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INSIGHTS

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EDITORS' NOTE

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

- **Failure to Prevent – The Future of Adviser Obligations.** The concept of failure to prevent has grown from its roots in the U.S. Foreign Corrupt Practices Act and is making inroads into the responsibilities of tax advisers. The recent trend begs the question, do advisors have a duty to prevent the evasion or improper reduction of tax or to report the activity in advance? A team of international advisors looks at the evolution of obligations: Peter Utterström of Peter Utterström Advokat AB, Stockholm, looks at the origin of the concept. Gary Ashford of Harbottle & Lewis, London, looks at recently adopted legislation in the U.K. imposing strict liability on advisers to naughty clients. Lawrence Feld, Attorney at Law, New York, looks at its presence in the U.S. Swiss Bank Program of the Justice Department. Dick Barmentlo of Jaegers & Soons, Amsterdam, addresses a recent case in the Netherlands that imposes civil liability on a Netherlands trust company and its employees for lost taxes suffered by the Dutch tax administration.

- **New Tax Treaty Between France and Luxembourg: French Tax Implications for Investors.** France and Luxembourg signed a new double tax treaty on income and capital in late March. Ratification by the end of the year is anticipated. The new treaty reflects the current post-B.E.P.S. environment. Among other things, the residence definition is tightened, the test for the existence of a permanent establishment is loosened, real estate funds face higher withholding tax, a credit method is adopted to avoid double taxation. Christophe Jolk, Attorney at Law, Paris, explains the implications for investors.

- **G.D.P.R. Is Imminent – Is Your U.S. Business Prepared?** In Europe, an individual's right to the protection of personal data is a fundamental right. The E.U. General Data Protection Regulation ("G.D.P.R.") takes effect on May 25, 2018, to protect that right. The G.D.P.R. is notable because it applies to all companies processing personal data of persons residing in the European Economic Area regardless of the company's location and irrespective of whether the company has a physical presence in these countries. Severe penalties are provided for violators. Fanny Karaman and Beate Erwin provide a layman's guide to the G.D.P.R.

- **Code §962 Election Offers Benefits Under U.S. Tax Reform.** Two provisions in the recent tax reform legislation – Code §§965 (transition tax) and 250 (50% deduction for G.I.L.T.I.) – focus on C.F.C.'s and their U.S. Shareholders. In each case, corporate U.S. Shareholders are entitled to a deduction that is not granted to an individual with regard to income that is taxed under Subpart F. However, Code §962 may allow an individual who is a U.S. Shareholder of a C.F.C. to elect to be taxed on the Subpart F Income as if a corporation. This allows for tax at a lower rate and a foreign tax credit for corporate income taxes paid by the C.F.C. Elizabeth V. Zanet and Galia Antebi explain the workings of Code §962 and focus on the position of naysayers who caution that it may not provide the relief it appears to provide.

- **A Comparative View of the Principal Purpose Test – U.S. Tax Court v. B.E.P.S.** In a post-B.E.P.S. world, aggressive tax planning is a mortal sin. If a principal purpose or a main purpose of entering a transaction is tax avoidance, the tax benefits are lost. A ruling in a recent pre-trial hearing in the U.S. Tax Court addressed a clearly abusive transaction aimed at importing high-basis, low-value assets into a U.S. partnership so that the U.S. investors could benefit from losses on nonperforming loans. The I.R.S. moved for summary judgment in its favor, but the motion was denied. Under applicable case law, a transaction can be respected even if it is tax motivated as long as economic substance is present. Consequently, the taxpayer is entitled to a day in court, even if the prospect of victory is slim. Rusudan Shervashidze and Stanley C. Ruchelman compare the approach followed by the U.S. Tax Court with the principal purpose test rules of the A.T.A.D. and B.E.P.S.

