that personal presence was required to subject a company to sales tax in a state. However, both courts limited the holding of *Quill* to sales and use tax and held it inapplicable to corporate income tax.

In yet another case brought by Geoffrey,[7] a court in Oklahoma upheld the existence of economic nexus. Geoffrey received income that was derived from Oklahoma customers. Consequently, a sufficient economic connection to Oklahoma was established.

Likewise, in *Lanco, Inc. v. Division of Taxation*,[8] the New Jersey Supreme Court, reversing the decision of the New Jersey Tax Court, held that the license of I.P. to a New Jersey company gave rise to royalty income that was taxable in New Jersey, based on the Division of Taxation's argument that the royalty income was from New Jersey sources. The court, like those in the *Geoffrey* cases, distinguished the bright-line nexus rule set forth in *Quill*, holding that the physical presence requirement for nexus applies only in the sales and use tax context. Subsequent New Jersey decisions have confirmed this treatment, permitting the state to tax income generated by I.P. even if the corporate recipient lacks physical presence in the state.[9]

PURPOSEFUL INTENT IS REQUIRED

The precise facts that give rise to economic nexus in a given state are not always clear. While taxpayers have argued that the commerce clause and the due process clause of the U.S. Constitution prevent a state from imposing tax in the absence of physical presence, state courts have largely rejected these claims.

Nonetheless, it seems clear that purposeful intent is required so that the use of I.P. in a state alone is not sufficient to give rise to nexus if the taxpayer does not have a purposeful intent to engage in activity in the state. For example, intangible income

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5 *Geoffrey, Inc. v. S.C. Tax Commission*, 437 S.E.2d 13 (1993).

6 *Id.*

7 *Geoffrey Inc. v. O.K. Tax Commission*, No. 99,938 (O.K. Civ. App. 2005).

8 *Lanco, Inc. v. Division of Taxation*, 188 N.J. 380 (N.J. S. Ct. 2006).

9 See *Praxair Tech., Inc. v. Division of Taxation*, 988 A.2d 92 (N.J. S. Ct. 2009).

from transactions taking place outside New Jersey will not give rise to nexus in New Jersey.[10]

Further, in *Griffith v. ConAgra Brands, Inc.*,[11] the Supreme Court of West Virginia refused to find economic nexus on the receipt of royalties from trademarks used in the state, holding that the taxpayer did not meet the "purposeful direction" test under the due process clause or the "significant economic presence" test under the commerce clause. The holding in that case was contingent upon the fact that the taxpayer did not provide services to licensees in West Virginia and did not dictate in any way how the licensees distributed products using the trademarks.

In *J.C. Penney Natl. Bank v. Johnson*,[12] the Tennessee Court of Appeals refused to uphold economic nexus where the taxpayer extended credit card lending services to residents in the state but did not issue credit cards in its Tennessee stores.

THE ROLE OF PASSIVE INVESTMENT COMPANIES

One common factor in many of the cases finding the presence of economic nexus, such as the *Geoffrey* cases and *Lanco*, was the existence of a passive investment company (also referred to as a Delaware holding company). In many cases, the taxpayer was a passive investment company formed by its parent company, and the parent company itself had physical nexus with the state in question. Thus, when the parent company transferred the intangible assets to the passive investment company, which then licensed it for use in the state, application of the economic nexus concept to the passive investment company allowed the state to maintain its tax base. Application of the physical presence test would have allowed a unitary group to shift income from the state by using a passive entity with no physical presence in the state to received deductible license fees.[13]

However, where the sole issue is the taxpayer's use of a passive investment company, rather than invoking economic nexus, states have instead sought to enact statutes prohibiting the parent companies from deducting royalties and licensing fees where the income of the passive investment company was not taxable in the state. This achieves the same revenue protection goal but does so in a less contentious way.

ADVANCED PLANNING IS NECESSARY

Ideally, a corporation should evaluate any potential state nexus issues prior to

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10 *Whirlpool Properties, Inc. v. Division of Taxation*, N.J. Tax Ct. No. 66-2007 (2013).

11 *Griffith v. ConAgra Brands, Inc.*, 2012 W.V. LEXIS 282 (W.V. May 24, 2012).

12 *J.C. Penney Natl. Bank v. Johnson*, 19 S.W.3d 831 (T.N. Ct. App. 1999).

13 To the same effect, see *Kmart Props. Inc. v. Tax and Rev. Dept. of N.M.*, No. 21, 140 (N.M. Ct. App. 2001) (upholding economic nexus based on use of intangibles in N.M.); *L.A. Dept. of Rev. v. Gap (Apparel) Inc.*, 886 So. 2d 459 (L.A. Ct. App. 2004) (upholding economic nexus based on use of intangibles in L.A.); and *A&F Trademark Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004) (upholding economic nexus based on use of intangibles in N.C.). In each of these cases, the taxpayer was an out-of-state passive investment company whose parent company had physical presence in the state.

entering into a licensing or other agreement governing the use of I.P. with any in-state corporation. If the corporation engages in advanced planning, there are tax planning opportunities that can give rise to savings for the corporation, given the differences in tax rates between states.[14] Thus, if a corporation's home state is a high-tax state, the corporation may benefit from having economic nexus in a lower-tax jurisdiction.

"It is critical for a corporation to evaluate nexus prior to entering into a contract in a state and to continue to review potential nexus issues on an ongoing basis."

If a corporation is unsure whether its activities are sufficient to give rise to nexus in a particular state, it should seek to determine its level of exposure prior to engaging in activities in the state. Some states permit ruling requests so a taxpayer may identify whether the state considers it to have nexus based on its activities in the state.[15]

REMEDYING PAST MISTAKES

If the corporation discovers that it has economic nexus in a state after entering into an agreement and after having failed to file a tax return in the state, but prior to being contacted by that state in connection with asserted noncompliance, the corporation may benefit from entering the state's voluntary disclosure program, if one is available. Typically, doing so would enable the corporation to avoid penalties on the failure to file a return and pay tax, and it may limit the number of years for which a filing is required. Many states have initiated voluntary disclosure programs as an easy revenue fix.

These states rely on disclosures of uncertain tax positions in the published financial statements of corporations having publicly traded shares. However, the states act at their own pace. As a result, it may be possible to enter a program even if the financial statement disclosure is publicly available.

If a voluntary disclosure program is not available, the corporation should still consider coming forward voluntarily, as penalties for late filing and payment may be abatable for reasonable cause. If the corporation waits for the state to assess taxes, the corporation's argument for abatement of penalties is substantially weaker.

Thus, it is critical for a corporation to evaluate nexus prior to entering into a contract in a state and to continue to review potential nexus issues on an ongoing basis. Keeping up-to-date with changing laws in different states is the best way to avoid what could be a costly mistake.

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14 See, *e.g.*, O.H. Rev. Code Ann. §5733.042.

15 See, *e.g.*, 830 Code M.A. Regs. §63.39.1(9), outlining the procedures for requesting nexus determination from the Department.

CORPORATE MATTERS:

FIVE STEPS FOR LEVERAGING YOUR START-UP'S EMERGING INTELLECTUAL PROPERTY

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Tags
Intellectual Property
Patent
Start-Ups
Trademark

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Start-up companies are often created because the founders have a concept that they think will take hold. Sometimes, this concept is novel and can be protected, which may result in considerable value. For an emerging business, this intellectual property ("I.P.") can be the business' most important asset and the difference between success and failure – that is, if the business considers these five important issues.

1. **Ensure you are not reinventing something someone already invented and protected.**

   These days, new start-ups spring up all the time. Many believe that they have better ways of solving known problems, and sometimes, someone else unknown to the start-up solved the same problem in a similar way. When others protect their designs, implementations, or names first, they may own I.P. rights, and you could be infringing on those rights. It is critical to the longevity of a business to be sure that the business has freedom to operate. To do so, it is often well worth the investment to engage a professional, such as a patent attorney, and obtain a prior art and/or name search to be sure you have the freedom to operate as you would like, and to do so *before* you begin to invest heavily in a solution.

   What happens if a patent search comes back with a prior reference including your invention? You have several options. First, come up with an even better and different solution that might not already be patent-protected. It could be that a new and improved version has even more long-term value. Alternatively, you can approach the owner of the I.P. for a license. That way, the originator obtains some benefit and you can move ahead with your plans and expand the innovativeness.

2. **File for patents as early as you can.**

   Patents can become extremely valuable assets for a company, particularly early in a new company's life when it has not yet developed assets that provide value. Patents and patent applications can provide value, enhance investment opportunities, and serve as collateral for financing arrangements.

   The timing for filing for patent protection is important. New companies should understand that they must file for patent protection before they release their product in order to protect their worldwide rights. Some countries do not grant a patent if the application is made after the product is publicly disclosed.

   To save early expense, companies can file provisional patent applications in the U.S. and still preserve their worldwide rights. Provisional applications are simpler to prepare, the fees are less than for non-provisional or formal applications, and once filed, you can use the term "patent pending" right away.

The main ingredient of a provisional patent application is that the application must describe the invention in such a way that a person "of ordinary skill in the art" could replicate the invention from the description.

3. **Choose and use branding carefully.**

Name recognition is important. New companies use branding, such as names and logos, to distinguish their products and services. Importantly, the branding cannot be confusingly similar to other companies' branding. Searches can help identify whether proposed brand assets meet this requirement.

Trademark protection is based on the adage "first in time, first in right" and applies to a category of goods or services, as well as geographic use. Once selected, the name or logo can be registered with the U.S. Patent and Trademark Office. The registration effectively locks in the name nationwide for those goods or services.

4. **Keep protecting innovation as innovation continues to occur.**

In this fast-moving age of disruptive technology, innovations happen frequently and throughout the world. Numerous people and companies worldwide are often trying to solve the same problem at the same time. When multiple parties solve the same problem in the same way, only the first to file a patent application is entitled to patent protection under U.S. law.

A product may evolve during a company's start-up stage and the company may continue to introduce innovations to the product. For example, a company may introduce new features over time to improve a product. The commercial importance of one or more of these features could grow over time and become even more important than the original offering. As such, it is important for the company to file a patent application to protect a new feature. The patent application for the new feature should be filed before public disclosure of the new feature.

5. **Don't be shy about your filings.**

Once you have filed for patent protection and/or trademark registration, it is your responsibility to police your rights. As a start, it is important to let the world know that you have a pending patent on your invention by using the term "Patent Pending" when marketing the product that includes the subject of a patent application. Similarly, before obtaining a trademark registration, use the "T.M." designation next to the product identifier. Once you receive the trademark registration, use the "R" in the circle (®) to show that you have a registered trademark.

If you encounter others with similar implementations, it is important to alert them to the existence of your patent application as soon as possible. If there are potential infringements, it is beneficial to establish a notification date, which can come into play in the event you are entitled to damages. Of course, you can also license your technology to them, so this notification may result in a new revenue stream for you.

For a discussion of tax deductions available to a start-up company, particularly with respect to its I.P., see "Taxation of Intellectual Property – An Introduction to the Basic Rules" in this edition of *Insights*.

U.K. DROPS CHANGES TO NON-DOMICILE REGIME, BUT LIKELY NOT FOR LONG

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Tags
Non-Dom
Remittance Basis
Tax Residency
U.K.

After months of H.M.R.C. consultation, it seemed a new regime for non-domiciled U.K.-resident individuals ("Non-Doms") was finally set to take effect on April 6, 2017. That was until the enacting legislation was suddenly pulled from Finance Bill 2017.

In an effort to hasten parliamentary approval ahead of the snap election on June 8, 2017, 72 of the 135 clauses were removed from Finance Bill 2017 on April 25, 2017. This allowed the Parliament to condense the customary two days of House of Commons debate, standing committee sessions, and an additional two days of report stage and third reading debate into a mere two hours.

The changes to Non-Dom taxation are the most significant since 2008 and follow a lengthy consultation period, during which several clarifications and modifications were made and numerous provisions were delayed as it was not possible to agree on final language. In many respects, this latest delay does not come as a surprise given the slow pace of the consultation process – for the portion dealing with trusts alone, the consultation period ran from December 5, 2016, to February 22, 2017.

Although the revised Non-Dom legislation has not been adopted, it is expected that the agreed-upon clauses, as outlined below, will appear in a later bill. Subject to the election result, enacting legislation could be passed as early as this fall with effect from April 6, 2017, upon enactment. Other proposed changes, which were delayed prior to the parliamentary vote, may be adopted in a later finance bill, presumably Finance Bill 2018.

DEEMED DOMICILE

The main revisions call for individuals who are not actually domiciled in the U.K. to be deemed domiciled for all U.K. tax purposes if either of the following fact patterns apply:

- They have been resident in the U.K. for 15 of the previous 20 tax years (the "15/20 Rule").
- They were born in the U.K. with a U.K. domicile of origin and they are resident in the U.K.

Under the revised regime, U.K.-resident Non-Doms who fall into either of the above categories will lose the opportunity to claim the remittance basis of taxation and will be subject to tax on worldwide income and gains from April 6, 2017. The pre-existing rule – under which Non-Doms who have been resident in the U.K. for 17 of the previous 20 tax years (the "17/20 Rule") are deemed to be U.K. resident for inheritance tax purposes – will all be aligned to the 15/20 Rule.

CAPITAL GAINS TAX REBASING

Non-Doms who become deemed domiciled on April 6, 2017, under the 15/20 Rule will be afforded some relief from capital gains tax on pre-existing gains through a step-up in basis to the value of the assets as of April 5, 2017. This relief will be available only to those who at some point prior to April 6, 2017, prepared tax returns under the remittance basis and paid the remittance basis charge ("R.B.C."). Non-Doms who have never paid the R.B.C. will be required to do so during the 2016-2017 tax year in order to benefit from the step-up in basis. The tax return deadline for claiming remittance basis tax and paying R.B.C. is January 31, 2018.

Certain limitations apply to Non-Doms wishing to benefit from the step-up in basis. First, the step-up in basis will be available only to assets owned as of March 16, 2016, that have been treated as being located outside the U.K. at all time through April 5, 2017. Second, Non-Doms born in the U.K. and having a U.K. domicile of origin cannot access this relief.

CLEAN UP OF MIXED FUNDS

U.K.-resident Non-Doms will also be given the opportunity to reorganize their non-U.K. bank accounts containing mixed funds. In anticipation of the enactment, many clients may want to consider splitting out such funds into separate accounts to facilitate tax-efficient remittances to the U.K. Under the agreed-upon clauses, the separation must be completed it prior to April 5, 2019.

This opportunity will be open to Non-Doms whether or not they become deemed domiciled on April 6, 2017. However, they must have reported income under the remittance basis of taxation at some point prior to the April 6, 2017, cutoff and, where appropriate, paid the R.B.C. As with many of the proposed changes, U.K.-resident Non-Doms who were born in the U.K. with a U.K. domicile of origin will not have the opportunity to cleanse mixed funds.

The Spring 2017 Budget included a statement that the opportunity to separate mixed funds will cover years ending prior to April 6, 2008. However, language to that effect was not part of draft legislation. A correction is expected post-election.

As of April 6, 2017, a new "Requirement to Correct" offense will also be instituted. If noncompliance in an earlier year is identified when undertaking the clean up a mixed fund, an obligation to correct likely will be imposed on the U.K.-resident Non-Dom, perhaps by way of a disclosure to H.M.R.C.

PROTECTION FOR NON-DOM SETTLORS

During the consulation process, various transitional rules were proposed to potentially soften the introduction of the revised Non-Dom regime.[1] These included protections for individuals becoming deemed domiciled on April 6, 2017, who set up nonresident trusts prior to becoming deemed domiciled.

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1 For more information, see Gary Ashford, "U.K. Non-Dom Taxation – Where it is and Where it is Going," *Insights* 10 (2015); see also Gary Ashford, "Further Developments for U.K. Non-Dom Individuals," *Insights* 9 (2016).

H.M.R.C. set out the first draft legislation on December 5, 2016, within the draft Finance Bill 2017. However, it was not until January 27, 2017, that H.M.R.C. published draft legislation regarding income tax, including the proposed amendments to the Transfer of Assets Abroad ("T.O.A.A.") legislation.

In general, U.K.-resident and domiciled settlors holding an interest in an overseas trust are taxed on all capital gains within the trust on an arising basis. The current rules exclude Non-Dom settlors. Therefore, they are taxed under the rules for beneficiaries, which provide only for taxation in relation to distributions, matched to any gains within the trust. Under these provisions, a Non-Dom has the opportunity to apply the remittance basis to limit any tax on gains resulting from U.K.-situs assets or overseas gains to the extent remitted to the U.K. Without the proposed protections, Non-Doms who become deemed domiciled on April 6, 2017, will become liable to tax on all capital gains arising in any trust, in the same way as U.K.-resident and domiciled settlors.

"The changes will effectively prohibit a widely-used planning strategy whereby a Non-Dom buys a U.K. home through a foreign company so as to remain outside of the U.K. inheritance tax net."

The transitional rule will prevent a deemed domiciled Non-Dom from being taxed on an arising basis and will defer taxation of capital gains to the time of distribution, without further benefit under a remittance rule. Note that the transitional rule will not be available to any Non-Dom who is deemed U.K. domiciled by virtue of being born in the U.K. with a U.K. domicile of origin. Those individuals will be taxable on all capital gains that arise within a trust.

Under the current regime, the pot of capital gains available to be matched can be reduced through certain methods, including capital payments made to nonresident or temporary nonresident beneficiaries and distributions linked to the cessation of the trust where at least one of the recipient beneficiaries is a nonresident. Attempts to limit the scope of these planning opportunities were not part of the final legislation. If enacted, these limitations will not come into effect before April 6, 2018, thereby providing taxpayers with additional time before the full impact is realized.

Additionally, where distributions are made to a beneficiary who is a close family member (*e.g.*, a spouse, civil partner, or minor child) that is a nonresident with regard to the U.K., or is a Non-Dom U.K.-resident reporting income on the remittance basis, tax will be imposed on the deemed domiciled settlor if the gains are not remitted to the U.K.

Where the settlement legislation applies, the settlor will be taxed on the income of the trust on an arising basis. This treatment is subject to transitional relief. If a trust is set up before the settlor becomes deemed domiciled and no further contributions of property are made to the trust, the settlor will be taxed in the year a distribution is received, not when it arises in the trust. Similar treatment is provided where a close family member receives a benefit from the trust. Relief under the transitional rule will not be extended to individuals who become deemed domiciled due to having been born in the U.K. with a U.K. domicile of origin.

It is expected that the T.O.A.A. rules will be amended to align with the protected income rules found in the settlements legislation, but only if included in Finance Bill 2018.

RESIDENTIAL PROPERTY AND INHERITANCE TAX

The draft legislation within Finance Bill 2017 stated that property would not be excluded property for inheritance tax purposes in a number of cases where the value is directly or indirectly attributable to U.K. residential property. Thus, where a nonresident entity owns U.K. real property, the interest in that entity will be subject to inheritance tax upon the death of the interest holders.

Interest covered by this rule includes (i) a right or an interest of more than 1% in a close company, (ii) an interest in a partnership, or (iii) an interest in a debt instrument that is a relevant "relevant loans." In this context, a relevant loan is a loan used to directly or indirectly finance the acquisition, maintenance, or enhancement of, or to procure a right to acquire, maintain, or enhance, U.K. residential property. A relevant loan is also one used to acquire an interest in a close company to the extent that the loan finance is used to acquire, maintain, or enhance U.K. residential property. The changes will effectively prohibit a widely-used planning strategy whereby a Non-Dom buys a U.K. home through a foreign company so as to remain outside of the U.K. inheritance tax net.

Many clients have been reviewing these structures in recent months, as in some cases, under the new rules, no benefit remains in using a company for this purpose, particularly in light of the annual costs and taxes. Instead, many have decided to "de-envelope" their U.K. property so that it is held personally. De-enveloping may likely be subject to significant costs, such as capital gains tax and stamp duty land tax charges. Nonetheless, in light of the political stance being taken by H.M.R.C. on offshore structures, de-enveloping may be worth the cost.

In computing value for inheritance tax purposes, debt will remain deductible after the April 6, 2017, effective date. However, offsetting it against a property's value to potentially reduce the attributable value for inheritance tax purposes may bring added complications, in that the loan will be subject to inheritance tax within the estate of the lender. This may, of course, discourage lenders from making such loans and would certainly introduce significant complexity into arrangements involving loans.

BUSINESS INVESTMENT RELIEF

To date, no draft legislation has been published in relation to the revised rules for business investment relief ("B.I.R."), however the issue is likely to resurface post election.

B.I.R., in its current form, was introduced on April 6, 2012. The purpose of this relief is to allow U.K.-resident Non-Doms who have claimed the remittance basis to bring foreign income or gains to the U.K. for investment in a targeted company without triggering the R.B.C. The investment can be made in the form of money or other property derived from foreign income and gains, or in the form of shares or a loan to the target company, so long as it originates from years in which a person was taxed on the remittance basis.

Several conditions must be met to benefit from B.I.R.:

- The investment must be a qualifying investment.
- It must be made in a target company within 45 days from the date funds are brought to the U.K.
- B.I.R. must be claimed on a self-assessment tax return.

Investments are qualifying investments where two conditions are met:

- The target company must be (i) an eligible trading company, (ii) an eligible stakeholder company, or (iii) an eligible holding company.
- No relevant person receives any benefit directly or indirectly from the target company or any company associated with it, whether or not the benefit is connected to the investment.

In terms of the first condition, qualifying companies are those that carry on a trade or generate income from land (including property), make investments into such companies, or hold shares in such companies. Note that a start-up period is allowed before a commercial trade is first carried on. Under prior law, the start-up period was capped at two years.

Under the revised regime, the cap on the start-up period will be expanded to five years, effective April 6, 2017. The new rules will extend the definition of a qualifying investment to include the acquisition of both existing shares and new shares in qualifying target companies. It will also clarify that the corporation must carry on trading activities itself. Activities of partnerships will not qualify for B.I.R.

When a company ceases its commercial operations, the investment of the U.K.-resident Non-Dom must be removed from the U.K. within a short period of time, which can be as little as 45 days. The changes to B.I.R. will extend the period for removal of funds so that it may be as long as two years from the date upon which the investor becomes aware of the cessation of trading activities.

LEGISLATION TO BE PUBLISHED IN A FUTURE FINANCE BILL

As previously mentioned, various proposals were delayed prior to the parliamentary vote on April 25, 2017. It is expected that H.M.R.C. will publish further draft legislation to address open items, presumably in Finance Bill 2018. A summary of the anticipated legislation is set out below.

Computation of Capital Gains Tax on U.K. Deemed Domiciled Settlors of Foreign Trusts on the Arising Basis, T.C.G.A., Schedule 5

- Disregard of §87 capital payments to nonresidents in connection with gains realized by foreign trusts with the effect that the gains are taxed to the settlor
- Disregard of §87 capital payments to migrating beneficiaries in connection with gains realized by foreign trusts with the effect that the gains are taxed to the settlor
- Transfer of §87 benefits charged to the settlor where the beneficiary is a close family member of the settlor and is not liable to capital gains tax on the payment in connection with gains realized by foreign trusts
- Attribution of gains to recipients of onward gifts (recycling rule)

Chapter 5 of Part 5 of I.T.T.O.I.A. (Settlements)

- Benefits charge for foreign domiciled settlors and deemed domiciled settlors in respect of benefits received by the settlor or close family member such as a spouse, cohabitee, or minor child (not including a minor grandchild)

- Benefits charge on settlor when beneficiary receiving benefits is close family member but is not taxable on the benefit
- Attribution of deemed income to a U.K.-resident recipient of a gift when a trust having income makes payments to nonresidents or remittance basis users who hold the money for a period of time before giving or lending it back to a beneficiary in the U.K. (tracing to stop when more than three years lapse between distribution and gift)

One question that remains is whether future legislative action on these items will be effective as of April 6, 2017.

CONCLUSION

For the time being, the U.K. Non-Dom rules live on in full force. However, subject to the result of the snap election, the revised provisions will likely be enacted within the year. While the changes slated for April 6, 2017, limit some of the opportunities provided by the Non-Dom regime, the remaining opportunities will still be quite significant. As has been the case since April 2008, arriving U.K.-resident Non-Doms will have seven years of access to the remittance basis regime with no cost. Thereafter, the R.B.C. will remain at £30,000 until the individual has been resident for 12 years, after which point it will increase to £60,000. The main changes to the legislation are focused on long-term residents (soon to be 15 years) and those born in the U.K. with a U.K. domicile of origin.

"This delay affords clients a unique opportunity: additional time to plan for the past."

Clients who would become deemed domiciled on April 6, 2017, should review their investments and, where appropriate, segregate those made before April 6, 2017, from those made after April 6, 2017. Consideration should also be given to investments that defer the point of taxation, such as bonds, equities, or funds. Consideration should be given to the impact of rebasing, whether positive or negative, and action taken accordingly.

B.I.R. remains a very attractive option and will become even more attractive going forward. For those who would become deemed domiciled on April 6, 2017, the soft landing provided by a step-up in tax basis and the two-year window in which to clean up mixed funds will be helpful. Non-Doms will be able to revisit their investments and potentially identify and extract or use clean capital in a variety of imaginative ways. In cases where it would be practically difficult to clean up a mixed fund, B.I.R. may allow such funds to be used in the U.K. without triggering an R.B.C.

In light of recent political shifts, the U.K. government is keen to make known to the world that the U.K. – and particularly the Non-Dom regime – is very much "open for business" and will remain so for newly arriving individuals not having been born in the U.K. with a U.K. domicile of origin. This delay affords clients a unique opportunity: additional time to plan for the past.

PRE-IMMIGRATION PLANNING: DROP-OFF TRUSTS + PRIVATE PLACEMENT LIFE INSURANCE – IF THE TOOLS FIT, USE THEM

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Tags
Drop-Off Trust
Estate Planning
Income Tax
Private Placement Life Insurance
Pre-Immigration Planning
Trusts

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INTRODUCTION

Given the worldwide reach of U.S. taxation, wealthy individuals who are contemplating a move to the U.S. will often seek advice on the construction of a pre-immigration plan that can minimize their tax exposure once in the U.S. Creating such a plan is no simple undertaking. It requires in-depth knowledge of myriad special rules and their exceptions. Care must be taken to ensure that the plan is compliant – not only with U.S. law but also with the laws of the home jurisdiction from which the individuals are planning to emigrate and, sometimes, other jurisdictions where assets are held. And, ultimately, the complexity and costs of pre-immigration planning often prevent individuals from achieving full implementation.

In this article, the use of the "drop-off" trust – a common planning tool that is often used in the pre-immigration planning context to reduce estate tax – is reviewed. When combined with private placement life insurance, the benefits may be substantially augmented. The results can be quite attractive.

PRE-IMMIGRATION PLANNING

Prior to immigrating to the U.S., nonresident aliens ("N.R.A.'s") are subject to U.S. income tax only on income sourced in the U.S. and to U.S. transfer taxes (*e.g.*, taxes on gifts, bequests, and generation-skipping transfers) on transfers of U.S.-situs real property and tangible property. Once an N.R.A. immigrates to the U.S., however, worldwide income is subject to U.S. income tax and worldwide assets are subject to U.S. transfer taxes once domicile in the U.S. is established.

Domicile results from a stronger connection to the U.S. than mere income tax residence. It requires both physical presence in the U.S. and no intent to leave at a later time.

Additionally, once an N.R.A. becomes a U.S. domiciliary, transfers of substantial assets outside the U.S. that could have been accomplished all at once before the establishment of domicile in the U.S. may require years to complete, because of strict limits on annual and lifetime gifts. Hence, it is generally best for wealthy individuals and families who intend to immigrate to the U.S. to implement tax plans *before* they immigrate, when they can still make unlimited transfers of property that does not have its situs within the U.S. without incurring U.S. taxes and without substantial delays.

One primary goal of pre-immigration planning is to minimize post-immigration exposure to U.S. transfer taxes by removing non-U.S.-situs property from the N.R.A.'s taxable estate before the N.R.A. establishes U.S. domicile. This goal is often

1 Bernstein does not provide tax, legal, or accounting advice. In considering this article, a reader should discuss his or her individual circumstances with tax, legal, or accounting professionals before making decisions.

accomplished by having the N.R.A. create a properly structured irrevocable offshore trust that the N.R.A. funds with foreign property before immigration. This type of trust is sometimes referred to as a drop-off trust.

Drop-off trusts require certain precautions to ensure that they successfully protect the assets from U.S. transfer taxes after the N.R.A. immigrates to the U.S. Appropriate precautions include the following:

- Drop-off trusts should not be funded with all the grantor's assets to avoid an inference that the N.R.A. grantor expected to have access to such funds after moving to the U.S. Doing so could cause the assets to be included in the grantor's U.S. estate.

- No subsequent additions should be made to drop-off trusts to avoid tainting the otherwise exempt trusts.

- Distributions to trust grantors should be kept to a minimum or avoided altogether. If multiple distributions are made to the grantor or if such distributions follow a pattern, the grantor could be considered to retain an interest in the trust. This would cause the entire trust corpus to be included in the grantor's U.S. estate when the grantor dies, if the death occurs while the individual is domiciled in the U.S.

Thus, ascertaining the amount to be transferred to a drop-off trust is an important undertaking. If funded with too little, an opportunity to protect assets from U.S. transfer taxes is wasted. On the other hand, if funded with too much, the grantor may be left with insufficient funds to support an accustomed lifestyle in the absence of trust distributions, which jeopardize the benefits of the structure.

This is further complicated by the fact that, while a properly-structured foreign drop-off trust can be effective in protecting assets from U.S. transfer taxes, most do not shield the asset income from being subject to U.S. income tax once the grantor immigrates to the U.S. This is due to special rules applicable to foreign drop-off trusts that (i) have U.S. beneficiaries and (ii) are established within five years of the N.R.A.'s immigration to the U.S. Such trusts are known as grantor trusts, and all trust income is taxable to the grantor beginning as of the grantor's residency starting date.

Thus, the grantor must have the financial wherewithal to not only irrevocably part with the property in the trust but also to pay income tax on that property on an ongoing basis. Of course, it stands to reason that if a grantor could somehow not be liable for the payment of income taxes (Federal, as well as state and local) on income generated within a foreign drop-off trust, more assets can be transferred to the trust without causing economic discomfort for the grantor. This is where private placement life insurance can come into play.

PRIVATE PLACEMENT LIFE INSURANCE

Private placement life insurance ("P.P.L.I.") can offer a unique pre-immigration planning solution and relieve drop-off trust grantors of the burden of paying trust income tax after the grantors move to the U.S.

From an income tax perspective, the owners of life insurance policies do not realize taxable income from the policy's underlying investment accounts. Thus, investing a drop-off trust's assets in life insurance can reduce some, or all, of the trust's taxable income because income earned inside the policy is not taxed currently to the policy owner. Moreover, death benefits paid out of the policy to the drop-off trust are not subject to U.S. income tax and effectively enjoy a stepped-up basis, despite not being included in the grantor's estate.

However, a traditional life insurance policy ordinarily comes at a relatively high cost, comprised of commissions and fees, and offers somewhat limited investment options. Both factors often outweigh the tax benefits of the policy, and funds locked up in a traditional life insurance policy may not be readily accessible.

"A P.P.L.I. policy within a drop-off trust . . . could enable the dropped-off assets to grow income tax free, receive a stepped-up basis upon the death of the insured, and avoid U.S. estate tax."

P.P.L.I. policies are potentially a better alternative to traditional life insurance policies, for several reasons:

- **P.P.L.I. policies are generally less costly**, primarily due to much lower or entirely nonexistent agent/broker compensation.
- **P.P.L.I. policies typically provide access to more investment options**, which can generate higher income and growth that may justify incurring the cost of a P.P.L.I. policy.
- **The insured can withdraw from the policy funds up to the policy's basis** without incurring tax, if the P.P.L.I. policy is not considered a modified endowment contract ("non-M.E.C.").
- **The insured can borrow funds from the policy in excess of the policy's basis** on favorable terms, if the P.P.L.I. policy is considered a non-M.E.C.
- **P.P.L.I. policies can be custom tailored to a client's needs.**

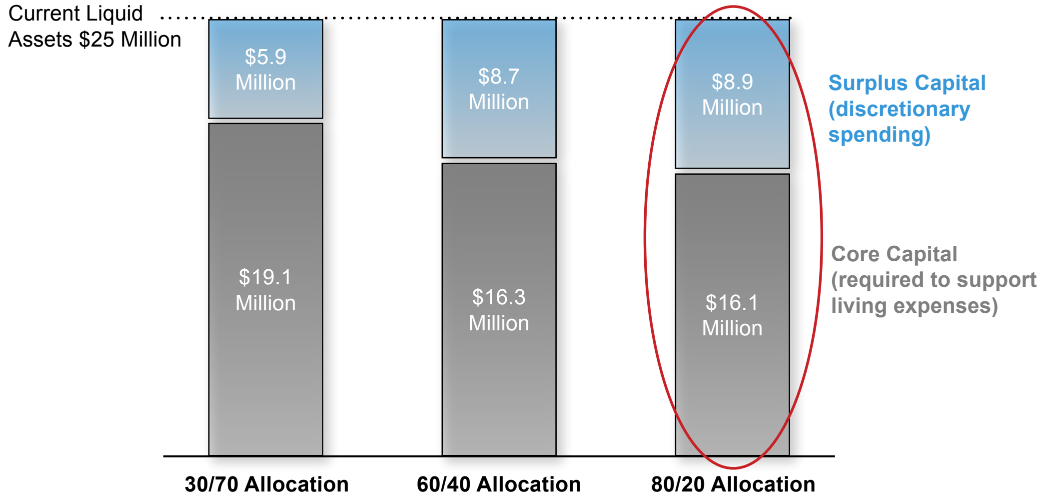
Mr. X, a 50-year-old executive, is preparing to relocate to the U.S. next year, along with his wife, of the same age, and their two teenage daughters. They intend to move to New York City to establish the presence of Mr. X's company there. The family's total liquid net worth is $25 million, held primarily in Mr. X's name. The couple expects to spend approximately $500,000 annually after their move. Mr. X's after-tax compensation should be sufficient to cover these expenses. Assuming that Mr. X will continue to work for 10 years, Mr. & Mrs. X will begin to draw from savings to support their spending needs in 2027.

Mr. & Mrs. X wish to implement a pre-immigration estate plan to reduce their taxable estate. Their attorney advises Mr. X to create and fund a foreign drop-off trust for the benefit of his wife and daughters. Mr. & Mrs. X require assistance in determining how much they can afford to dedicate to funding the drop-off trust.

The analysis begins by quantifying Mr. and Mrs. X's core capital requirement (*i.e.*, the amount of liquid capital they need today to support their lifestyle for the rest of their lives). The calculation takes spending and life expectancies into account, along with projected investment returns and inflation. In order to determine core capital with a high degree of confidence, one should assume poor returns in the capital markets, higher-than-expected inflation, and the possibility that Mr. and Mrs. X could live to be very old.

Using our Wealth Forecasting System,[1] the amount of core capital required to sustain Mr. & Mrs. X's spending for the next 40 years was calculated as follows:

Core Capital Based on Asset Allocation*



* Core capital is calculated at a 90% level of confidence of maintaining spending over 40 years.

The right-hand bar shows that if Mr. & Mrs. X invest for growth, allocating 80% to equities and 20% to bonds, their core capital would be $16.1 million. That would leave nearly $9 million of surplus capital – property that they are unlikely to need to support their lifestyle. In comparison, the other bars indicate that their core capital contribution would be greater, and their surplus capital smaller, if they invested in a less stock-heavy portfolio. In any case, it should be noted that surplus capital not otherwise disposed of will be subject to U.S. estate tax upon their deaths.

One could argue that Mr. X should contribute all his surplus capital to the proposed drop-off trust before moving to the U.S. to shelter it from future U.S. transfer taxes. However, such a plan would be fatally flawed, because it fails to account for Mr. X's ongoing income tax liability with respect to the $9 million of surplus capital contributed to the drop-off trust.

In funding a foreign drop-off trust, the key question should not address simply the computation of the grantors' surplus capital. Rather, it should focus on the amount the grantors can afford to part with if they continue to pay tax on income generated by that capital for the rest of their lives. The correct amount depends on the specifics of each case, including the ages of the N.R.A.'s involved, their tax brackets, their locality, and how the funds are invested. An older N.R.A. who intends to live in Florida will have a different tax burden than a younger N.R.A. who intends to live in a high-tax jurisdiction like New York or Los Angeles. The younger individual will

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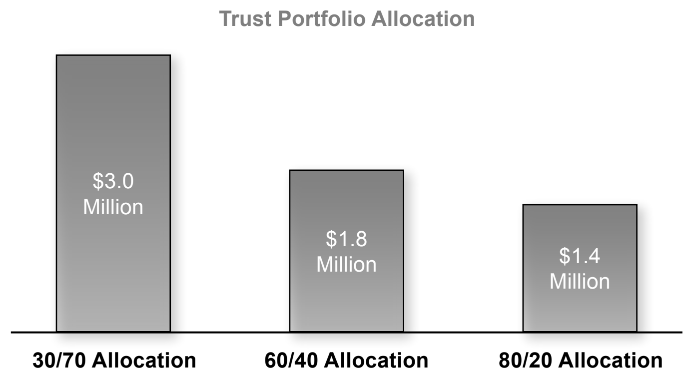
1 The Bernstein Wealth Forecasting SystemSM seeks to help investors make prudent decisions by estimating the long-term results of potential strategies. It uses the Bernstein Capital Markets Engine to simulate 10,000 plausible paths of return for various combinations of portfolios; and for taxable accounts, it takes the investor's tax rate into consideration. Data in this article do not represent past performance and are not a promise of actual results or a range of future results.

need to retain a greater portion of his or her capital to fund a higher tax liability for a longer period of time.

Given Mr. & Mrs. X's ages and their plan to move to New York City, the anticipated income tax liability was calculated on each $1 million of surplus capital invested for growth.

Reserve Required to Pay Tax Liability*



* Capital required to support payment of grantor trust taxes with 90% confidence over 40 years.

The chart shows that over 40 years, every $1 million of capital invested for growth will likely generate an income tax liability that requires a current reserve of $1.4 million to be included in core capital. As a result, Mr. X can afford to fund the drop-off trust with $3.7 million, as it would be necessary to keep $5.2 million of the nearly $9 million surplus capital in reserve to pay the trust's income tax liability.[2]

In practice, core capital (*i.e.*, money the investor will need) is often invested more conservatively than surplus capital (*i.e.*, money the investor doesn't need). If Mr. & Mrs. X invested their core capital more conservatively – with 30% allocated to stocks and 70% to bonds – they would require more than twice as much reserve capital: $3 million for each $1 million they put in the trust. This is because the trust's growth-oriented investments could outperform the core capital portfolio's more conservative investments.

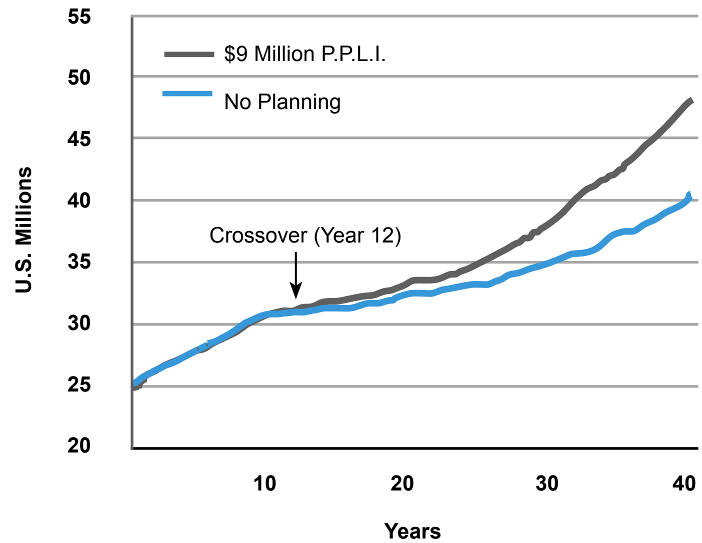
In that case, the trust would generate a greater tax liability, which would be paid from the reserve. Mr. & Mrs. X's core capital requirement would also be higher if they adopted a more conservative allocation, as the previous chart showed, which would leave only $5.9 million in surplus capital. Subtracting the greater reserve from the reduced surplus capital would leave Mr. & Mrs. X with $1.5 million to fund the trust.