- **I.R.S. Notice 2018-28 Announces Code §163(j) Regulations on Interest Payment Deductions.** Prior to recent tax reform legislation, Code §163(j) was an earnings stripping provision that placed a cap on interest expense deductions on debt instruments held or guaranteed by foreign related persons that were not subject to full 30% withholding tax on U.S.-source interest income or guarantee fees. Under the T.C.J.A., Code §163(j) is now simply a cap on all business interest expense. Notice 2018-28 addresses open matters arising from the change. This includes the carryover of disallowed interest from prior years to 2018, the Super-Affiliation Rules under the new law, and the loss of excess limitation carryforwards. Elizabeth V. Zanet and Beate Erwin explain these and other items in the Notice.

- **Updates and Other Tidbits.** This month, Tomi Oguntunde and Nina Krauthamer look briefly at several recent developments in international tax: (i) the Financial Accounting Standards Board continues to study the effect of the recent tax reform legislation on quarterly and annual reports, (ii) winners and losers under the recent tax reform legislation, and (iii) *South Dakota v. Wayfair, Inc.*, a case involving the right of a state to impose an obligation on out-of-state internet retailers who maintain a “digital presence” in the state through internet sales.We hope you enjoy this issue.

\- The Editors

FAILURE TO PREVENT – THE FUTURE OF ADVISER OBLIGATIONS

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Tags
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INTRODUCTION

Between F.A.T.C.A., C.R.S., the Panama Papers, and the Paradise Papers, taxpayer information has become increasingly transparent and available to authorities in many countries. Banks were once paradigms of confidentiality. Now, they are beholden to compliance and reporting obligations imposed by the O.E.C.D. and European Commission directives. Documents thought to be confidential are regularly hacked for "bad" reasons such as ransom and "good" reasons. The risk of embarrassing public disclosures incentivizes acceptable tax planning behavior.

The quantum of data that is in the public domain has stimulated a debate on the ethics of those who make a living advising others on tax reduction schemes. When clients commit a bad act, should tax and financial advisers be responsible? Should responsibility be eliminated if information is provided after the close of the tax year? Or do advisers have a duty to prevent the evasion or improper reduction of tax or to report the activity in advance?

This article looks at the history of liability exposure for failing to prevent a wrongful act. Starting with efforts to combat corporate bribery, it addresses the evolution of the failure-to-prevent standard of ethical behavior, highlighting recent U.K., U.S., and Dutch initiatives placing obligations on advisers.

THE EVOLUTION OF FAILURE TO PREVENT

Anti-Bribery Legislation

> The millions and – sometimes billions – in settlement and fines in anti-bribery cases is just a beginning! The rules which are implemented in anti-bribery legislation in many countries are here to stay – and are, as noted below, expanding to other areas of (corporate) compliance.

The failure-to-prevent standard of ethical behavior that now exists in many countries has its roots in U.S. Foreign Corrupt Practices Act ("F.C.P.A."). The F.C.P.A. was designed to prevent bribery of foreign government officials with the power to issue or approve contracts.

The F.C.P.A. applies to U.S. entities as well as foreign that have a legal tie to the U.S. (*e.g.*, by U.S. direct or indirect ownership), or foreign companies with publicly traded shares on a U.S. securities market. U.S. jurisdiction may also be invoked where a bribe has been facilitated by use of a U.S. bank or financial institution, the U.S. Postal Service, or a U.S. telecommunication service (including the use of U.S. servers). Companies caught by this legislation have found that turning a blind eye

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to bad acts and actors often leads to untold expenses and harmful public relations that drag down share value. Monetary penalties to the Department of Justice and to the Securities and Exchange Commission are to be expected as a part of a possible settlement, and the risk of individuals serving time in jail is imminent. The cases of very expensive settlements are many, and many U.S. and foreign international businesses have implemented ethical policies and procedures to prevent incompliant actions by the companies, their employees, and their agents. Equally important, ethical investor groups, including many universities and public pensions, have policies in place that limit shareholdings to corporations that meet a "good citizen" standard. Companies caught violating F.C.P.A. rules tend to be "sadder but wiser" concerning ethical behavior.