However, if Mr. & Mrs. X instead purchased a P.P.L.I. policy with the surplus capital, they wouldn't have to worry about paying income tax on the trust's income, allowing them to dedicate more of their surplus capital to the trust. They should, however, consider the costs incurred in issuing and maintaining the P.P.L.I. policy. Would the tax savings outweigh the costs of the P.P.L.I. policy? The charts below illustrate the answer.

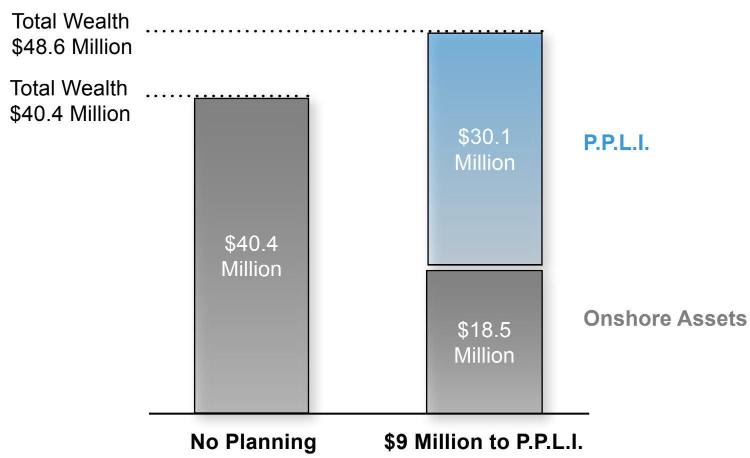
2 The probability of sustaining spending and taxes for a $9 million grantor trust over 40 years is 41%.

Potential Income-Tax Benefits of P.P.L.I.*

Lifetime Wealth of Mr. & Mrs. X



Accumulated Wealth of Mr. & Mrs. X After 40 Years



* Charts reflect median outcomes (adjusted for inflation) based on estimates of the range of returns for the applicable capital markets over the periods analyzed. Asset values represent the estimated market value; if the assets were liquidated, additional capital gains or losses would be realized that are not reflected here.

"The cumulative income-tax savings would begin to outweigh the costs of the P.P.L.I. policy after 12 years and, in 40 years, would result in an additional $8 million of wealth for the family."

If Mr. X were to fund the drop-off trust with $9 million, and the trust, in turn, were to use that amount to purchase a P.P.L.I. policy,[3] the cumulative income-tax savings would begin to outweigh the costs of the P.P.L.I. policy after 12 years and, in 40 years, would result in an additional $8 million of wealth for the family.

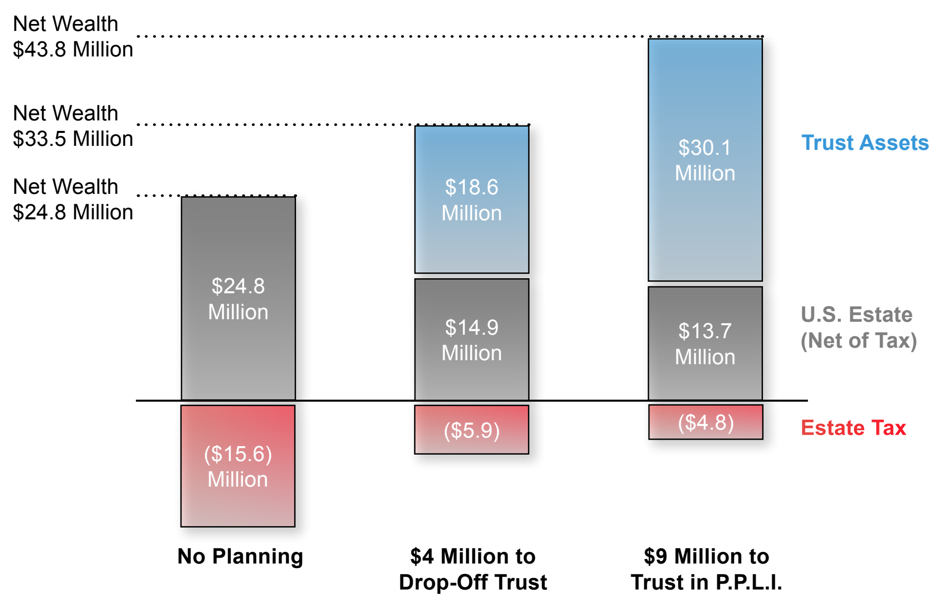
Using the P.P.L.I. policy for the trust investments would also give Mr. & Mrs. X greater flexibility to choose investments based on total-return potential. Their options could include tax-inefficient investments that are typically avoided for grantor trusts

3 Because it is the desire of Mr. & Mrs. X to maximize flexibility and keep access to the funds, the policy can be structured as a non-M.E.C.

– when the grantor is responsible for paying the tax. It would also significantly reduce the cost of compliance for Mr. & Mrs. X with respect to the drop-off trust.

The final chart highlights the incremental estate- and income-tax savings achieved by combining a drop-off trust with a P.P.L.I. policy.

Potential Tax Savings*



* Chart reflects median outcome of the range of returns for the applicable capital markets for the next 40 years with 80/20 asset allocation. Estate tax calculation assumes combined Federal exclusion of $10.98 million (adjusted for inflation), marginal Federal estate tax rate of 40% on assets in excess of the exclusion amount, and marginal state estate tax of 16% on all assets.

It is estimated that if Mr. & Mrs. X were to pass away in 40 years without immigration planning, their after-tax family legacy would be $24.8 million (adjusted for inflation). Creating a drop-off trust and funding it with $4 million before immigrating to the U.S. would add $8.7 million (also adjusted for inflation) to their after-tax legacy. By adding a P.P.L.I. policy to their plan, Mr. & Mrs. X can pass an additional $10.3 million to their daughters, more than doubling the tax savings benefit of the drop-off trust.

Additionally, since Mr. & Mrs. X's P.P.L.I. policy is structured as a non-M.E.C. policy, in the highly unlikely event that their core capital proves to be insufficient, in 15 years' time they should be able to withdraw the $9 million of premiums and borrow the excess at a very reasonable cost, free of income tax, as long as the loan meets certain requirements.

CAVEATS

Life insurance policies commonly marketed to Europeans may be viewed as investment accounts rather than life insurance under U.S. tax laws. As a result, income accumulating inside such a policy may be recognized currently, rather than deferred, and the death benefit may not be wholly exempt from U.S. income tax.

Advisers planning for impending establishment of U.S. tax residence should coordinate with tax counsel in the N.R.A.'s home country to ensure that establishing a P.P.L.I. policy and/or drop-off trust prior to a move to the U.S. does not give rise to unintended adverse tax and other consequences in the home jurisdiction of the N.R.A. Matters related to information reporting under the Common Reporting Standard must also be taken into account during the pre-immigration period.

"P.P.L.I. is a variable policy supported by segregated accounts and, therefore, must satisfy a diversification test on a quarterly basis."

Compliance requirements in the U.S. are substantial. In order for a P.P.L.I. policy to be considered an insurance policy for U.S. tax purposes, several tests must be met:

- The contract must qualify as a life insurance contract under the law of the state or foreign country where issued.
- The contract must meet either (i) the cash value accumulation test or (ii) the guideline premium/cash value corridor test,[4] as follows:
  - The cash value accumulation test is met if the cash surrender value of the insurance contract may not, at any time during the life of the policy, exceed the net single premium that would have to be paid at that time to fund future benefits under the contract. This test is designed to ensure that the value of the policy does not exceed an amount that is reasonably appropriate for the death benefit to be met, using sound actuarial assumptions.
  - The guideline premium requirement is satisfied if the sum of the premiums paid under the contract does not at any time exceed the guideline premium limitation at that time as provided by U.S. tax law. The cash value corridor is satisfied if the death benefit under the contract at any time is not less than the applicable percentage of the cash surrender value determined under tables provided in the Internal Revenue Code. This test is intended to prevent a buildup of cash value beyond that required to fund the death benefit.
- P.P.L.I. is a variable policy supported by segregated accounts and, therefore, must satisfy a diversification test on a quarterly basis. Under the diversification test, the following requirements must be met each testing date:
  - There must be at least five different investments.
  - Not more than 55% of the value of the total assets of the account can be represented by any one investment.
  - Not more than 70% of the value of the total assets of the account can be represented by any two investments.
  - Not more than 80% of the value of the total assets of the account can be represented by any three investments.
  - Not more than 90% of the value of the total assets of the account can be represented by any four investments.

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4 "Frozen cash value" policies arguably qualify for favorable U.S. income tax treatment, despite failure to comply with either the cash value accumulation test or guideline premium test. Investment in such a policy requires close consultation with competent tax and insurance advisers.

- Furthermore, the owner of a variable policy is restricted in his or her ability to control the investment choices under the policy.

Three final caveats should be considered in connection with this planning opportunity:

- First, for an individual to have tax-free access to the cash value of the P.P.L.I., it cannot be categorized for U.S. income tax purposes as a modified endowment contract, or M.E.C. An insurance policy is considered to be an M.E.C. where premiums are heavily front loaded. To avoid M.E.C. status, the total amount of premiums paid by the holder within the first seven years cannot exceed the amount required to have the policy be considered paid up within that time. If the P.P.L.I. is an M.E.C., gains are deemed distributed before capital and a 10% penalty is imposed on distributions prior to age 59½.

- Second, premium payments made to a foreign insurance company in connection with an insurance policy covering the life of a U.S. insured person are subject to a 1% excise tax. This excise tax may be eliminated under an applicable income tax treaty that covers the issuer of the policy and through certain elections under U.S. law by the insurance company.

- Finally, a P.P.L.I. is viewed to be a foreign financial account that must be reported to the I.R.S. Financial Crimes Enforcement Network. It is also a financial account under F.A.T.C.A. As a result, insurance companies located outside the U.S. must report information regarding U.S. policyholders and the policyholders must comply with reporting obligations with respect to Form 8938, *Statement of Specified Foreign Financial Assets*. Substantial penalties are imposed for noncompliance.

CONCLUSION

Pre-immigration drop-off trusts have long been used by practitioners as an effective technique to reduce estate tax. However, by combining the drop-off trust with a P.P.L.I. policy practitioners can turn the drop-off trust into a tool that reduces both estate and income taxes. Furthermore, the substantial income-tax savings should enable an N.R.A. to fund the drop-off trust with additional assets and ultimately achieve even greater U.S. estate-tax savings.

The ability to transfer assets freely out of one's estate without the use of exclusion amounts or the imposition of transfer taxes makes this combination particularly compelling in the pre-immigration planning context. However, planning that includes a P.P.L.I. policy should not be undertaken without input from a tax planner with experience.

INDIA BUDGET 2017-18

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Tags
Budget
Capital Gains
Income Tax
India
Tax Policy

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

The Indian Finance Minister ("F.M.") presented the budget for financial year ("F.Y.") 2017 to 2018 ("Budget 2017-18") in parliament on February 1, 2017. Along with proposed amendments to the tax law, key economic numbers from the annual economic survey and additional policy proposals were announced.

Budget 2017-18 was presented in an economic environment fraught with the challenges of the recent demonetization exercise and weak investor sentiment, set amidst a V.U.C.A. world. This budget therefore posed a daunting task for the F.M., requiring him to achieve equilibrium between growth, job creation, and fiscal prudence on one hand and popular expectations on the other.

Budget 2017-18 is unique in three aspects. For the first time in Indian history, the Rail Budget has been folded into the country's fiscal plan, the bifurcation between plan and non-plan expenditures has been eliminated with a view towards focusing on capital and revenue expenditure, and the budget presentation to the parliament was advanced by a month.

Demonetization has caused short-term disruption in the Indian economy and has slowed down demand and consumption. The gross domestic product ("G.D.P.") growth forecast for F.Y. 2016-17 was reduced to 7.1% from the earlier estimate of 7.6%. The impact of demonetization on the G.D.P. is not, however, expected to spill over into the next year, and coupled with the roll out of the new goods and services tax ("G.S.T."), it is expected to spur G.D.P. growth in the long run. The wholesale price index ("W.P.I.") has reversed from -5.1% to 3.4%, while consumer price index ("C.P.I.") has declined from 6% in July 2016 to 3.4% in December 2016. The current account deficit has declined from 1% of G.D.P. in F.Y. 2015-16 to 0.3% of G.D.P. in the first half of F.Y. 2016-17.

Budget 2017-18 focuses on infrastructure, agriculture, rural development, and housing, in order to bolster growth through job creation and the elimination of black money. The F.M. outlined the Budget 2017-18 proposals under the "Transform, Energize and Clean India" agenda for the next year.

KEY POLICY ANNOUNCEMENTS

Some of the important policy announcements from Budget 2017-18 are described below.

Foreign Investment Policy

- The Foreign Investment and Promotion Board ("F.I.P.B.") is to be abolished in F.Y. 2017-18, and the roadmap to this end will be announced in the next few months.

- Further liberalization of the Foreign Direct Investment ("F.D.I.") policy is under consideration and pertinent announcements will be made in due course.

Financial Sector

- To improve ease of doing business, the registration process for financial market intermediaries, such as mutual funds, brokers, and portfolio managers, will now be handled online.

- With a view towards enhancing the operational flexibility and ease of access to Indian capital markets, a common application form will be introduced for the registration and opening of bank accounts and Demat[1] accounts, and for the issuing of permanent account numbers ("P.A.N.'s") for foreign institutional investors ("F.I.I.'s") and foreign portfolio investors ("F.P.I.'s").

- The commodities and securities derivative markets will be unified further through the integration of the participant, broker, and operational frameworks.

- Systematically important non-banking finance companies ("N.B.F.C.'s") that are regulated by R.B.I. and are above a certain net worth will be categorized as qualified institutional buyers, thereby making them eligible for participation in initial public offerings ("I.P.O.'s") with specifically earmarked allocations. This will help to strengthen the I.P.O. market and channelize more investments.

Digital Economy

- Digital payment infrastructure and grievance handling mechanisms will be strengthened.

- A proposal to mandate that all government receipts exceeding a certain amount be handled through digital means is being considered.

Labor Law Reforms

- Legislative reforms are to be undertaken to simplify, rationalize, and amalgamate the existing labor laws into four codes: wages, industrial relations, social security and welfare, and safety and working conditions.

Railways and Infrastructure

- About 7,000 stations with solar power are to be created in the medium term.

- A new Metro Rail Policy will be introduced with a focus on innovative models of implementation and financing, as well as standardization and indigenization of hardware and software.

- A new Metro Rail Act will be introduced to increase private participation and investment in construction and operation.

- Airports in Tier 2 cities will be taken up for operation and maintenance using the public-private partnership ("P.P.P.") model. The Airport Authority of India

[1] The term "Demat" refers to dematerialization of investment accounts. Stock certificates for publicly traded companies are being phased out and replaced with electronic accounts.

Act will be amended to enable the effective monetization of land assets. The resources, so raised, will be utilized for airport upgrades.

- 2,000 kilometers of coastal connectivity roads are to be constructed.

Housing

- By 2019, 10 million new houses are to be constructed.
- To facilitate greater investment in affordable housing, housing projects will be afforded the status of infrastructure, subject to certain conditions, thereby enabling such projects to receive the associated benefits.

KEY DIRECT TAX PROPOSALS

The direct tax proposals discussed below are effective for F.Y. 2017-18, *i.e.*, from April 1, 2017, unless otherwise specifically stated.

Rates of Tax

No change is proposed on the rates of tax, surcharges, and education cess for partnership firms, limited liability partnerships, and foreign companies for F.Y. 2017-18.

For domestic companies, the rate of tax is proposed to be reduced from 30% to 25% in cases where the company's total turnover or gross receipts for F.Y. 2015-16 did not exceed I.N.R. 500 million ($7.5 million).

"For individuals with a total income between I.N.R. 250,001 ($3,750) and I.N.R. 500,000 ($7,500), the rate of tax is proposed to be reduced from 10% to 5%."

For individuals with a total income between I.N.R. 250,001 ($3,750) and I.N.R. 500,000 ($7,500), the rate of tax is proposed to be reduced from 10% to 5%. It is further proposed to levy a surcharge at 10% where an individual's total income is between I.N.R. 5 million ($75,000) and I.N.R. 10 million ($150,000).

No change is proposed for the rate of Minimum Alternate Tax/Alternate Minimum Tax ("M.A.T./A.M.T."). However, the carryforward of M.A.T./A.M.T. credit is now proposed to be allowed for 15 years instead of the present limit of 10 years.

Indirect Transfer of Assets

Budget 2017-18 proposes to clarify that the provisions relating to the indirect transfer of assets will not apply to the transfer of an asset or a capital asset held by a nonresident, directly or indirectly, in an F.I.I. that has been notified by the government and has registered as a Category I or Category II F.P.I. with the Securities and Exchange Board of India ("S.E.B.I"). This clarification will help to alleviate the concerns of investors in F.I.I.'s and F.P.I.'s and is welcome. However, no similar relief is proposed to be provided to private equity funds or venture capital funds investing in Indian securities.

The proposed amendment is effective as of April 1, 2011, *i.e.*, from the year in which the provisions relating to indirect transfer of assets were introduced into domestic tax law.

Special Taxation Regime for Offshore Funds

Eligible offshore investment funds carrying out fund management activities in India through an eligible fund manager are neither considered to be resident in India nor to be constituting a business connection in India, subject to the fulfilment of certain conditions. One of the specified conditions is a requirement to maintain the fund's monthly average of the corpus at a minimum of I.N.R. 1 billion ($15 million). It is proposed to do away with this requirement in the year in which the fund is wound up.

The proposed amendment is effective from April 1, 2015, *i.e.*, from the year in which the special taxation regime for offshore funds was introduced into domestic tax law. However, no relief is proposed in respect to several other onerous conditions that are required to be fulfilled by offshore funds.

Interpretation of Terms Used in Agreements Entered into with Different Countries

Budget 2017-18 proposes to clarify that any term used in a double taxation avoidance agreement ("D.T.A.A.") entered into between the government of India and the government of any other country will be assigned the meaning as provided in the D.T.A.A. In cases where a term is not defined in the D.T.A.A., the term will be assigned the meaning as defined in Indian domestic tax law or any other explanation issued by the government of India. This amendment seeks to reverse the decision of the High Court in a past judgment, wherein it was held that unless the context otherwise requires, it would be impermissible to interpret a particular expression that was not defined in a D.T.A.A. by ascribing to it the meaning drawn from the definition of a different term in the domestic law.

Provisions Relating to Transfer Pricing – Secondary Adjustments in Transfer Pricing Cases

In order to align India's transfer pricing provisions with the O.E.C.D.'s transfer pricing guidelines and international best practices, Budget 2017-18 proposes that a resident taxpayer entering into an international transaction will be required to carry out secondary adjustments in cases where the primary adjustment has been made in any of the following ways:

- *Suo moto* by the taxpayer in his return of income
- By the tax authority, and accepted by the taxpayer
- As determined by an advance pricing agreement
- As per safe harbor rules
- As a result of a mutual agreement procedure ("M.A.P.") under a D.T.A.A.

It is further proposed that where, due to a primary adjustment to the transfer price, there is an increase in total income or reduction in loss to the taxpayer and excess funds available to its associated enterprise ("A.E.") are not repatriated to India within the prescribed timeframe such excess will be deemed to be an advance made by the taxpayer to its A.E., the interest on which will be computed as income of the taxpayer.

However, the secondary adjustment would not be carried out if the following conditions were met:

- The amount of the primary adjustment made by the taxpayer in any F.Y. does not exceed I.N.R. 10 million ($150,000).

- The primary adjustment is made in respect to F.Y.'s prior to F.Y. 2016-17.

Thin Capitalization Rules

A new provision is proposed to be introduced to curb companies from enjoying excessive interest deductions. This provision will be in line with the recommendations of O.E.C.D. B.E.P.S. Action 4.

The new provision seeks to restrict the deduction for interest expenses paid or payable by an entity to its A.E.'s to 30% of its earnings before interest, taxes, depreciation, and amortization ("E.B.I.T.D.A."). This provision will be applicable to an Indian company or the permanent establishment ("P.E.") of a foreign company that pays interest exceeding I.N.R. 10 million ($150,000) on any form of debt issued to a nonresident or the P.E. of a nonresident and which is an A.E. of the borrower. Such excess interest will not be deductible in the hands of the Indian company or P.E.

Further, the debt will be deemed to be issued by an A.E. where it provides an implicit or explicit guarantee to the lender, or where it deposits a corresponding and matching amount of funds with the lender. Such disallowed interest expenses will be allowed to be carried forward for eight F.Y.'s immediately succeeding the F.Y. for which the disallowance was first made, and deduction against income computed under the heading of "profits and gains of business or profession," to the extent of the maximum allowable interest expenditure, will be permitted.

Banking and insurance businesses would be excluded from the scope of the thin capitalization provisions.

Minimum Alternate Tax ("M.A.T.")

Currently, companies are required to pay M.A.T. at 18.5% of their book profits (computation of which is specified by law) if the tax payable as per the regular provisions of the domestic tax law after considering all other allowable deductions is less than 18.5% of the book profits. The time limit for the carryforward of the difference between the M.A.T. paid and the tax payable under the normal tax provisions, referred to as M.A.T. credit, is now proposed to be increased to 15 years from the present limit of 10 years. No M.A.T./A.M.T. credit will be allowed if the credit relates to the difference between a foreign tax credit ("F.T.C.") allowed against the M.A.T./A.M.T. and an F.T.C. allowed against the tax computed under the regular tax provisions.

As the adoption of Indian Accounting Standards ("Ind. A.S.") is a mandatory requirement for certain companies as of F.Y. 2016-17, it is proposed to introduce a framework for the computation of book profits for such companies in the first year of their adoption of Ind. A.S. and thereafter.

Extending the Period to Claim Tax Deductions and Carry Forward Loss for Start-Ups

A 100% deduction of profits is available to eligible start-ups that were incorporated after March 31, 2016, and before April 1, 2019, and are engaged in the business of innovation, development, deployment, or commercialization of new products, processes, or services driven by technology or intellectual property. The deduction is available for any three consecutive F.Y.'s out of a block of five years after the date of incorporation of the start-up.

In view of the fact that start-ups may take time to derive profit from their business, it is now proposed to increase the period of the block from five years to seven years. It is also proposed that in the case of a change in the shareholding structure of an eligible start-up company during an F.Y., the loss incurred during the period of seven years beginning from the year in which such company is incorporated will be carried forward and set off against the income of that F.Y. if all the shareholders of such company who held shares carrying voting power on the last day of the year in which the loss was incurred continue to hold those shares on the last day of the F.Y. in which the loss is set off.

Capital Gains

Definition of Long-Term Capital Asset

To make the real estate sector more attractive to investors, it is proposed to reduce the holding period required to qualify as a long-term capital asset for land or buildings from 36 months to 24 months.

Shifting of Base Year for Computation of Capital Gains

The base year for calculating the indexed cost of acquisition for the purposes of computing capital gains has been proposed to be changed from the year beginning April 1, 1981, to the year beginning April 1, 2001. The cost of acquisition in relation to any capital asset acquired before April 1, 2001, will be the cost of the acquisition of the asset to the taxpayer or the fair market value ("F.M.V.") of such asset as of April 1, 2001, at the option of the taxpayer. Thereafter, the actual cost of improvement incurred after April 1, 2001 will only be considered when calculating the indexed cost of acquisition.

Conversion of Preference Shares to Equity Shares

To provide tax neutrality on the conversion of preference shares of a company into equity shares of that company, it is proposed that such conversion will not be regarded as a "transfer" for the purposes of capital gains. The cost of acquisition and the holding period of such preference shares will be considered to be part of the cost and the total holding period of the converted equity shares. Therefore, the conversion of preference shares into equity shares will not be considered a taxable event.

Fair Market Value to be Full Value of Consideration in Certain Cases

In cases were the full value of consideration for a transfer of shares of a company (other than quoted shares) is less than the F.M.V., the F.M.V. will be deemed to be the full value of consideration. This may impact private equity investors who are thought to sell stocks of closely held companies to other financial investors at prices that are lower than the F.M.V.

Tax on Certain Long-Term Equity Shares or Units

At present, any income arising from the transfer of specific long-term capital assets, *i.e.*, an equity share in a company, a unit of an equity-oriented fund, or a unit of a business trust, is exempt from tax provided that such transaction is subject to securities transaction tax ("S.T.T.").

It is proposed that the above exemption will not be granted to the transfer of equity shares in a company if the transaction to acquire such equity shares was entered into on or after October 1, 2004, without payment of S.T.T. However, to preserve the exemption for genuine cases where the S.T.T. could not have been paid (such as for the acquisition of shares in an I.P.O.; follow on public offering ("F.P.O."), bonus, or rights issue by a listed company; or an acquisition by nonresidents in accordance with the F.D.I. policy) it is proposed to eliminate the condition of chargeability to S.T.T. upon acquisition of shares in specific cases of transfer, which will be notified by the government.

Computation of Capital Gains in Case of Joint Development Agreement

For individuals and Hindu Undivided Families ("H.U.F.'s") entering into a specific agreement for the development of a project, capital gains arising from the transfer of a capital asset (whether land or building or both) will be taxable in the year in which a certificate of completion for the whole or a part of the project is issued by the competent authority.

The full value of consideration for the purposes of computing such capital gains will be the total of the stamp duty value of the taxpayer's share in the project on the date of issuance of the certificate of completion and the monetary consideration received, if any. The benefit of the proposed regime will not apply to a taxpayer if he or she transfers his or her share in the project to any other person on or before the date of issue of the certificate of completion, in which case the taxpayer will be liable for capital gains in the year in which the transfer takes place. The cost of acquisition of the share in the developed project in the hands of such taxpayer will be the amount that is deemed to be the full value of consideration. Tax at the rate of 10% will be withheld from the monetary consideration payable under the specific agreement.

This amendment has been proposed with the intent to minimize the ambiguity in the interpretation of the meaning of "transfer," which has long been the subject of litigation.

Extension of Capital Gains Exemption to Rupee-Denominated Bonds

The transfer of rupee-denominated bonds (issued by an Indian company outside India) held by a nonresident to another nonresident will be exempt from capital gains tax. Any gains arising due to forex appreciation of the rupee-denominated bonds in the computation of capital gains at the time of redemption will also be extended to secondary holders of such bonds.

Tax on Income from a Transfer of Carbon Credits

The taxation of carbon credits has been litigated in many cases, and various courts and tribunals have taken the view that such a credit is a capital receipt. However, one court held a sale of carbon credits to be revenue in nature, and this matter is pending before the Apex Court. Budget 2017-8 proposes to provide that the gross income from the transfer of carbon credits will be taxed at a concessional rate of 10% (plus surcharge and education cess). No expenditure or allowance in respect to such income will be allowable as a deduction.

Cost of Acquisition in a Tax Neutral Demerger of a Foreign Company

The transfer of shares of an Indian company by a demerged foreign company to the resulting foreign company is not regarded as a transfer under the domestic tax law.

It is proposed to clarify that the cost of acquisition of such shares in the hands of the resulting foreign company will be the same as it was in the hands of the demerged foreign company.

Widening the Scope of "Income from Other Sources"

Budget 2017-18 proposes to extend to all taxpayers the taxation of the receipt of any sum of money exceeding I.N.R. 50,000 ($750) or any movable or immovable property without consideration or with inadequate consideration (as defined). Currently, this provision is applicable only to individuals and H.U.F.'s, and to firms and companies only with respect to shares of unlisted companies.

Tax on Dividends

Budget 2017-18 proposes to expand the scope of the tax on dividends inserted by Finance Act 2016 that was applicable only to resident individuals, H.U.F.'s, and firms (including L.L.P.'s). Accordingly, the proposal will tax dividends exceeding I.N.R. 1 million ($15,000) in the aggregate in the hands of all resident taxpayers except the following:

- Domestic companies
- Certain approved trusts, funds, or institutions established for charitable or religious purposes

Nonresident taxpayers continue to remain outside the scope of this provision.

The proposed amendment eliminates any opportunity for tax planning by corporations and their promoters by setting up an intermediary trust or Association of Persons ("A.O.P.").

Transparency in Electoral Funding

Budget 2017-18 proposes that income received by political parties should be exempt, subject to the following conditions:

- No donations exceeding I.N.R. 2,000 ($30) are to be received in cash.
- All political parties are required to file a return of income on or before the prescribed due date.

An amendment is proposed to the Reserve Bank of India Act, 1934, to provide for the issuance of electoral bonds to facilitate the funding of political parties via banking channels. Political parties will not be required to furnish the name and address of the donors who contribute by way of electoral bond.

Withholding Tax Provisions

Interest Payable to a Nonresident Taxpayer on Borrowings in Foreign Currency

The concessional rate of 5% withholding tax on interest on borrowing made under a loan agreement or by way of any long-term bond, including a long-term infrastructure bond, which is applicable until July 1, 2017, is proposed to be extended to July 1, 2020. Further, the benefit of the lower rate of withholding tax of 5% is also proposed to be extended to rupee-denominated bonds issued outside India before July 1, 2020. The proposed amendment will be effective as of April 1, 2015.

Interest Payable to Qualified Foreign Investors

The concessional rate of 5% withholding tax, which is applicable to interest payments to F.I.I.'s and qualified foreign investors ("Q.F.I.'s") in respect to investments in government securities and rupee-denominated corporate bonds made before July 1, 2017, is now proposed to be extended to July 1, 2020.

Disincentives for Cash Transactions

"To promote digital transactions with a view towards transitioning to a 'less cash' economy and tackling the issue of growing black money, several amendments are proposed."

In order to promote digital transactions with a view towards transitioning to a "less cash" economy and tackling the issue of growing black money, several amendments are proposed to reduce the limit of permissible cash transactions. Specifically, no cash transactions will be permitted for amounts exceeding I.N.R. 300,000 ($4,500). Further, penalties are proposed to be introduced for contravention of the restrictions on to cash transactions.

KEY INDIRECT TAX PROPOSALS

Given the impending introduction of the G.S.T. by July 1, 2017 or thereabout, there are few noteworthy amendments and proposals regarding the indirect tax laws in Budget 2017-18. Nevertheless, the F.M. has tried to address issues such as inverted duty structure in the chemicals sector, de-incentivizing the drain of vital mineral resources from India, and boosting the renewable (solar and biogas) energy sector.

The F.M. asserted in his budget speech that the G.S.T., by far the biggest tax reform since India's independence, is on schedule and that preparation of the information technology ("I.T.") system for G.S.T. is progressing well. He assured the business community at large that extensive outreach efforts to trade and industry for G.S.T. will start from April 1, 2017.

The key indirect tax proposals are briefly discussed below.

Service Tax

- The effective service tax rate remains unchanged at 15% (service tax at 14%, *Swachh Bharat* cess at 0.5%, and *Krishi Kalyan* cess at 0.5%).
- Services provided by select airline operators to the government, including the transportation of passengers by air either embarking from or terminating at Regional Connectivity Scheme ("R.C.S.") Airport, weighed against consideration in the form of viability gap funding ("V.G.F."), have been exempted from service tax with effect from February 2, 2017. This exemption will not be available more than one year from the date of the commencement of operations at R.C.S. Airport, as advised by the Ministry of Civil Aviation.
- A one-time, upfront amount collected by the State Government Industrial Development Corporation Undertaking from industrial units for the grant of the long-term lease of industrial plots (for 30 years or more) is proposed to be exempted from service tax retrospectively from June 1, 2007, *i.e.*, when the service of the "renting of immovable property" was made exigible to service tax.
- For the purposes of the reversal of the central value added tax ("CENVAT") credit on common input services under Rule 6(3) or 6(3A) of the CENVAT

Credit Rules, 2004 ("C.C.R. 2004") by banks and financial institutions, including N.B.F.C.'s, the value of services provided by way of extending deposits, loans, or advances – insofar as the consideration is represented by interest or a discount – will form part of the value of the exempted services (with effect from February 2, 2017).

Customs Duty

- The standard ad valorem rate of basic customs duty ("B.C.D.") remains unchanged at 10%. The education cess and secondary and higher education cess will also continue to apply to B.C.D.
- The following proposals will be effective as of the date of assent on Finance Bill, 2017:
  - It is proposed that the provisions relating to unjust enrichment will not apply to cases where the refund is given in relation to excess duty paid by the importer prior to the order permitting the clearance of goods for home consumption and the same is evident from the bill of exchange filed.
  - Facilities for the storage of imported goods in public warehouses for up to 30 days has been extended to imported goods that cannot be removed for warehousing within a reasonable time.

Excise Duty

- The standard ad valorem rate of excise duty remains unchanged at 12.5%.
- In the case of a transfer of business undertakings or a change in ownership, a timeframe of three months has been prescribed for permission to be granted for the transfer of accumulated CENVAT credit under Rule 10 of C.C.R. 2004. This period could be further extended by six months by the Principal Commissioner/Commissioner of Central Excise (with effect from February 2, 2017).

CONCLUSION

The provisions in Budget 2017-18 that relate to infrastructure, the financial sector, accountability, prudent fiscal management, and tax administration reflect a view that times are changing in India. The government appears to remain steadfast in bringing the tax and regulatory environment up to global standards.

SWISS CORPORATE TAX REFORM POSTPONED

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Tags
Corporate Tax
Income Taxation
Notional Interest Deduction
Patent Box
Step-Up in Basis
Switzerland

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INTRODUCTION

Besides its beautiful mountains and lakes, Switzerland is traditionally known as an attractive and stable location with regard to corporate income taxation. However, in recent years, Switzerland has been under high international pressure from organizations including the E.U. and the Organisation for Economic Cooperation and Development ("O.E.C.D."), which claim that the Swiss tax system is not in line with international best practices. In particular, the E.U. has expressed the opinion that the tax regimes granted by Switzerland to certain companies – such as holding or mixed companies – represent prohibited State Aid and violate the 1972 free trade agreement between Switzerland and the E.U.

In 2014, this dispute was settled by a joint statement on business taxation between Switzerland and the E.U. In the settlement, Switzerland agreed to abolish five preferred tax regimes (see below for details), prompting a proposal for broader reform the Swiss corporate tax system. However, the E.U. has stipulated that it will re-impose sanctions against Switzerland should the agreed-upon obligations under the joint statement not be fulfilled within a reasonable amount of time or should Switzerland introduce new harmful tax regimes.

In 2012, the O.E.C.D. launched the B.E.P.S. Project, which deals with tax avoidance strategies used by multinational enterprises ("M.N.E.'s"). M.N.E.'s try to shift profits from jurisdictions that have high taxes – such as the U.S. and many countries in western Europe – to jurisdictions that have low or no taxes, even though there is little or no economic substance (*i.e.*, business activities, employees, office premises, etc.) in the latter jurisdictions. The B.E.P.S. Project has led to the publication of several reports and actions plans by the O.E.C.D. Since Switzerland is a member state of the O.E.C.D. and its goal is to be in line with international best practices, compliance with B.E.P.S. Project recommendations is an essential component of the proposed reform of Swiss corporate income taxation.

In the summer of 2016, the two chambers of the Swiss parliament formally approved new legislation that would have led to a tax system consistent with international standards. However, on Sunday, February 12, Swiss voters defeated the tax reform package known as the Corporate Tax Reform III ("C.T.R. III").

This article describes the state of the proposed reform that was put before Swiss voters and ponders steps that may be taken in order to fulfill all obligations under the settlement between Switzerland and the E.U. Even though the proposal did not find final approval by voters, substantial portions are expected to form part of a new proposal that will be submitted to the Swiss Parliament.

CURRENT CORPORATE INCOME TAXATION IN SWITZERLAND

Switzerland is comprised of 26 states (cantons). Taxes are levied at the Federal and cantonal/municipal levels. As a result, there is no standard tax rate since the cantonal/municipal rates differ. Federal corporate income tax is levied at a flat rate of 8.5% of net income. Since a company may deduct its taxes in the respective year, the effective Federal corporate income tax rate is approximately 7.8%. The aggregate effective income tax rate for Federal and cantonal/municipal taxes for ordinarily taxed companies – as opposed to preferred companies (see next paragraph) – varies from 12% to 24%, depending on the canton and municipality in which it will be taxed.

The current Swiss tax system provides for preferred tax regimes enabling certain companies (*i.e.*, holding, administrative, mixed, and principal companies and Swiss finance branches) to reduce their effective tax burdens significantly:

- Swiss holding companies are exempt from cantonal/municipal income taxes ("Holding Company Status"), provided they fulfill certain conditions:

    - At least two-thirds of the holding company's total assets must consist of substantial investments in participations, or at least two-thirds of the company's total income must be derived from such investments.

    - The company may, in general, not engage in an active business in Switzerland.

    - The company's statutory purpose is investing in subsidiaries.

  Thus, a holding company typically receives dividend income and/or realizes capital gains. On a Federal level, holding companies may profit from a participation exemption on dividends and capital gains if certain conditions are satisfied (*i.e.*, at least 10% shareholding, or the value of the shares equals more than CHF 1,000,000 with respect to dividends). In practice, such dividends are typically 90%- to 95%-exempt from corporate income tax. As a result, Swiss holding companies are currently taxed marginally or not at all.

- If a Swiss company is engaged primarily (*i.e.*, a mixed company) or fully (*i.e.*, an administrative company) in activities abroad, income from non-Swiss sources may be taxed at substantially reduced rates at a cantonal/municipal level. These companies are typically used for the sales, financing, or holding of intellectual property ("I.P.") or other activities in relation with non-Swiss markets. Although there is no preferred tax rate on a Federal level, the overall corporate income tax rate can be reduced to approximately 8% to 10%.

- In a principal company, functions, responsibilities, and risks of a group are centralized in one company while the distribution of products is carried out by group entities or agents. On a cantonal/municipal level, the above-mentioned rules regarding mixed companies apply. On a Federal level, foreign trading activities are allocated to the profit of the principal company. In other words, foreign profits may be shifted to Switzerland. On an aggregated level, these companies are able to reduce their corporate income tax rate to approximately 5% to 6%.

- A branch of a foreign company providing finance services to group members may profit from qualifying as a Swiss finance branch for Federal tax purposes. On a cantonal level, the above-mentioned rules regarding mixed companies apply. Further, there is a deemed interest deduction on the cantonal and Federal level. On an aggregated level, these companies are able to reduce their corporate income tax rate to approximately 2% to 3%.

Due to the increase in international pressure, the Swiss government approved a new law – the C.T.R. III – in 2016, in order to adapt the Swiss corporate tax system to international standards. The tax reform was not only expected to be internationally acceptable, but it would also have allowed the Swiss tax system to remain one of the most competitive and attractive tax systems in Europe. Since companies benefiting from the above-mentioned tax regimes create jobs and demand for services, they contribute to Switzerland's economy. In addition, they pay a significant part of the overall corporate income and capital taxes. It is estimated that all companies benefiting from the outgoing preferred tax regimes pay approximately half of all direct Federal corporate income taxes collected in Switzerland. Therefore, the two of the main goals of the C.T.R. III were keeping these companies in Switzerland and attracting new companies to Switzerland.

CORPORATE TAX REFORM III

Under the C.T.R. III, the above-mentioned preferred tax regimes would be abolished and holding, administrative, and mixed companies would be taxed at ordinary tax rates. Furthermore, the favorable principal allocation scheme and the Swiss finance branch taxation regime would be abolished on a Federal level. For Switzerland to remain attractive to companies profiting from these regimes, the C.T.R. III provided for a number of countermeasures. The cantons could then decide if and how the countermeasures would be implemented on a cantonal/municipal level.[1] Proposed measures regarding Federal and cantonal level taxation are outlined below.

Step-up Mechanism to Reveal Hidden Reserves

During a transition period of five years, the cantons would have the option to impose a tax on the realization of undisclosed hidden reserves and self-generated goodwill (*i.e.*, a step-up in basis) at a special low tax rate, provided neither was taxable under the previous tax rules. Assets such as buildings or trademarks typically bear hidden reserves since the book value is lower than the actual fair market value. The special low tax rate would lead to a fair and predictable transition for companies formerly profiting from the preferred tax regimes.