As a consequence of litigation, or an in effort to avoid it and to mitigate the consequences many international companies have introduced codes of ethics and business conduct as well as the necessary processes to implement, train and follow up such programs and policies that apply to all members of the multinational group, their employees, and their agents. Best practices have been adopted and are updated periodically as new exposure areas are identified. Employees are trained to adhere to these codes as well as to international and local legislation that attacks bribery and corruption. Monitoring systems have been implemented to track compliance. Companies have introduced due diligence procedures with business partners – customers as well as suppliers – mandating adoption of best practice policies. Today, it is impossible for many multinational companies to sell or buy products from a new or existing customers or suppliers without having performed proper due diligence as to the business practices of the counterparty to a transaction.

In most jurisdictions, the traditional view has been to look at the board of directors and hold the board responsible. The managing director is responsible only in very specific and identified cases. When bad acts are discovered, the perpetrator is described as a "rogue employee," suggesting that the act is isolated and reflects hidden behavior. Adoption of failure-to-prevent standards will change this. The board of directors typically establishes policy, but operating management is responsible for day-to-day operations. To influence operating management, anti-bribery statutes must have an enforcement mechanism. Otherwise, the anti-bribery rules are more of a wish than a mandate.

Failure-to-prevent rules in the U.S. and the U.K. are enforced by the U.S. Department of Justice and the U.K. Serious Fraud Office, governmental agencies that have a mandate to monitor compliance and punish noncompliance. However, not all countries have such stringent tools to incentivize ethical business practices.

In Sweden, modifications were made to the anti-bribery legislation in 2012 to define a new crime: gross negligent financing of bribery. In principle, management must secure that a due diligence system exists to control counterparties to a transaction. Any agent who receives corporate funds must be vetted, and management must be able to show that all reasonable steps were taken to prevent any risk of improper use of the funds. However, the Swedish rules have been designed to be relatively weak. In comparison to other countries, Swedish law does not require the implementation of concrete steps such as training programs and monitoring after-training behavior. A high burden of proof is not placed on Swedish companies to demonstrate compliance. Consequently, Swedish companies do not face an upward battle to demonstrate compliance with ethical standards.

Data Privacy

Recently, failure-to-prevent standards have migrated to other areas of law, including finance, anti-trust, anti-money laundering, and tax. The most recent example relates to the E.U.'s General Data Privacy Regulation ("G.D.P.R."), which takes effect for corporations on May 25, 2018. The G.D.P.R. is directed to the data protection and privacy of individuals and consumers. Organizational accountability is mandated by requiring organizations to implement robust privacy governance policies and procedures that among other things require risk assessment for data collected on E.U. individuals. Data collectors will be held responsible regardless of their location and the existence of an actual data breach. The penalty for failure to comply is a fine of up to 4% of group turnover. The G.D.P.R. is similar to the anti-bribery legislation in that management is incentivized to give attention because the penalty is enormous and painful.

Gender Equality

In some countries, the failure-to-prevent standard has also been applied to combat gender discrimination. Iceland has introduced legislation calling upon companies to show the reason for pay disparities between employees who perform essentially the same work and to be responsible for damages if management failed to have in place a policy on gender equality in workforce compensation.

Tax Evasion

In the tax area we see a trend in this direction with respect to tax planning and the role of the tax adviser – most recently in the B.E.P.S Action Plan adopted by the O.E.C.D. Some actions focus on transparency, putting a burden on the taxpayer to report information and actions to the tax authorities beyond what is reported in the annual report and/or tax return. In European countries, tax advisers and their clients must report "aggressive tax planning" to give the tax authorities advance warning of abusive tax planning. Obligations are imposed on the outside tax adviser and internal management. These are recent examples of the expansion of the failure-to-prevent principle. Other examples are discussed in detail below.

U.K. FAILURE TO PREVENT TAX EVASION

U.K. attacks on abusive tax planning provide a real-life example of the expansion of the failure-to-prevent principle in the context of cross-border tax planning. The new offences for failure to prevent the facilitation of tax evasion reflect the government's frustration at the difficulty encountered in successfully prosecuting large institutions when a criminal act has been carried out by a "rogue employee." The offences are "strict liability" so that they do not require proof of the involvement of senior management.

There are two offences identified in the legislation: (i) failure to prevent U.K. tax evasion and (ii) failure to prevent tax evasion in other countries. The offences extend to corporations, limited partnerships, and other structures located in the U.K. or outside that have failed to prevent the facilitation of tax evasion. In the case of foreign tax evasion, one of the following conditions must be met for the act to be punishable in the U.K.:

- One of the advisers is incorporated or formed in the U.K.

- The adviser conducts business in the U.K.
- The conduct that constitutes foreign tax evasion facilitation takes place in the U.K.

This means that overseas advisers that visit the U.K. in connection with an advisery or financial business activity fall within the scope of the legislation.

“If the adviser fails to prevent the tax avoidance transaction from occurring, the underlying advice is not reliable.”

The new offences carry the threat of unlimited fines. Fortunately, as with many other failure-to-prevent offences, entities have opportunities to protect themselves under the U.K. legislation. The key defense is that the entity has reasonable “preventative procedures” in place. H.M.R.C. issued guidance in October 2016 to help entities establish appropriate procedures. Those procedures are focused on five guiding principles:

- Risk assessment
- Proportionately of risk-based prevention procedures
- Top level commitment
- Due diligence and communication (including training)
- Monitoring and review

These are the same guiding principles used in connection with the anti-bribery statutes previously discussed. They are similar to principles that have been adopted by financial organizations required to manage anti-money laundering (“A.M.L.”) risk within a large organization. While it is apparent that A.M.L. encompasses tax evasion matters, H.M.R.C. has made it clear that A.M.L. procedures, *per se*, will provide an entity with all the procedures it needs to make a complete defense against the new offences.

As mentioned above, acts of associated persons can result in liability under the offences. An associated person can be an employee or a contractor or subcontractor that can be seen to represent the entity. This risk of responsibility for the acts of others leads to the adoption of codes of ethical conduct in tax planning that are rigorously enforced. It follows that the organization must require each contractor or subcontractor to demonstrate that it has in place similar procedures that are rigorously enforced. On the other hand, it is expected that liability would not reach a corporation or partnership if it refers a client to a local adviser who then has an independent relationship with the client that leads to a prohibited act. In sum, management likely will face greater risk exposure if the company cannot prove that it has the necessary processes in place to secure proper and reasonable behavior by employees and third-party representatives that interface with taxpayers. Again, processes likely are not sufficient if they fail to include regular monitoring of behavior.

Another new development in the area of avoidance in the U.K. is the recent change to the penalties for compliance errors related to an avoidance arrangement. These changes seek to deem all behavior linked to tax avoidance arrangements as careless or deliberate for penalty purposes. These rules introduce the concept of disqualified advice, a significant and worrying development. Where a penalty is being considered and a taxpayer raises the defense of reliance on an adviser, no account is taken of advice that is disqualified. As a result, disqualified advice is treated as the absence of advice. Disqualified advice generally is the advice provided by the person who designed the plan – not one who independently evaluated the effectiveness of the plan for the taxpayer – or the person who was involved in implementing the plan based on the advice. In a sense, if the adviser fails to prevent the tax avoidance transaction from occurring, the underlying advice is not reliable. This may incentivize clients to bring malpractice actions against advisers who bring pre-packaged plans to a client or to file complaints against advisers with professional licensing bodies.

U.S. SWISS BANK PROGRAM

The United States does not criminalize the failure to prevent the facilitation or commission of a tax offense as of yet. It does, however, criminalize offshore acts that facilitate U.S. tax evasion. In addition, failure to prevent specified conduct is embodied in non-prosecution agreements and plea agreements resulting from these efforts.