A corporation's undisclosed hidden reserves and self-generated goodwill would be determined by the cantonal tax administrations at the time of enactment of the C.T.R. III. Companies transferring assets or functions from abroad to Switzerland would be permitted to disclose hidden reserves and self-generated goodwill in the tax balance sheet. The disclosed hidden reserves would be deductible in subsequent years according to the applicable tax depreciation rates. Goodwill could be amortized over a maximum period of ten years.

To illustrate the step-up mechanism, consider a Swiss company that is currently

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[1] This substantial flexibility is a consequence of the Swiss concept of federalism.

benefiting from the tax regime as a mixed company, which divides its profits into a Swiss part and a foreign part. The average profits in the years 2016 to 2018 (*i.e.*, prior to the implementation of the reform) amount to CHF 8,000 for the Swiss part and CHF 2,000 for the foreign part, totaling CHF 10,000. Additionally, the company has CHF 40,000 in hidden reserves and CHF 100,000 in equity, totaling CHF 140,000 in equity including hidden reserves. Based on a two/one ratio of capitalized income (*i.e.*, average annual profits plus interest) to equity including hidden reserves, the tax administration would calculate a weighted company value. Assuming a 5% interest rate, this would result in a weighted company value of CHF 180,000.

	SWISS	FOREIGN	TOTAL
Average Profits 2016 to 2018	CHF 8,000	CHF 2,000	CHF 10,000
Equity Including Hidden Reserves			CHF 140,000
Weighted Company Value			**CHF 180,000**

As a next step, the tax administration would calculate the goodwill by taking the difference between the weighted company value and the equity including hidden reserves, resulting, in this example, in CHF 40,000 in goodwill.

Finally, the hidden reserves and the goodwill would be divided into a Swiss part and a foreign part according to the allocation of profits from the years 2016 to 2018 (*i.e.*, an 80/20 ratio). The Swiss part would be subject to a special (lower) tax rate. Further, the total hidden reserves and goodwill could be included in the future tax balance sheet and amortized over subsequent years.

	SWISS (80%)	FOREIGN (20%)	TOTAL
Hidden Reserves	CHF 32,000	CHF 8,000	CHF 40,000
Goodwill	CHF 32,000	CHF 8,000	CHF 40,000
Amount Taxed at Special Rates	**CHF 64,000**		
Amount Taxed at Ordinary Rates		**CHF 16,000**	
Amount Included in Future Balance Sheet			**CHF 80,000**

Introduction of Federal and (Optional) Cantonal Notional Interest Deductions

While cantons would be given the option to introduce a deemed interest deduction on excessive shareholder's equity – known as a notional interest deduction ("N.I.D.") – such N.I.D. would be mandatory on a Federal level. This measure is intended to encourage companies with highly mobile financing functions to remain in Switzerland.

A similar concept is already used in European countries such as Belgium and Luxembourg. For the time being, the N.I.D. has not been addressed as a harmful tax practice by the O.E.C.D. or E.U. However, in 2016, the U.S. Department of the Treasury issued a revised U.S. Model Income Tax Convention, which provides that an N.I.D. may fall under the provisions of a preferred tax regime and will result in disadvantages with regard to U.S. withholding taxes. However, the currently applicable convention between the U.S. and Switzerland does not yet include such a clause.

To illustrate the application of the N.I.D., consider a Swiss company operating a power plant that has taxable equity of CHF 80,000,000. The balance sheet shows liquid assets of CHF 10,000,000 and real estate valued at CHF 90,000,000. The taxable profits for the given year amount to CHF 1,000,000.

"While cantons would be given the option to introduce a deemed interest deduction on excessive shareholder's equity . . . such N.I.D. would be mandatory on a Federal level."

The N.I.D. would be calculated taking the different types of assets into account. First, each type of asset would be linked to a base equity capital ratio determined by the tax administration. The assets of the company would also be weighted by a ratio determined by the tax administration. Since these ratios are not outlined in the C.T.R. III, assumptions will be used in the following example.

The asset ratio illustrates the risk linked to the asset in question and the equity needed for such assets. In the example, the estimated ratio of 55% shows that the tax administration requires equity of at least CHF 49,500,000 in order to finance the real estate.

ASSET	VALUE	ESTIMATED RATIO	BASE EQUITY
Liquid Assets	CHF 10,000,000	0%	CHF 0
Real Estate	CHF 90,000,000	55%	CHF 49,500,000
Total Base Equity			**CHF 49,500,000**

In the example, the Swiss company has an equity surplus of CHF 30,500,000. The notional interest rate would be based on the rate of return of a ten-year Federal government bond, which is currently 0%. For illustration purposes, we assume an N.I.D. rate of 1%. Therefore, the company could include a deduction of 1% of the surplus equity (*i.e.*, CHF 305,000 for (notional) interest from its taxable income for Federal corporate income tax purposes) on its tax return.

Finally – after the deduction of the N.I.D. – the taxable profits for the given year would amount to CHF 695,000. On a cantonal/municipal level, the deduction would be granted if the applicable canton introduced the N.I.D. in its cantonal law.

Taxable Equity	CHF 80,000,000
Total Base Equity	CHF 49,500,000
Surplus Equity	CHF 30,500,000
Estimated 1% N.I.D.	CHF 305,000
Taxable Profit after N.I.D.	**CHF 695,000**

Introduction of a Patent Box Regime at the Cantonal Level

By introducing an I.P. or "Patent Box" regime, revenues from specific I.P. rights could be excluded from taxable profits up to a maximum of 90% of cantonal/municipal taxes.

The Patent Box regime is also used in other European countries such as Luxembourg and the U.K. However, it should be noted that these regimes are under international pressure from the O.E.C.D. Luxembourg has already announced its plan to abolish the current regime since it is not in line with international standards.

To ensure legal certainty, the Swiss Patent Box regime would follow the approach recommended by the O.E.C.D. and thus fulfill international standards. Action 5 of the B.E.P.S. Project requires companies to have substantial activity in a jurisdiction in order to benefit from this type of preferred tax regime.

Introduction of an Optional Deduction for Research and Development at the Cantonal Level

In addition to the Patent Box regime, the C.T.R. III would introduce an optional deduction of 50% for research and development ("R&D") costs incurred in Switzerland. Since the optional deduction was limited to costs incurred in Switzerland, it was anticipated that the measure would be in line with the prospective standards of the O.E.C.D. and E.U. This incentive was intended to encourage entities with innovative activities to move to or remain in Switzerland.

Consider, as an example, a Swiss company that sells watches, parts of which are researched and developed by the Swiss company. The taxable net profit amounts to CHF 2,000,000 and the costs for R&D incurred in Switzerland amount to CHF 300,000. The final taxable profit would be calculated as follows:

Taxable Net Profit for Federal Tax Purposes	CHF 2,000,000
50% Deduction for R&D	CHF 150,000
Taxable Profit for Cantonal/ Municipal Tax Purposes	**CHF 1,850,000**

Introduction of an Overall Limitation at the Cantonal Level

The measures of the reform would have allowed for up to an 80% reduction of profits at the cantonal/municipal level. However, individual cantons could introduce lower thresholds in order to allow for more planning possibilities.

General Lowering of Cantonal Corporate Income Tax Rates

Under the C.T.R. III, the cantons would be free to decrease their cantonal/municipal corporate income tax rates, and prior to the public vote, certain cantons had already announced plans for substantial rate reductions. In Geneva, for example, the aggregate tax rate (including Federal taxes) was expected to be lowered from approximately 24% to as low as 13.5%. The canton of Zug, known as one of the most attractive cantons in Switzerland, also announced a plan to further reduce its aggregated tax rate from approximately 14.6% to 12%. However, other cantons, such as the canton of Zürich, were expected to adjust their aggregate tax rates only slightly, from 21.1% to 18.2%, while introducing the other above-mentioned measures in order to remain attractive.

Abolishment of Stamp Duty and Introduction of Tonnage Tax

In the course of Parliamentary review, other measures, such as abolishing the stamp duty of 1% on equity, were rejected or postponed. Additionally, the introduction of a so-called tonnage tax for shipping companies that operate marine transport services was deferred for further analysis within a consultation procedure and was expected to be dealt with in a separate proposal.

Tax Holidays

As a side note, the Federal and cantonal tax holidays would not affected or altered by the reform. Therefore, newly established businesses could continue to profit from a tax holiday of up to ten years in designated areas in Switzerland.

Companies Affected by the C.T.R. III

For Swiss-resident companies, the specific consequences and opportunities created under the C.T.R. III would require individual assessment. In general, all Swiss-resident companies would profit from the lower corporate income tax rates. In certain cases, a relocation of activities to a low-tax canton may have proved beneficial. For companies currently profiting from preferred tax regimes, direct implications of the C.T.R. III would have been as follows:

Holding companies would be subject to ordinary taxation on a cantonal/municipal level. However, the participation exemption, as currently applied for Federal taxes, would also become applicable on a cantonal/municipal level. Thus, the reform would, in most cases, not have a significant impact, as most holding company income is derived from participations.

Mixed, administrative, and principal companies would also be subject to ordinary taxation on the cantonal/municipal and Federal levels. During a transitional period, such companies could profit from depreciations and/or amortizations on hidden reserves and self-generated goodwill, and lower tax rates would apply. In cases where such companies have I.P. rights, they could also profit from the Patent Box regime.

Swiss finance branches would be subject to ordinary taxation on a cantonal/municipal level. While the same consequences as for mixed and administrative companies apply, Swiss finance branches may profit from the N.I.D.

OUTLOOK

On February 12, 2017, 59.1% of Swiss voters rejected the fundamental overhaul of the Swiss tax system under the C.T.R. III. Supporters argued that the reform would help to attract and keep multinational companies in Switzerland. Opponents said that taxpayers, especially of the middle class, would pay higher taxes because the lower tax rates will lead to a shortfall in revenue.

The C.T.R. III would have led to a tax system consistent with international standards. Although the C.T.R. III included significant changes to Swiss Federal and cantonal tax legislation, the measures were aimed at keeping Switzerland competitive for multinational companies operating globally. At the same time, Switzerland would have retained an internationally competitive and attractive tax system that should have held up to the new standards under B.E.P.S. and the European Commission's State Aid investigations. Small- and medium-sized companies may also have benefitted from the reform.

Accordingly, in a statement issued shortly after the referendum, E.U. Commissioner for Economic and Financial Affairs Pierre Moscovici expressed the Commission's disappointment with the outcome, saying "the rejection of the reform and referendum means we need to redouble our efforts when it comes to taxation. The Commission plans to consult the member states so we can decide together how to proceed." O.E.C.D. Tax Director Pascal Saint-Amans cautioned that "Switzerland's partners will expect it to implement its international commitments within a reasonable time period," noting that "this need not happen within the context of a wider reform, which could take longer than the two years originally foreseen for these changes." Though the consequences of not abolishing the preferential tax regime within a reasonable time are understood, neither official mentioned a potential blacklisting of Switzerland.

"It is expected that after an in-depth analysis a new reform proposal will be submitted to Parliament as soon as possible. . . [and] the main core of the above outlined C.T.R. III will be included in the reassessed reform."

It is expected that after an in-depth analysis a new reform proposal will be submitted to Parliament as soon as possible. While it may not include the N.I.D. (one of the most debated items), the patent box regime and tax incentives for R&D could remain subject to a consensus between proponents and left-wing opponents of the recent reform proposal. It is estimated that the main core of the above outlined C.T.R. III will be included in the reassessed reform and the anticipated 2019 effective date may be postponed. Finally, Swiss cantons may reassess their plans to reduce their corporate income tax rates since this was one of the main reasons the reform did not pass the vote.

ITALY INTRODUCES A 15-YEAR PREFERENTIAL TAX REGIME FOR WEALTHY INDIVIDUALS TAKING UP TAX RESIDENCE IN ITALY

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Tags
Italy
Non-domiciled Taxation
Pre-immigration Planning
Tax Residency

New measures aimed at making Italy an attractive destination for high net worth individuals were contained in the 2017 Italian Budget Law and went into effect on January 1, 2017. The new Italian regime is comparable to the U.K. regime for non-domiciled individuals ("Non-Doms") and to regimes adopted in other countries. In essence, it allows individuals who become Italian tax residents to opt for a flat yearly tax of €100,000 on income from sources outside Italy, regardless of the amount of such income. The new regime, to be elected on the annual tax return, is available for up to 15 years and can be waived at any time during that term.

WHO CAN BENEFIT FROM THE NEW REGIME

To qualify for the option, an individual must have been a tax resident of one or more countries other than Italy for at least nine of the ten years preceding the year in which the individual becomes an Italian tax resident. If this condition is met, the option is available regardless of the taxpayer's nationality (*i.e.*, it is available for both non-Italian and Italian nationals).

SCOPE OF APPLICATION OF THE FLAT TAX

The flat tax, if opted for, will replace any tax to which an Italian tax resident would otherwise be subject on income from sources outside Italy. The only exception is that, during the first five years, the new resident will still be taxed on capital gains from the sale of a "qualified participation" in a company. In the case of a closely held corporation, a qualified participation means (i) an interest to which more than 20% of voting rights is attached or (ii) an interest of more than 25%, regardless of the voting rights attached to it. In the case of a publicly-traded corporation, it means (i) an interest to which more than 2% of voting rights is attached or (ii) an interest of more than 5%, regardless of the voting rights attached to it.

Income from Italian sources will be taxed in accordance with the regime ordinarily applicable to Italian tax residents. No tax credit is available for foreign taxes paid against the €100,000 annual amount. However, an option is available to exclude foreign income arising in one or more countries. This election may be made upon opting for the flat tax, or at any time during the 15-year term. Excluded foreign income will remain subject to ordinary tax rules and may therefore access the relief provided for by the applicable tax treaties.

OPTION ALSO AVAILABLE FOR RELATIVES AT A REDUCED AMOUNT

An attractive feature of the new regime is that if an individual moves to Italy together

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with family members who also receive income from non-Italian sources, the election for the regime can be extended to those family members, and each of them will be liable for an annual flat tax of €25,000 instead of €100,000. The range of family members who can benefit from the regime encompasses spouses, sons and daughters (including sons-in-law and daughters-in-law), parents (including parents-in-law), and brothers and sisters. Absent sons and/or daughters and their direct closest descendants may benefit as well.

OTHER TAX ADVANTAGES ASSOCIATED WITH THE FLAT TAX OPTION

"If an individual moves to Italy together with family members who also receive income from non-Italian sources, the election for the regime can be extended to those family members."

Individuals who are Italian tax residents are normally required to report on their annual tax return financial investments and other assets held outside Italy, whether or not such investments and assets produce income, (so-called "R.W. reporting obligations"). In addition, a tax is levied on financial investments ("I.V.A.F.E.") and on properties ("I.V.I.E.") so reported. New tax residents who choose to be taxed under the special regime will also be exempt from R.W. reporting obligations and, consequently, from I.V.A.F.E. and I.V.I.E. However, C.R.S. and F.A.T.C.A. reporting obligations would still apply.

Italian tax residents are normally liable for gift tax and inheritance tax with respect to transfers of assets by way of life time gift or an inheritance or bequest at death, regardless of physical location of the in Italy or abroad. The new regime provides tax relief to individuals on an elective basis. For successions and gifts taking place throughout the election period, inheritance and gift tax is indeed levied only on assets and rights situated in Italy (*i.e.*, the new tax resident will be exempt from gift tax and inheritance tax with respect to transfers of assets located outside Italy).

PROCEDURAL RULES

To benefit from the flat tax, a new tax resident must request a ruling ("*interpello*") from the Italian tax authority (the *Agenzia delle Entrate*) approving the election. The *interpello* must specifically indicate the jurisdiction(s) where the applicant was previously tax-resident, so that the *Agenzia delle Entrate* can exchange information with the tax authority of such jurisdiction(s). The *Agenzia delle Entrate* will have 120 days to approve or deny the request, and if no answer is provided to the applicant within this period, the request is deemed to have been approved. After having obtained a positive ruling, the applicant must make an election to apply the regime before the deadline for the submission of the tax return related to the tax year of transfer.

The new regime cannot be combined with other favorable regimes, such as the one provided for the repatriation of scientists and researchers. Within 90 days of the 2017 Italian Budget Law's entry into force, the *Agenzia delle Entrate* will issue additional regulations regarding implementation.

NEW INVESTOR VISA FOR NON-E.U. NATIONALS

The new flat tax regime is accompanied by changes to Italian immigration laws designed to make it possible for individuals who are not nationals of an E.U. Member

State to avoid restrictions that usually apply to the acquisition of Italian residency, as long as they are prepared to make investments in Italy.

Specifically, an individual can obtain an investor visa on the condition that he or she invests either €2 million in Italian governmental bonds or €1 million in securities issued by a company based and actually operating in Italy. The investment must be maintained for at least two years. The investor visa can also be obtained by making a donation of at least €1 million to a project of public interest in sectors such as culture, education, immigration handling, scientific research, and the like. In addition to fulfilling the investment requirement, an applicant for an investor visa will also be required to prove possession of financial resources that are sufficient to support him or herself during the planned stay in Italy.

The investor visa will have an initial term of two years and, under certain conditions, it will be possible to obtain extensions of three years each. Family members of the investor will be entitled to obtain a "family connection" visa granting residence with the investor.

PROPOSED DIRECTIVE ON THE E.U. COMMON (CONSOLIDATED) CORPORATE TAX BASE – A PRIMER

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Tags
C.C.T.B.
C.C.C.T.B.
European Commission
MNE Planning
Permanent Establishment
Tax Administration

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INTRODUCTION

On October 25, 2016, the European Commission announced major corporate tax reforms for the E.U. market. In particular, the European Commission issued three proposal directives that deal with (i) the Common Corporate Tax Base ("C.C.T.B.") and the Common Consolidated Corporate Tax Base ("C.C.C.T.B."), (ii) resolution of double tax disputes, and (iii) mismatches with non-E.U. Countries.

Regarding the C.C.C.T.B. and C.C.T.B. proposals (collectively, the "Proposal Directive"), the European Commission essentially revamped a failed 2011 proposal in light of recent developments in the international tax environment (*e.g.*, the O.E.C.D. B.E.P.S. Project and the Action Plan for a Fair and Efficient Corporate Tax System in the E.U.). It may be "old wine," but the new bottles may make it drinkable.

As Commissioner for Economic and Financial Affairs, Taxation and Customs Pierre Moscovici stated:

> With the rebooted CCCTB proposal, we're addressing the concerns of both businesses and citizens in one fell swoop. The many conversations I've had as Taxation Commissioner have made it crystal-clear to me that companies need simpler tax rules within the EU. At the same time, we need to drive forward our fight against tax avoidance, which is delivering real change. Finance Ministers should look at this ambitious and timely package with a fresh pair of eyes because it will create a robust tax system fit for the 21st century.[1]

The project appears to be extremely ambitious, as the Proposal Directive would have a huge impact on the tax systems of the E.U. Member States. Indeed, should the Proposal Directive be approved, Member States would lose autonomy to set rules concerning the corporate tax bases of companies falling within the ambit of the Proposal Directive – companies that carry-on business within the E.U. market and belong to a multinational group with a total annual turnover in excess of €750 million. The Proposal Directive intrudes on the sovereignty of E.U. Member States in regard to internal income tax systems, leaving them little leeway with respect to corporation tax matters other than the establishment of a corporate tax rate in accordance with national budgetary policy. The computation of income, the allowance of credits, and accelerated deductions would be set centrally by the European Commission.

To overcome the difficulties preventing the approval of the 2011 proposal, the European Commission has overhauled the proposal – advocating for a new two-step approach. Even though the C.C.C.T.B. and C.C.T.B. proposals have been

1 European Commission, "Commission Proposes Major Corporate Tax Reform for the EU," news release, October 25, 2016.

submitted simultaneously by the European Commission, they represent two distinct phases that contemplate an initial approval of the C.C.T.B. and subsequent approval of the C.C.C.T.B.

AIM OF THE PROPOSAL DIRECTIVE

The Proposal Directive aims at providing E.U.-resident companies and foreign companies doing business across the internal market with a single set of corporate tax rules for calculating the tax base, thereby allowing these companies to treat the E.U. as a single market for corporate income tax purposes as well as V.A.T. purposes. The intention is to create a fair and level playing field no matter where a corporation is resident, to provide certainty to taxpayers, and to reduce costs, administration burdens, and red tape.

The Proposal Directive is expected to constitute an effective tool against tax avoidance, as the application of a single set of rules across the E.U. market would eliminate mismatches between national systems that may be exploited by aggressive tax planners, resulting in base erosion and profit shifting. Moreover, tax avoidance risk would be reduced because a uniform base would be expected to eliminate the incentive to manage transfer prices of goods, services, and the use of intangible property with the goal of directing profits towards group members based in countries with preferential tax regimes.

With regard to transfer pricing, the Proposal Directive endorses an arm's length principle that reflects the O.E.C.D. standard. In this respect, it should be noted that under the C.C.C.T.B. proposal transfer pricing only applies to intra-group dealings involving E.U.-resident companies and third-country-resident companies. In comparison, intra-C.C.C.T.B. group dealings fall outside the scope of arm's length transfer pricing because consolidated income would be subject to formulary apportionment.

The Proposal Directive also includes specific rules to address key actions under the B.E.P.S. Project. In particular, the Proposal Directive provides for (i) a general anti-abuse rule ("G.A.A.R."), (ii) a controlled foreign corporation ("C.F.C.") rule, (iii) a switch-over clause, and (iv) an anti-hybrid mismatch rule.

OUTLINE OF THE PROPOSAL DIRECTIVE

Subjective Scope

The Proposal Directive applies to companies, including permanent establishments ("P.E.'s"), based in a Member State that belong to a consolidated group with a total consolidated group revenue exceeding €750,000,000 during the prior financial year. Companies established under the laws of a third country also fall within the scope of the Proposal Directive with respect to each P.E. situated in a Member State. The Proposal Directive provides specific requirements regarding company form, liability to specific taxes, and the controlling relationship between a parent company and its subsidiaries. The application of the rules set forth by the Proposal Directive is mandatory for all entities and P.E.'s so described.

Companies that do not belong to a consolidated group with total consolidated group revenue exceeding €750,000,000 during the prior financial year but meet all the other conditions provided for by the Proposal Directive may elect to apply the C.C.T.B.

and C.C.C.T.B. rules. The election would remain in effect for a period of at least five tax years. This election includes affiliates and P.E.'s situated in other Member States.

P.E. Definition

The Proposal Directive provides for a definition of a P.E. that reflects the standard laid down in Article 5 of the O.E.C.D. Model Tax Convention, including the proposed amendments suggested by B.E.P.S. Action 7 – Preventing the Artificial Avoidance of Permanent Establishment Status.

The definition applies to a P.E. of an E.U.-resident taxpayer, if that P.E. is established in a Member State. However, if a P.E. of an E.U.-resident taxpayer is established in a third country or a P.E. of a third-country-resident taxpayer is established in a Member State, the P.E. will continue to be governed by the provisions of the tax treaty concluded between the third country and the E.U. Member State, and the domestic tax laws of the states involved.

"Eligibility for the C.C.T.B. and the C.C.C.T.B. will be determined in accordance with a two-part test based on control and ownership or profit rights."

Definition of Group

Eligibility for the C.C.T.B. and the C.C.C.T.B. will be determined in accordance with a two-part test based on control and ownership or profit rights. Control means the right to exercise more than 50% of the voting rights of another corporation. Ownership or profit rights means ownership of more than 75% of the subsidiary's capital or rights to more than 75% of the subsidiary's profits.

In calculating the thresholds for control and ownership or profit rights in relation to lower-tier subsidiaries, the following rules apply:

- Once the voting-right threshold is reached in respect of a subsidiary, the parent company will be considered to hold 100% of these rights.
- Entitlement to profit and ownership of capital will be calculated by multiplying the interests held, directly or indirectly, in subsidiaries at each tier. Ownership rights amounting to 75% or less held, directly or indirectly, by the parent company will be taken into account in the calculation. Indirect ownership rights will be taken into account whether the intermediary company is based in a Member State or outside the E.U.
- A taxpayer who is a group member must meet the above-mentioned thresholds without interruption, throughout the tax year. Newly acquired companies and companies that have been sold to third parties will be treated as group members if held within the group for a minimum period of nine consecutive months. If that minimum period of ownership is not met, the company will be treated as a non-member for the entire year. A taxpayer ceases to be a group member the day after it no longer meets the thresholds for control and ownership or profit rights.

Features of the C.C.T.B. and C.C.C.T.B.

The Proposal Directive contains the following features:

- A system is adopted for the establishment of a common base for the taxation of companies that are members of a group.

- Rules regarding the calculation of the base are established under the C.C.T.B. proposal.
- Rules regarding the allocation of the consolidated tax base to Member States and administration by the national tax authorities are established under the C.C.C.T.B. proposal.
- The tax base is to be calculated as revenues less exempt revenue, deductible expenses, and other deductible items.

Exempt Revenue

Exempt revenue includes, *inter alia*, capital gains from disposals of shares and dividend distributions, although specific exclusions apply to eliminate double taxation at the corporate level within certain related corporations.

Regarding capital gains, a participation exemption generally applies to proceeds from a disposal of shares, provided that the taxpayer has maintained a minimum holding of 10% in the capital or voting rights of the company during the 12 months preceding the disposal.

Regarding profit distributions, a participation exemption applies to the receipt of profit distributions, provided that the taxpayer has maintained a minimum holding of 10% in the capital or voting rights of the distributing company for 12 consecutive months. When a corporation establishes a P.E. in another Member State, profits distributed to the corporation's head office will qualify as exempt revenue.

Deductible Expenses

Expenses are deductible only to the extent that they are incurred in the direct business interest of the taxpayer.

"Super-Deduction" of Research and Development Expenses

Regarding research and development ("R&D") expenses, a "super-deduction" is granted to the taxpayers in addition to the R&D costs incurred for the purposes of the business. The super-deduction amounts to an extra 50% of the costs incurred during that year. When computing the super-deduction cost base, costs related to movable tangible fixed assets are excluded. Presumably, this means that expenditures for machinery and equipment are not eligible for the super-deduction.

To the extent that R&D costs exceed €20,000,000, the taxpayer may deduct 25% of the excess. The deduction ceiling may be further increased for start-up companies that meet specific conditions.

Allowance for Growth and Investment

The Proposal Directive also provides for an Allowance for Growth and Investment ("A.G.I."), which is intended to put equity and debt financing on similar a footing and boost growth. Under the measure, taxpayers are granted a tax-deductible notional yield computed on equity increases. The notional yield corresponds to the Euro Area 10-Year Government Benchmark Bond Yield as of December of the preceding tax year, as published by the European Central Bank, increased by a 2% risk premium. A 2% floor applies where the curve of the annual yield is negative. Equity base decreases are taxable in the hands of the taxpayer to an amount that corresponds to the notional yield computed on the relevant equity base decrease. Companies incurring losses will find that the loss is magnified to the extent of the clawback of prior benefits of the notional yield under the A.G.I.

Interest Limitation Rule

The Proposal Directive provides for an interest limitation rule based on a fixed ratio of net interest to earnings before interest, tax, depreciation, and amortization ("E.B.I.T.D.A.") that resembles the limitation established in Article 4 of the E.U. Anti-Tax-Avoidance Directive (the "A.T.A. Directive"). According to the rule, borrowing costs are deductible to the extent of interest, or other taxable revenues from financial assets, received by the taxpayer. Excess borrowing costs are deductible in the tax year in which they are incurred up to 30% of the taxpayer's E.B.I.T.D.A. (fixed ratio rule) or €3,000,000, whichever is greater. The interest limitation rule also provides for a group ratio rule, a carryforward rule, and a grandfathering clause.

Losses

Losses incurred in a tax year by a resident taxpayer or a P.E. of a nonresident taxpayer may be carried forward indefinitely and deducted in subsequent tax years. The Proposal Directive also provides for a specific anti-abuse provision that tackles abusive planning intended to circumvent the rules on loss deductibility through the purchasing of loss-making companies.

G.A.A.R.

The Proposal Directive provides for a G.A.A.R. in line with the rule adopted in the A.T.A. Directive. The G.A.A.R. is designed to cover gaps that may exist in Member State' specific anti-abuse rules. Taking into account all relevant facts and circumstances, Member States are entitled to disregard an arrangement, or a series of arrangements, that has been put in place for the essential purpose of obtaining a tax advantage that defeats the object or purpose of the Proposal Directive and is therefore not genuine. An arrangement is to be regarded as non-genuine to the extent that it is not put in place for valid commercial reasons that reflect economic reality. If an arrangement falls within the scope of the G.A.A.R., a substance over form approach will apply. When calculating the tax base, the arrangement will be treated by reference to its economic substance.

Formulary Apportionment

Under C.C.C.T.B., the consolidated tax base is apportioned among the group members in each tax year on the basis of a formula. The formula takes into consideration three equally weighted factors, *viz.*, labor, assets, and sales by destination. In this way, the C.C.C.T.B. is intended to reflect a balanced approach to distributing taxable profits amongst eligible Member States. The labor factor is weighted equally between payroll and headcount of employees in order to account for wage gaps across the E.U. The asset factor consists of all fixed tangible assets. Intangibles and financial assets are excluded from the formula due to their mobile nature and the risks of circumventing the system. Profits and losses arising from intra-group transactions are eliminated when calculating the consolidated tax base.

A safeguard clause is provided for by the C.C.C.T.B. proposal in cases where the parent company of the group (the "Principal Taxpayer") or a competent authority considers that the outcome of the apportionment of the consolidated tax base to a group member does not fairly represent the extent of the business activity of that group member. In such a case, the safeguard clause allows the Principal Taxpayer or competent authority to request the use of an alternative method for calculating the tax share of each group member. Specific rules apply to particular sectors, such as financial services and insurance, oil, and gas as well as shipping and air transport.

Administrative Procedures

The Directive Proposal will have a significant impact on the administrative procedures. Indeed, while companies applying only the C.C.T.B. rules will continue to fall within their national administrative provisions, taxpayers involved in the C.C.C.T.B. will deal with a single tax administration ("Principal Tax Authority") in the E.U. The Principal Tax Authority is the one based in the Member State where the Principal Taxpayer resides for tax purposes. The Principal Tax Authority is empowered to initiate and coordinate tax audits involving the consolidated group.

However, the national authorities of any Member State in which the profits of a group member are subject to tax may request the initiation of an audit. Moreover, the competent authority of a Member State in which a group member is tax resident, or a P.E. is established, may challenge a decision by the Principle Tax Authority concerning a notice to create a group or an amended tax assessment. This challenge must be made before the courts of the Member State of the Principal Tax Authority.

Disputes between taxpayers and tax authorities will be dealt with by an administrative body that will be competent to hear appeals at first instance according to the laws of the Member State of the Principal Tax Authority.

CONCLUSION

The Proposal Directive, if approved, will have a massive impact on Member States' tax systems. Indeed, the enactment of the E.U. single market through the Proposal Directive will result in a significant limitation of Member State autonomy on a crucial tax matter. That is why, at this stage, it appears difficult to predict whether a unanimous favorable decision will be reached. Moreover, even if the Proposal Directive is approved, the entry into force of the relevant provisions will not take place until 2019 with regard to the C.C.T.B. and 2021 with regard to the C.C.C.T.B.

Given the existing uncertainty regarding the approval of the Proposal Directive and the time span between approval and actual implementation of the relevant provisions, it appears too early for multinational companies that fall within the scope of the Proposal Directive to begin revising E.U. structures to cope with the provisions. It is, however, crucial for multinational companies and practitioners to keep updated on the development of the project and to the possible outcome of the Proposal Directive.

INDIA – GUIDLINES ISSUED FOR DETERMINING PLACE OF EFFECTIVE MANAGEMENT

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Tags
Active Trade or Business
Foreign Corporation
India
P.O.E.M.
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BACKGROUND

Under the Income Tax Act, 1961 ("the Act"), the tax residence of a corporation formed outside of India was determined based on whether the control or management of its affairs was wholly situated in India. On the other hand, most of India's tax treaties determined the tax residence of a foreign corporation using the place of effective management ("P.O.E.M.") principle.

The P.O.E.M. principle for determining the tax residence of a foreign corporation was introduced into the domestic law by amending §6(3) of the Act, and is effective from F.Y. 2016-17. In December 2015, the Central Board of Direct Taxes ("C.B.D.T.") released draft guidelines laying down principles to apply when determining the P.O.E.M. of a foreign corporation.[1] Now, the C.B.D.T. has issued final guidelines in the form of Circular No. 6/2017 (the "Circular"), dated January 24, 2017.

PRESS RELEASE

According to the press release issued with the Circular, the intention of the final guidelines is not to target Indian multinational groups engaged in business activities outside India. Rather, the target is shell corporations and corporations used for retaining income outside India where the real control and management of affairs is in India.

In addition, the guidelines are not intended to cover foreign corporations or to tax their global income merely because a permanent establishment ("P.E.") or a business connection exists in India. The P.O.E.M. provisions do not apply to foreign corporations with a turnover or gross receipts of less than INR 500 million (U.S. $7,424,132 converted at an exchange rate of U.S. $1 = INR 67.3479) in a financial year, although this was not stated in the Circular or in the Act.

EXISTENCE OF AN ACTIVE BUSINESS OUTSIDE INDIA

Like the draft guidelines, the final guidelines provide that for testing the applicability of P.O.E.M. provisions the first step is to determine whether the foreign corporation is engaged in "active business outside India."

A foreign corporation is engaged in active business outside India if it meets the following criteria:

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1 Regarding these draft guidelines, see "CBDT Issues Draft Guiding Principles for Determination of Place of Effective Management," Tax Edge 12.3 (2015).

- Its “passive income”[2] is not more than 50% of its total income.
- Less than 50% of its total assets and employees are situated and resident in India.
- Its payroll expenditure related to employees in India is less than 50% of its total payroll expenditure.

The final guidelines establish the method for computing the percentages used in each of the three factors listed above. Data for each factor listed above – (i) income, (ii) assets and employee headcount, and (iii) payroll expenses – is gathered for the fiscal year in issue and the preceding two fiscal years. The data is gathered first by looking at India alone and then on a global basis (*viz.*, India and the rest of the world). For each factor, the average of the Indian data is divided by the average of the global data and the relevant percentage is computed for each factor. If the Indian fiscal year differs from the tax year used by the foreign corporation, the data for the foreign corporation’s tax year ending within the relevant Indian fiscal year is used.

The final guidelines further provide that interest income is not considered passive income for a foreign corporation that is engaged in the business of banking or is a public financial institution and whose activities are regulated under the applicable laws of the country of incorporation.

FUNCTIONS OF THE BOARD OF THE FOREIGN CORPORATION

The final guidelines provide that the P.O.E.M. of a foreign corporation that is engaged in an active business outside India will be considered to be outside India if the majority of its board meetings are also held outside India, provided that no person resident in India actually exercises the powers of management over the foreign corporation.

If the board of the foreign corporation merely follows the Indian group’s policies in functional areas such as accounting, payroll, and human resources, the board will be regarded as not exercising its powers of management over the foreign corporation. This rule is subject to the following clarifications:

- Where board resolutions are passed through written consent of the board members instead of board meetings, the mere location of the proposer of a resolution is not determinative of the place of management. Other aspects, such as the frequency of use of this mode of decision making, the type of decisions being made, and the other parties involved, will be considered in order to determine the actual person who has the authority to make a decision.
- Shareholder activities in terms of making decisions on matters that fall within their domain as shareholders under corporation laws (*viz.*, approving mergers or acquisitions) are not relevant to the determination of the P.O.E.M. of the foreign corporation. However, where the shareholders, and not the board, are the persons who are exercising the real authority over the affairs

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[2] Passive income will include, *inter alia*, interest income and income from the purchase and sale of goods from associated enterprises.

of the foreign corporation, then this will be relevant for the determination of the P.O.E.M. of the foreign corporation.

PROCEDURAL ASPECTS

While the draft guidelines provided that a tax officer must obtain prior approval of the Commissioner before deeming a foreign corporation to be a resident of India under the P.O.E.M. provisions, the final guidelines now provide a two-tier procedure:

- The tax officer must obtain prior approval of the Commissioner before initiating any inquiry into the tax residence of a foreign corporation under the P.O.E.M. provisions.
- The tax officer must further obtain prior approval of a panel of three Commissioners before deeming a foreign corporation to be a resident of India under the P.O.E.M. provisions, and as a part of the process, the panel must provide an opportunity to the foreign corporation to make submissions in the matter before issuing its directions to the tax officer.

OTHER ASPECTS

It has also been clarified that the presence of a P.E. in India on behalf of a foreign corporation does not constitute conclusive evidence that its P.O.E.M. is in India.

The final guidelines also provide certain illustrations explaining the manner of application of the guidelines, for example:

- Even where the foreign corporation meets the "active business outside India test" and the majority of its board meetings are conducted outside India, it can be regarded as a tax resident of India under the P.O.E.M. provisions if it is established that the foreign corporation seeks permission from its Indian parent with respect to virtually all business transactions.
- In a two-tier holding structure where the top tier entity is regarded as a tax resident of India under the P.O.E.M. provisions, the tax residency of the downstream entities must be separately evaluated under the P.O.E.M. provisions.

COMMENTS

The P.O.E.M. provisions could have been withdrawn and replaced by a controlled foreign corporation ("C.F.C.") provision that eliminates deferral immediately in certain circumstances, but the Indian government has refrained from adopting that approach. Instead, it adopted final P.O.E.M. guidelines with certain safeguards, clarifications, and illustrations. Notably, the safeguards now provided should give taxpayers comfort against the indiscriminate use of P.O.E.M. provisions.

Indian multinational groups with captive subsidiaries that undertake purchases and sales with group corporations may need to revisit their structures and decision-making processes, as they may not pass the active business outside India test under the P.O.E.M. guidelines.

Given that the P.O.E.M. provisions have already come into effect as of the beginning of the current F.Y. 2016-17, the final guidelines may lead to hardship because of their retroactive effect. The Indian government has been urged to consider deferring the effective date of the P.O.E.M. provisions to F.Y. 2017-18. Additionally, various other aspects related to the computation of income of foreign corporations having a P.O.E.M. in India (*e.g.*, tax rate applicable, tax credit mechanism, etc.) are yet to be clarified.

"Indian multinational groups with captive subsidiaries that undertake purchases and sales with group corporations may need to revisit their structures and decision-making processes."

U.K. CRIMINAL PENALTIES FOR IMPROPER TAX PLANNING – COULD YOU BE AFFECTED?

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Tags
Compliance
Offshore Accounts
Tax Evasion
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BACKGROUND

New powers for H.M.R.C. to ferret out and punish tax evaders have been introduced in the U.K. and more have been proposed for introduction in the coming months. Together, they are expected to have a significant impact on financial institutions and professional advisers based outside the U.K. with employees or associates operating in the U.K. market.

CRIMINAL FINANCES BILL 2017

The recently published Criminal Finances Bill 2017 proposes two new corporate criminal tax offences that affect advisers to taxpayers. These are offense for (i) the failure to prevent facilitation of U.K. tax evasion offences and (ii) the failure to prevent facilitation of foreign tax evasion offences. Each is discussed below.

U.K. Tax Evasion Facilitation Offence

Criminal charges will be asserted against any corporate body or partnership involved in a transaction that constitutes tax evasion. The predicate facts constituting the criminal offense are as follows:

- A client has committed an offence constituting U.K. tax evasion.
- An individual employed or associated with the adviser knowingly acted in a way to assist the person who has been found guilty of the tax evasion offence.
- The adviser does not have reasonable procedures in place to prevent employees and associates from helping the individual commit the tax evasion offence.

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To determine the exposure of a corporation or a partnership to prosecution three questions must be answered.

1. *When does an individual knowingly provide assistance to a person committing tax evasion in the U.K.?*

   There are two instances in which an individual can be viewed to knowingly provide assistance to the persons committing U.K. tax evasion. The first is that the individual was knowingly concerned in the fraudulent act of tax evasion or took steps with a view to assisting in the fraudulent act of another person. The second is that the individual aided, abetted, counselled, or procured the commission of the fraudulent act of tax evasion.

2. *When is an individual employed or associated with a corporation or partnership?*

A person is associated with a corporate body if that person is an employee or agent of a corporate body or performs services for it or on its behalf. The term associate, as defined, may extend to an individual or an incorporated body. H.M.R.C. has stated that determination is made by reference to all the relevant facts and circumstances, and not merely by reference to the nature of the legal relationship between the individual and the organization. In short, an individual who acts in concert with a corporation may be associated with the corporation if both are carrying out a common enterprise. It does not matter whether the associated person or the relevant body is based in the U.K. or overseas. The U.K. offence may be committed by any corporation or partnership, no matter where incorporated or formed.

3. *Must the client be convicted of a crime in order for H.M.R.C. to prosecute a corporation of partnership?*

For the corporate offence to be committed there must first be a criminal offence. Noncompliance, falling short of fraud, will not result in the corporate offence being committed. What is fraudulent behavior for these purposes? The legislation is focused on any dishonest activity that intends to divert funds from the public revenue. In the U.K. this could be an offence under common law. There are also a range of statutory offences, such as (i) fraudulently evading Value Added Tax ("V.A.T.") or (ii) fraudulently evading income tax.

H.M.R.C. has stated that a conviction for tax evasion is not a prerequisite for bringing a prosecution against a relevant body under the legislation. Voluntary disclosures by clients, for example, could still result in a prosecution conducted by H.M.R.C. against the relevant body. This is of particular concern in the current climate. Over the last decade, in line with O.E.C.D. principles, the U.K. has offered individuals the opportunity to regularize untaxed offshore assets by making voluntary disclosures. A voluntary disclosure of tax evasion, after the new offences are enacted, could potentially trigger H.M.R.C. action against any relevant corporate body that served as an adviser and had an employee or associate that provided the relevant degree of assistance. The relevant body may consider making its own voluntary disclosure in these circumstances, unless it has an adequate defense.

Foreign Tax Evasion Facilitation Offence

The foreign offence, is narrower in scope. It can be committed only by a relevant body that is

- incorporated under U.K. law (*e.g.*, a limited company incorporated under U.K. law),
- incorporated outside the U.K. but carrying on a business activity from a permanent establishment within the U.K., or
- incorporated outside the U.K. but whose associated person is located within the U.K. at the time of the criminal act that facilitates the evasion of the overseas tax.

In addition to the above, the foreign offence requires dual criminality. This occurs in two instances. The first is that the overseas jurisdiction has a tax evasion offence at the client level that is comparable to an offence under U.K. tax law, so that the actions carried out by the client would constitute a crime had they taken place in the U.K. Second, the overseas jurisdiction must have an equivalent offence covering the associated person's criminal act of facilitation, so that the actions of the associated person would constitute a crime had they taken place in the U.K.

The legislation also requires personal consent of the Director of Public Prosecutions or the Director of the Serious Fraud Office before proceedings for the foreign offence are issued in England, Wales, or Northern Ireland.

Penalties

The penalties for this offence include unlimited financial penalties and ancillary orders confiscation and injunctions to prevent serious crime after the conviction. H.M.R.C. has stated that a criminal conviction will also have consequences for a relevant body, such as requirements of disclosure to professional regulators.

Deferred Prosecutions

Deferred prosecution agreements ("D.P.A.'s") were introduced in the U.K. in February 2014 and are in place for fraud, bribery, and other economic crimes. A D.P.A. is an agreement between a prosecutor and a defendant organization that is reached under the supervision of a judge. Prosecution is deferred indefinitely, as long as subsequent criminal acts are not committed. D.P.A.'s will likely be pursued for the new corporate criminal tax offences.

Defenses Against the Offences

The principal defense for a corporation or partnership is that it has put in place reasonable procedures to prevent the criminal facilitation of tax evasion by the employee or associated person. H.M.R.C. has published draft government guidance for determining whether reasonable procedures exist. Advisory bodies must undertake risk assessment when taking on a new client, and risk-based prevention procedures must be proportional to the amount at stake. A due diligence procedure must also be in place in order to evaluate new matters. Top level management must be committed to preventing facilitation by employees and associates, and company policy must be communicated to employees and associates. This includes tax fraud prevention training. Finally, there must be a program in place for monitoring and review.

Advisers with clients based outside the U.K. who attempt to establish an account at a U.K. bank have discovered that the process is time consuming and disappointing. Several months and significant fees must be paid to clerks who challenge any arrangement that is not "plain vanilla." With the new act, clients should anticipate that longer periods of time will be required and greater fees will be charged to pursue the simple task of opening a bank account in the U.K. With the new rules, U.K. banks will likely find that business will be ring-fenced to include only "mom and pop" businesses and fortune 100 corporations.

FINANCE ACT 2016

Last year, the U.K. government introduced offshore tax legislation, as part of Finance

Act 2016, related to the following offenses and penalties:

- Offences relating to offshore income, assets, and activities
- Penalties for enablers of offshore tax evasion or noncompliance
- Penalties in connection with offshore matters and offshore transfers
- Asset-based penalties for offshore inaccuracies and failures

Each of these topics is discussed in the following paragraphs.

Offences Relating to Offshore Income, Assets, and Activities

The most significant of the Finance Act 2016 provisions is a strict liability criminal offence against individuals who commit acts of offshore noncompliance, even if it is not evasion. The offence relates to offshore income, assets, or activities involving a person who (i) fails to submit a tax return, (ii) fails to notify liability, or (iii) submits an incorrect return in relation to income or capital gains tax.

The significance of this offence is the absence of a link between the offence and any underlying negligence, carelessness, or fraudulent behavior, which is a predicate fact in relation to most criminal offences. Consequently, there is no requirement for H.M.R.C. to demonstrate the cause of the behavior. Taxpayers may commit an offence by the mere fact of noncompliance involving offshore matters.

As the U.K. imposes tax on a residence basis, rather than a citizenship basis, the offense reflects a view that persons savvy enough to open an offshore account should be savvy enough to arrange for proper reporting. Nonetheless, defenses exist beyond arguing that proper compliance procedures were followed. Thus, for example, a person charged with the offence can argue that reasonable cause exists for noncompliance. Also, H.M.R.C. has introduced a £25,000 threshold for triggering the offense. Finally, H.M.R.C. has suggested that the new offence will be limited to noncompliance involving offshore jurisdictions that have not signed up for automatic exchange of information under the Common Reporting Standard ("C.R.S."). Given the U.S. view that F.A.T.C.A. reporting is equivalent to the C.R.S., it will be interesting to see how the matter will play out in relation to accounts in the U.S.

Penalties for Enablers of Offshore Tax Evasion or Noncompliance

Civil penalties have been enacted with regard to those who advise clients in relation to offshore tax matters. The civil penalty is imposed on those who enable a U.K. taxpayer to commit offshore tax evasion or noncompliance.

An offence is committed when two conditions are met in relation to the adviser's relationship with the client, and the client commits a relevant offshore tax offence or is noncompliant. First, the adviser must know or have reason to know that his or her actions could assist the client in committing offshore tax evasion or noncompliance. Second, the client must have been convicted of a tax offence or, in the case of offshore tax evasion or noncompliance, the client is liable to a relevant penalty. A relevant penalty includes any offshore civil penalty relating to offshore tax matters. This could include circumstances where an adviser is caught for actions that resulted in a client becoming liable to a civil penalty for carelessness. Presumably, H.M.R.C. will not prosecute this type of technical offense, as a conviction would almost be worse for the government than for the adviser.

The legislation also applies, as well to an adviser that turns a "blind eye" to the evasion of the client. The offence effectively extends to tax advisers, legal advisers, trustees, private bankers, and any intermediary based anywhere in the world as long as the facts involve providing services to U.S. resident clients with offshore U.K. tax matters. Risk of prosecution will depend on many factors including the reach of H.M.R.C. to obtain jurisdiction over a person outside the U.K. and the deterrence factor inherent in the defendant. Not all advisers are worth prosecuting.

If found liable, the adviser could be liable for the greater of £3,000 or 100% of the tax revenue lost by the U.K. Reductions to these penalties for unprompted disclosures are possible. In the case of an unprompted disclosure, the penalty can be reduced to £1,000 or 10% of the tax revenue lost, or in cases of prompted disclosures to £3,000 or 30% of the tax lost. Presumably, if a client paid the tax as part of an examination by H.M.R.C., the penalty based on a fixed amount will be due. However, no guidance exists to date.

Penalties in Connection with Offshore Matters and Offshore Transfers

The existing civil penalty regime for offshore matters and offshore transfers is increased. Offshore civil penalties were introduced by Finance Act 2010 that (i) increased the civil penalties under Schedule 24 of Finance Act 2007 for errors and (ii) increased the civil penalties under Schedule 41 of Finance Act 2008 for failure to notify H.M.R.C. relating to income tax and capital gains tax.

"Risk of prosecution will depend on many factors including the reach of H.M.R.C. to obtain jurisdiction over a person outside the U.K. and the deterrence factor inherent in the defendant."

The new legislation increases the penalties when the transfer or matter relates to jurisdictions that have no commitment to exchange of information and the fostering of transparency. In a post-B.E.P.S. world, those jurisdictions are quite limited. If the jurisdiction is categorized as highly non-transparent and has not signed up to the C.R.S., the standard penalty of up to 100% of the potential lost revenue is increased from 100% to 200%. The same principles apply for offshore penalties in relation to minimum penalties for prompted and unprompted disclosures. Finance Act 2016 essentially increases those minimum penalties by 10% where the underlying behavior is deliberate.

H.M.R.C. has also stated that it will require disclosures in any case where reductions to penalties are sought. The information to be disclosed includes structures used, processes for transferring funds offshore, and the identity of all enablers who facilitated the evasion.

Amendments have also been made to the Schedule 94 of Finance Act 2009. This schedule authorizes the publication of names of those who deliberately defaulted on offshore disclosure obligations. H.M.R.C. will publish the details of those who control offshore companies and partnerships, where the person who is subject to the offshore deliberate penalty is the body itself.

Asset-Based Penalties

H.M.R.C. has introduced a new asset-based civil penalty for cases where civil offshore penalties are in point and the potential lost revenue exceeds a threshold of £25,000. The asset-based civil penalty applies where the offshore penalty relates to deliberate behavior and the tax involved is capital gains tax, inheritance tax, or asset-based income tax. The standard amount of the penalty will be limited to the lower of 10% of the value of the asset or ten times the potential lost revenue.

Again, reductions to the penalty are allowed when the person (i) discloses the inaccuracy or failure relating to the standard offshore tax penalty, (ii) provides H.M.R.C. with a reasonable valuation of the asset, or (iii) provides H.M.R.C. with information or access to records that H.M.R.C. requires for the purposes of valuing the asset. The reduction must reflect the quality of the disclosure, valuation, and information provided. The timing, nature, and extent of the disclosure are taken into account when measuring its quality. Guidance regarding the maximum amount of the penalty reduction are left to future regulations.

FINANCE BILL 2017 – REQUIREMENT TO CORRECT OFFENCE

Obligation to Correct

The Autumn Statement 2016 and Schedule 22 of Finance Bill 2017 introduce legislation addressing a Requirement to Correct Offence ("R.T.C.O."). The R.T.C.O. is a civil offense rather than a criminal offense. It will be effective from April 6, 2017, and will require persons with offshore noncompliance in relation to income tax, capital gains tax, and inheritance tax to correct all errors before September 30, 2018. The R.T.C.O. will be timed to coincide with automatic exchanges of information through the C.R.S. Any person who has not rectified past "relevant" offshore tax noncompliance by September 30, 2018, for noncompliance occurring in periods up to and including April 5, 2017, will face significant penalties.

Penalties

The penalty for not correcting the offshore noncompliance by September 30, 2018, may include the following:

- 200% of the potential lost revenue attributable to the uncorrected offshore noncompliance
- An asset-based penalty of up to 10% of the asset value
- A further 50% penalty if assets have been moved to avoid exchange of information
- Public identification of the offender

The penalty is appealable using the usual reasonable cause defense.

Correcting the Offence and Disclosure

Offshore noncompliance may be corrected in several ways, depending on whether the offence relates to (i) the failure to notify, (ii) the failure to file a tax return, or (iii) the submission of an incorrect return. Voluntary disclosure programs with favorable terms were terminated on December 31, 2015, and have been replaced by the new Worldwide Disclosure Facility, launched by H.M.R.C. in September 2016. This is one route by which historical offshore noncompliance can be rectified. However, the Worldwide Disclosure Facility provides no protection from prosecution. Where tax fraud is at issue, a disclosure under Code of Practice 9 (Contractual Disclosure Facility) may be the safer path.

DUTY TO DISCLOSE

According to the Law Society, H.M.R.C. has adopted a practice under its No Safe Havens program that requires law firms that participate in the formation of offshore companies or trusts to report on the beneficial ownership of the offshore entities. Presumably, the failure to report the information may be taken as evidence of a law firm's role in enabling offshore tax evasion or noncompliance.

CONCLUSION

In 2013, H.M.R.C. set out its Offshore Evasion Strategy building on earlier policy statements to counter offshore tax evasion and noncompliance. We have seen many developments in the intervening time, including numerous disclosure campaigns allowing holders of untaxed offshore assets to regularize U.K. tax obligations on favorable tax terms. Now, the offshore campaign is entering a new tougher phase. Individuals with untaxed offshore assets will be required to regularize their positions by September 30, 2018, by reason of the R.T.C.O. rules that will be effective from April 2017. Persons under investigation by H.M.R.C. and found to be noncompliant will face the significant penalties. H.M.R.C. intends to increase the number of criminal investigations to force home the message. If a carrot and a stick can be used to incentivize compliance, the days of the carrot are over. H.M.R.C. is now conducting a vendetta against those holding undeclared wealth offshore.

"Now, the offshore campaign is entering a new tougher phase. . . . Persons under investigation by H.M.R.C. and found to be noncompliant will face the significant penalties."

INCOME TAXATION OF TRUSTS IN BELGIUM

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Tags
Belgium
Income Tax
Trusts

INTRODUCTION

Trusts do not exist under Belgian civil law. However, trusts governed by foreign law are generally analyzed by applying conflict of law rules. As a result, Belgium will generally recognize trusts formed under applicable foreign laws. In Belgium, trusts can be subject to both income tax and gratuitous transfer taxes (by reason of death or *inter vivos*). This article only focuses on income tax issues.

INCOME TAX ISSUES

The Belgian income taxation of trusts is governed by the "Cayman Tax" law ("C.T.L.") enacted in 2015. The C.T.L. has introduced "pass-thru" tax treatment of income generated through foreign private wealth structures referred to in the law as "legal constructions" (and as "Type 1" entities in practice – see below). Trusts fall within this definition. The law also applies to low-taxed foundations and offshore companies (referred to as "Type 2" entities – see below) but in a different way as it does to trusts.

The C.T.L.[1] is applicable as of January 1, 2015,[2] and has been amended by a law dated December 26, 2015.[3] Prior to the C.T.L., another set of rules applied to trusts. While, no specific Belgian law dealt with the treatment of trusts, foreign trusts were analyzed based on scholarly articles and case law, including several decisions by the Federal ruling commission. The author is of the view that the C.T.L. replaces prior practice, although differing opinions exist.[4]

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Pursuant to the C.T.L., income tax may be imposed on the "Founder(s)" of a trust or on "Third-Party Beneficiaries," depending on the applicable facts. Prior to this legislation, a 2013 law required Belgian-resident Founders and Belgian-resident Third-Party Beneficiaries to disclose the existence of a trust on their annual income

1 Program Law 10 August 2015, art. 38–47, Chamber of Parliament Doc. 54 1125/001-021, Belgian Official Journal (August 18, 2015), ed. 2.

2 For a full analysis see Gerd D. Goyvaerts, "*De Kaaimantaks, Een Kritische Benadering*," T.F.R. 490-491 (2015), pp. 865–923 (article in Flemish); Valérie-Anne De Brauwere and Christelle Wils, "*Taxe Caïman, Le Crocodile aux Dents Longues*," *Wolters Kluwer* Revue Générale de Fiscalité 8 (2015), pp. 5–23 (article in French).

3 Law of 26 December 2015, B.O.G., (December 30, 2015).

4 For an extensive comment on the "old regulations" see Gerd D. Goyvaerts, "The Tax Aspects of the Use of Foreign Trusts in Belgium for Private Wealth Purposes," *The Journal of International Tax, Trust and Corporate Planning* 2011, p. 267.

tax returns.[5] This reporting allows the Belgian tax administration to gather trust-related information and assess tax on trust income, and the C.T.L. has been drafted with the same purpose in mind.

At first glance, the C.T.L. may appear to be a useful legal instrument in the fight against the fraudulent or abusive use of trusts. However, the C.T.L. does generally not take into account the complexity of internationally structured estates and the wide variety of reasons why an individual may wish to use a trust structure in another jurisdiction – be it low-tax or not. While families often seek practical solutions to civil, corporate, or common law issues, these answers cannot always be found under Belgian law. Hence, families may turn to trust indentures to achieve stability in an uncertain financial environment generated by the internationalization of family ties.

Other statements in the C.T.L. parliamentary documents reflect a general lack of knowledge regarding trusts, including the discretionary character of certain trusts. Although this misconception served as the parliamentary basis for taxing the international wealth of Belgian citizens involved with trusts, the C.T.L. is more accurately viewed as a matter of tax policy and a reflection of Federal budget considerations.

Nonetheless, the Belgian Parliament must respect international tax treaties and E.U. and European Economic Area ("E.E.A.") regulations, as well as regulations that pertain to the resolution of international conflicts of law. It remains to be seen whether the C.T.L. Tax fully conforms to these rules. Notably, the C.T.L. produces several adverse tax consequences relating to retroactive double taxation. The most important of these is that the C.T.L. does not allow for relief from double taxation where foreign taxes are paid on trust income, a significant issue when the new legislation is applied to an existing trust structure.

Trusts as Legal Constructions (Type 1 Entities)

The C.T.L. applies to trusts, yet it does so under a specific legal definition without referring to the notion of a "trust" or "trust law." Instead, the law refers to a very broad definition of a Type 1 legal arrangement that includes trusts.[6]

Since trusts are not known under Belgian tax or civil law, they have been defined as "legal relationships/arrangements" based on the general look and feel of the Anglo-Saxon trust. The term "legal relationship" is inspired by the definition of a trust as used in the Belgian Code on International Private Law ("B.I.P.L."), which contains the codification of Belgian conflict laws.

The translated Flemish text provides the following definition of "trust" (*i.e.*, a Type 1 entity):[7]

> Legal relationship(s) created by an act of the founder or by a court order, by which assets are placed under the control of a trustee in

5 Gerd D. Goyvaerts, "Belgium: A New Obligation to Declare Foreign Private Wealth Structures," *The Journal of International Tax, Trust and Corporate Planning* 2014, p. 64.

6 Article 2-§1-13° of the Belgian Income Tax Code ("B.I.T.C.").

7 Note that in the translation the word "trustee" is used, although the law refers to *beheerder* or *administrateur*. One may therefore also use the term "administrator." There is no reference whatsoever to "trust law."

order to be administered for the benefit of one or more beneficiaries or for a certain purpose. This legal relationship presents the following characteristics:

1. the property title to the assets of, or to the entitlements from, the 'legal construction' is drafted in the name of the trustee or in the name of another person on behalf of the trustee;

2. the assets of the 'legal construction' form a separate estate and are not part of the estate of the trustee;

3. the trustee has the authority and the duty, in respect of which he is accountable, to manage, administer or dispose of the goods in accordance with the provisions of the legal construction and the special duties imposed by law on the trustee.

Trust-like arrangements are within the scope of this Type 1 designation, regardless of the level of tax incurred.

"Since trusts are not known under Belgian tax or civil law, they have been defined as 'legal relationships/ arrangements' based on the general look and feel of the Anglo-Saxon trust. "

Exclusions from Pass-thru Treatment (Article 2-§1-13°/1 B.I.T.C.)

The C.T.L. provides a list of entities that are excluded from pass-thru treatment. In order to be so excluded, the listed entities must meet certain requirements. Although these exclusions may also apply to trusts, they have not been designed for trusts as such. Pension trusts or trusts designed to hold employee stock participations (defined as "settlements for the financing of legal or additional retirement payments") are generally excluded entities; however, the analysis is made on a case-by-case basis.

The Substance Exemption (Article 5/1-§3(b) B.I.T.C.)

The substance exemption provides criteria for a trust to be outside the scope of the C.T.L. This exemption was inserted to improve compatibility with E.U. and E.E.A. regulations, following the Court of Justice of the European Union's ("C.J.E.U.'s") decision in *Cadbury Schweppes Plc v. Revenue and Customs Commissioners*[8] and the E.F.T.A. Court's judgment in Olsen.[9]

Under this exemption, the Founder and/or Third-Party Beneficiary can avoid pass-thru treatment by showing that the trust meets a substance test, *i.e.*, that it is not a "wholly artificial arrangement" and that it has a "genuine economic activity" based on "objective factors[,] which are ascertainable by third parties." These factors include "offices, staff[,] and equipment which stands in relation to the mentioned genuine economic activity." It is unclear what proof will be accepted by the tax authorities. On one hand, it may be expected that a trust that merely controls a holding company would not require as many offices and staff as a company providing services in the course of an active business. On the other hand, proving when a genuine economic activity exists in a specific case will likely be a difficult undertaking.

The substance exemption is available for all trusts formed in the E.E.A. and/or

8 *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, No. C-196/04 (2007), at ch. 30.

9 *Fred. Olsen and Others v. the Norwegian State*, No. E-3/13 and No. E-20/13 (July 9, 2014).

countries with which Belgium has concluded a double tax treaty ("D.T.T.") or Tax Information Exchange Agreement ("T.I.E.A."), including a bilateral or multilateral agreement in relation to which tax information can be exchanged on request. In light of recent developments regarding exchange of tax information, a large number of offshore trusts may theoretically claim this exemption. However, it remains to be seen to what extent invoking the substance exemption and claiming real economic activity may give rise to adverse tax consequences in the country of establishment.

To meet the substance test, substantial verifiable evidence must be provided. One should expect the highest level of scrutiny to be applied by the tax authorities. In that respect, the Belgian Parliament has indicated that the substance exemption cannot be claimed by trusts that "limit their activities solely to the management of private wealth." It is however highly questionable whether this limitation on the substance exclusion would stand up to a challenge before the E.F.T.A. Court or the C.J.E.U.

The substance exemption is not automatic and must be claimed on a Belgian tax return. As a result, claiming the exemption does not relieve the taxpayer from Belgian filing obligations, which are intended to increase transparency, and noncompliant taxpayers cannot attribute non-filing to the application of the substance exemption.

Founders

The C.T.L. provides for tax transparent treatment of the trust instrument. Thus, trust income is taxed as if directly received by the Founders, irrespective of actual distributions. Certain qualifying trust distributions may also be taxable in the hands of Third-Party Beneficiaries. This combination of both potentially taxable distributions and pass-thru taxation makes the application of the C.T.L. quite complex.

With regard to trusts, the law lists three types of Founders in Article 2-§1-14° B.I.T.C.:

- The individual who settled the trust outside the course of his or her professional activities
- The individual who, outside the course of his or her professional activities, contributed assets and "entitlements" to a trust settled by a third party (including also a declared trust)
- The "Founder by Heirship," *i.e.*, an individual who is the direct or indirect heir of one of the above-mentioned individuals (from the death of the latter onwards, unless the heir provides proof that neither they themselves nor their issue, will benefit at any time nor in any way from financial, or other, benefits granted by the trust)

The definition of Founder by Heirship is intended to be as broad as possible, encompassing several future generations of potential beneficiaries. The legislative intent here is to prevent the application of an old 1962 High Court case that excluded heirs from a comparable anti-abuse rule related to income taxes.

As an example of a (potential) heir, parliamentary documents cite a person who is to receive a benefit from a trust upon a certain condition (*e.g.*, reaching a certain age – which is common practice in many trust instruments). The example further provides that the existence of a condition will not preclude the heir from being considered a

Founder, which will lead to the transparent taxation of income received by the trust, regardless of any actual distribution. Every individual who is entitled by legal heirship to a part of the estate of the initial Founder is considered to be an heir for C.T.L. purposes. This is the case regardless of otherwise applicable intestate inheritance laws or the presence of a will or testament.

Any legal heir of the Founder can avoid being qualified a Founder by showing that he or she cannot, nor did, receive any financial or other benefit from the trust. This may be virtually impossible to prove, since one may never exclude receiving a voluntary entitlement from a trust established by ancestors, especially if it is administered by an independent discretionary trustee. However, solutions are available to prevent taxation without having received any economic benefits.

Based on the parliamentary documents, it appears that a Belgian taxpayer may avoid Founder status by irrevocably renouncing any benefit from the trust and providing a letter of the trustee stating that neither that person nor his or her heirs can ever, at any point in time, receive in any form or way any benefit from the trust. The explanatory memorandum to the law specifies that the tax authorities will in principle accept such a letter as proof. However, should it appear that such a letter does not reflect reality, the tax authorities may invoke the offence of forgery of fiscal documents against the Founder who used the letter, as well as against the legal construction that issued it. In particular, trustees of a discretionary trust should consider to what extent they are able to provide such assurances prior to the issuance of a letter.

Third-Party Beneficiaries

According to the definition under Article 2-§1-14°/1 B.I.T.C., Third-Party Beneficiaries are individuals who, at any given moment and in any given manner, effectively receive (taxable) benefits allocated by a trust. It can be argued that only an actual distribution of a benefit triggers C.T.L., along with the qualification of Third-Party Beneficiary. Hence, any reporting obligation and/or taxability depends thereon. This is relevant for beneficiaries of a trust of which the settlor is still alive. These persons will have no reporting obligations in Belgium, as long as they do not receive an effective distribution.

It is also possible that the same taxpayer can be seen as both a Founder and a Third-Party Beneficiary in the same tax year. This will mainly be the case when an entity within the scope of the C.T.L. makes a distribution to a Founder.

Pass-thru Taxation of Trust Income

The C.T.L. provides for pass-thru treatment of trust income. As a result, income from a trust is generally taxed in the hands of the Founders, and the trust is disregarded as a separate entity for Belgian income tax purposes. This means that the underlying income retains its original qualification and no effective distribution is required for taxation to occur.

Do note that this regime is not limited to merely "passive income." One example of applicable income might be a consultancy fee received by a trustee of a trust settled by a Belgian tax resident. It is unclear how the application of pass-thru treatment will interact with the previously mentioned definitions of Founder. Indeed, individual Founders will, in general, only be individuals that established an eligible entity outside the course of their professional activities. On the other hand, mere shareholders are also seen as Founders under a distinct fourth category, which falls outside the scope of this article.

Under the C.T.L., interest received by the trust remains interest, dividends remain dividends, and capital gains remain capital gains. The first two categories of income are generally taxed at a flat 30% tax rate in Belgium (rate as from January 1, 2017). Capital gains on movable assets realized by a private individual are generally tax exempt under Belgian tax law, to the extent that they are realized within the course of the normal management of a (private) estate. Taxation of so-called miscellaneous income at 33% may occur. Parliamentary documents confirm that capital gains realized through a trust, are (in principle) deemed to qualify as capital gains realized within the course of the normal management of a (private) estate.

The investment policy undertaken by the trustees may therefore be highly relevant from a Belgian tax point of view. Indeed, to the extent the trustees invest in assets generating tax-exempt income for Belgian tax purposes, the investment policy could be beneficial, even under the C.T.L. Tax-exempt income that is attributed or distributed to a Founder or Third-Party Beneficiary may also, as a general matter (and provided certain timing requirements are met), remain tax exempt under the C.T.L.

The parliamentary documents state, "It is self-evidently [sic] that [the] Cayman Tax has to take into account the double tax treaties [D.T.T.] concluded by Belgium." For example, in cases of foreign real estate income, the D.T.T. generally attributes the right to tax to the partner state. As a result, no Belgian income tax can be levied under the C.T.L. All this is to be verified in detail, based upon the specific facts of the case at hand.

"To the extent the trustees invest in assets generating tax-exempt income for Belgian tax purposes, the investment policy could be beneficial."

Where there is a multitude of Founders, each Founder is taxed in proportion to his or her contribution to the assets held in trust. If their respective shares cannot be determined, each Founder is allocated an equal part of the assets held in trust. This may lead to disputes and difficulties in practice. It may prove difficult, for instance, when grants and settlements took place a long time ago, thus making it almost impossible to re-establish the origins of the funds.

Founders by Heirship are taxable in proportion to "their share" in the trust or, if this cannot be proven, in proportion to their part in the hereditary succession of the Founder to whom the individual is heir. Valid proof to the contrary can be provided by the heirs. This may also lead to difficulties in practice.

Take, for instance, the case where a Belgian-resident father is the Founder of a trust. He leaves two-thirds of the estate to his son and daughter by last will and testament and transfers the other one-third of the estate more than three years prior to his death. The son and daughter are both beneficiaries of the trust. According to the trust deed and in practice, it remains wholly in the trustees' discretion to decide if and to what extent the children will or will not receive distributions of income and/or capital. In the example, the trustee decides not to make distributions within the first five years after the death of the father (Founder). In these five years, both the son and the daughter will be taxable on half of the income received by the trust, given their equal entitlement to the estate of the father. If the trustee decides after five years to distribute 90% of the total of assets only to the daughter, for whatever reason, the son will have been liable to tax on income he never received.

Parliamentary documents also give a comparable example, from which it appears that qualifying Founders remain taxable under the pass-thru tax regime, even though (i) they never received any actual distribution out of a trust and (ii) distributions were made to Third-Party Beneficiaries.

As indicated above, the parliamentary documents do mention the possibility for Founders by Heirship to demonstrate that they will never benefit from a trust, via a letter sent by the trustees. The Belgian tax administration will, in principle, accept such a letter as means of proof. Self-evidently, such a letter must reflect a genuine and irrevocable exclusion or removal from entitlement for the taxpayer and his or her heirs.

> ***"When 'past income' is distributed to a Third-Party Beneficiary, no taxation will occur."***

To the extent a Founder can demonstrate that income obtained by the trust has been effectively distributed to a Third-Party Beneficiary, who is a Belgian tax resident or tax resident of a qualifying country, this income will not be taxable in the hands of the Founder. However, such proof can only be given for income received and distributed in the income year itself.

Indeed, when "past income" is distributed to a Third-Party Beneficiary, no taxation will occur since the tax will already have been paid by the Founder.[10] No tax credit or claw back can be claimed in such cases. This is the so-called X–(X+1) rule – where "X" refers to the income year and "X+1" refers to the year in which the income has been distributed – also referred to as the "Current Income Year Principle." This principle is not described as such in the wording of the law, though the parliamentary documents apply the rule in several examples given, and the Minister of Finance has also confirmed its application in a reply to a parliamentary question. The Current Year Income Principle has also been described in a number of very recent tax rulings that were issued in November of 2016.

The following example best illustrates this principle. A father sets up a trust in 2005 for the benefit of his two children, X and Y, as well as his friend, Z. All are Belgian tax residents. The Belgian father passes away in 2012. Until 2015, the trust received €100,000 in capital gains and €100,000 in dividends. In 2015, the first year to which the C.T.L. applies, the trust received €20,000 in capital gains (tax exempt for Belgian individual income tax purposes, to the extent they are realized within the "normal management of a private estate") and €20,000 in dividends. Since X and Y can be qualified as Founders by Heirship, they are taxable under the C.T.L. on the €20,000 in the dividends. The same facts apply to 2016 and 2017. At the end of 2018, the trustees wish to make a distribution of €100,000 to Z. This distribution is financed by dividend income (€20,000) and capital gains (€20,000) received by the trust in 2018, and by income received in the past by the trust (€60,000). For 2018 (*i.e.*, tax year 2019), X and Y will most likely be able to demonstrate that Z received the €40,000 in dividends and capital gains. Hence, Z will be taxable as a Third-Party Beneficiary under the C.T.L. for the €20,000 in dividends. The capital gains remain tax exempt. In this example, the Belgian-resident children, X and Y, will have to pay tax on income they will never receive and which is finally attributed to Z.

As mentioned earlier, Belgian-resident Founders can provide valid proof to the contrary. This proof will require that the Third-Party Beneficiaries are resident in Belgium, another E.E.A. country, a country with which Belgium has a treaty containing

[10] Article 5/1-§1 B.I.T.C.

an exchange of information provision, or a country with which Belgium has a T.I.E.A. in place. Useful to note here is that since 2009 Belgium has entered into agreements for the exchange of information with many countries, including several offshore jurisdictions. According to the parliamentary documents, the possibility of exchanging information is sufficient. An actual exchange is not necessarily required.

Specific Anti-Abuse Regulations Do Not Genuinely Apply to Trusts[11]

The C.T.L. provides for a specific anti-abuse clause aimed, in particular, at Type 2 entities (*i.e.*, low taxed foundations and offshore companies). The provision allows the Belgian tax administration to disregard transactions made by these entities when subject to pass-thru taxation.[12] This regulation is not applicable to trusts.

Parliamentary documents clearly state that the general anti-abuse clause of Article 344-§1 B.I.T.C., which applies to income taxes, remains in place and can also be of use in cases where the taxpayer "makes an appeal on several multi-layered legal structures with a view to escaping the scope of the Cayman Tax." These very broad anti-abuse provisions give the tax administration a wide range of action and may be subject to challenges from taxpayers.

C.T.L. legislation also contains a specific anti-abuse clause, which states that, as of October 9, 2014, modifications to the deed of settlement of a trust with a view to restructuring a Type 1 entity into a Type 2 entity, or vice versa, cannot be upheld against the tax administration. The parliamentary documents clarify however that restructuring an "in scope entity" into an "out of scope entity" cannot be targeted by this specific anti-abuse provision. Nonetheless, it should be borne in mind that in such a case the general anti-abuse clause of Article 344-§1 B.I.T.C. may be applied.

Ruling Request

The parliamentary documents provide that the Belgian (Federal) Ruling Commission is competent to grant advance clearance on the application of the C.T.L. Given the many uncertainties in the application of the C.T.L., seeking advanced clearance may often be the only way to achieve legal certainty for Founders or Third-Party

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[11] This new anti-abuse clause is not to be confused with Article 344-§1 B.I.T.C., which contains the general anti-abuse rule as it applies to Belgian income taxes. This rule allows the Belgian tax administration to "restore" the taxable base and tax computation to achieve taxation in accordance with Parliament's objectives, as if the alleged abuse had not taken place. In order to apply this anti-abuse rule, the tax administration must provide (complex) proof of "tax abuse," based on objective circumstances. In principle, tax abuse exists when the taxpayer realizes, through a legal act or a set of legal acts, a transaction that meets either of the following criteria:

- Contrary to the law's objectives, the transaction results in the taxpayer being excluded from the scope of the Tax Code or an executing decree's application.
- The essential goal of the transaction is to obtain a tax benefit, provided under the Tax Code or an executing decree, which if granted would be contrary to the law's objectives.

The taxpayer can avoid the anti-abuse provision's application by demonstrating that the legal act(s) is justified by (sufficient) motives other than tax avoidance.

[12] Article 344/1-§1 B.I.T.C.

Beneficiaries. Among the tax rulings issued by the Belgian Ruling Commission in November of 2016, at least five related to trusts.

Reporting Obligations for Founders and Third-Party Beneficiaries

The Belgian tax authorities are entitled to request that Founders or Third-Party Beneficiaries provide ample documentation on trusts. These reporting obligations have been further increased by the Law of December 26, 2015. Since the reporting obligations may have an impact on beneficiaries, trustees must also pay close attention to the requirements, which include providing adequate and timely information as well as documentation about the trust assets and the trust income. Sometimes, it will be useful to provide written statements on a person's beneficial entitlement, or the denial thereof, thus safeguarding that person from adverse tax consequences.

Even though the C.T.L. is not targeting trustees *per se*, trustees must closely monitor the obligations applicable to Belgian-resident Founders and Third-Party Beneficiaries. C.T.L. provisions require that the existence of a trust be reported in the taxpayer's annual tax return, along with the income generated by the trust assets. More precisely, the following information must be reported:

- The full name of the entity
- The legal character of the entity
- The address of the entity
- The name and address of the trustee

To the extent a trust has received income that is subject to pass-thru taxation, the Belgian taxpayer is required to report the income on his or her income tax return. However, as a practical matter, taxpayers do not always have full access to the necessary information in order to comply with these reporting requirements. Trustees should bare this obligation in mind when requested to provide information that would enable the Belgian taxpayer to file a correct income tax return. Noncompliance by a Belgian-resident Founder or Third-Party Beneficiary results in a fine of €6,250 per legal construction per tax year. Hence, trustees should verify their legal position in relation to a fine imposed on a Founder or Third-Party Beneficiary in the event of undue failure of the trustee to provide the necessary information.

No Automatic Indication of Fraudulent Behavior

Finally, the parliamentary documents clearly specify that the mere existence and reporting of an entity within the scope of the C.T.L. cannot be seen as an indication that the Founder and/or Third-Party Beneficiary has committed a tax offence in the past, nor can the first declaration of taxable income under C.T.L. legislation be seen as such. However, the tax administration's full range of investigative possibilities will remain in place, *inter alia*, in relation to the source of the funds transferred to a trust.

CONCLUSION

The tax treatment of trusts under Belgian tax laws is extremely complex. Although the principles, as proclaimed by the Belgian tax authorities, of pass-thru income taxation upon distribution may seem relatively straight forward, in practice there is a high level of uncertainty involved. Moreover, pass-thru treatment under C.T.L. regulations is not matched with the regulations that apply in relation to death duties. Therefore, when dealing with trusts in a Belgian tax environment, the utmost caution is advised.

NEW ZEALAND FOREIGN TRUST DISCLOSURE REGIME

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Tags
Information Disclosure
New Zealand
Transparency
Trusts

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In April 2016, the New Zealand government convened an independent inquiry into the use of New Zealand foreign trusts. Following this inquiry, the New Zealand government proposed a new Foreign Trust Disclosure Regime ("F.T.D.R."). The new regime will run in parallel to New Zealand's adoption of the Common Reporting Standard ("C.R.S.") and will be entirely separate to any C.R.S. reporting.

The bill that will introduce the F.T.D.R. is currently going through the New Zealand parliamentary process. Parliament returns to sit on February 7, 2017 and the legislation will be considered in due course on the legislative agenda; it is expected that the bill will not be amended substantially before it is passed into law. Once the bill has been passed, regulations will be put in place which will set out the specific requirements of the regime. The draft regulations for the F.T.D.R. are currently unknown.

It is expected that the new F.T.D.R. will become effective from June 30, 2017. All existing New Zealand foreign trusts will need to comply with the legislation by that date.

Although the relevant legislation has not yet been passed and the final specific details of the new regime are unknown, we are currently able to highlight the following points about the new F.T.D.R.:

- Nothing disclosed under the F.T.D.R. may be used for C.R.S. reporting by the New Zealand government. The information gathered under the regime will be collated by the Inland Revenue Department ("I.R.D.") for the New Zealand government's records purposes only.
- The information will not be publicly available and will be protected by New Zealand's extremely strong privacy and confidentiality legislation. New Zealand government agencies have a proven track record of upholding this legislation.
- No change to the fully tax-exempt status of New Zealand foreign trusts has been proposed.
- New Zealand foreign trusts already disclose their establishment to the I.R.D., however, the information required under the F.T.D.R. is more detailed. It is proposed that the F.T.D.R. will require the following information to be filed with the I.R.D.:
  - Trust deed and particulars of settlors and, in certain cases, protectors
  - T.I.N.'s where applicable

- Beneficiaries where they have a fixed right to distributions
  - Class of beneficiaries where beneficiaries are discretionary and identification of individual beneficiaries when distributions are made
  - Any amendments to the above arrangements
  - Annual financial statements (see below)
  - An annual return
- The government will levy fees for the initial filing and the annual return filing.
- Following the introduction of the F.T.D.R., New Zealand foreign trusts will be required by law to prepare financial statements. However, consolidated financial statements will not be required. As an example, in the case of a trust holding shares in an investment company, only the shares will be shown in the statement, not the underlying assets of the investment company.

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