The Swiss Bank Program, announced in August 2013, enabled Swiss financial institutions to avoid criminal prosecution for facilitating offshore tax evasion by U.S. taxpayers. Banks already under criminal investigations for Swiss activities were excluded from the program. However, a Swiss bank was eligible to receive a non-prosecution agreement if it fulfilled all the following conditions:

- It made a complete disclosure of cross-border activities.
- It provided detailed information on an account-by-account basis for accounts in which U.S. taxpayers had a direct or indirect interest.
- It cooperated in treaty requests for account information.
- It provided detailed information as to other banks that transferred funds into secret accounts or that accepted funds when secret accounts were closed.
- It agreed to close accounts belonging to account holders who failed to come into compliance with U.S. reporting obligations.
- It paid appropriate penalties.

There were four program categories based on the nature of the crime which determined the sort of agreement that would be available to a bank:

- Banks already under investigation were excluded from the program and generally entered a deferred prosecution agreement.
- Banks that were not yet under investigation and had reason to believe that they committed tax-related offenses sought non-prosecution agreements.
- Banks that did not believe they engaged in activities against the U.S. needed an independent examiner to verify the fact and sought non-target letters.
- Banks with a local client base, as defined under F.A.T.C.A., sought non-target letters as well.

Under the program, the U.S. government executed non-prosecution agreements with 80 Swiss banks and imposed more than $1.36 billion in penalties.

Once the Swiss Bank Program was terminated, F.A.T.C.A. became the policing measure in the U.S. Currently, F.A.T.C.A. requires U.S. persons living offshore to report their foreign financial accounts to the Financial Crimes Enforcement Network annually. Simultaneously, foreign banks now request their U.S. clients to complete forms declaring their citizenship and residency for tax purposes. This imposes a duty upon both the taxpayer to report its accounts and the financial institution to disclose its U.S. clients to ensure assets are not being concealed.

DUTCH DUTY OF CARE

Not all failure-to-prevent matters are handled by passing new law. Dutch trust companies have been targeted since the publication of the Panama Papers. Recently, the civil-law division of the Court of Amsterdam rendered an interesting judgment on a trust office's liability for the tax debts of a number of its clients.

In the case referred to as *Tradman v. Dutch Tax Administration*, clients used the trust office's advice to conceal companies that were liable to pay tax in the Netherlands. According to the Dutch Tax and Customs Administration, the trust office contributed to the fact that the tax authorities were unable to collect tax or to do so in good time. The court accepted this argument and ruled that the trust office should have borne the interests of the Tax and Customs Administration in mind when it provided assistance to its clients.

This is a remarkable judgment – in large part because a duty to the Tax and Customs Administration does not exist under Dutch law. In principle, the Tax and Customs Administration had sufficient powers under tax administrative law to safeguard its rights against the taxpayers in respect of a tax assessment. It has the power to raise an estimated assessment, which it failed to do. However, this point was not raised in the case. Instead, it seemed to rely on a concept that the trust office is an "insurer" for payment of Dutch tax by customers. Guilt by association would be a good description of the position of the Tax and Customs Administration.

The civil-law division of the Court of Amsterdam does not generally address tax matters, and certain conclusions of law do not appear to be widely accepted in tax jurisprudence. The court was correct to find that, in general, a trust office cannot be expected to weigh the interests of its client against the interests of third parties (*i.e.*, the Tax and Customs Administration). However, the court subsequently swept this consideration aside with the platitude that essentially applies to every adviser, namely that given its "social position in financial transactions and professional expertise" it should "to a certain extent" take the interests of third parties into consideration in the performance of its assignment. The court considered this to be a trust office's duty of care. Thus, if the trust office fails to perform its duty, standards of due care have been violated.

The court added to this that the directors and employees of the trust office may also be held personally liable if they can be "attributed serious blame" for the relevant trust office's actions and omissions. According to the court, this is the case if the directors and employees are personally involved in giving advice to the taxpayer. The court expressed the view that the trust office's duty of care implies that it is the trust office's task to investigate whether the service provided could be used for tax evasion.

The open issue, should the case be appealed, is whether the court's pronouncements are based on tax law that exists or simply on general views that are not found in tax practice.

Part of the court's ruling was favorable for the taxpayer. The tax authority argued that once fraud is asserted, no defense is available to the trust company. This is consistent with the view that the trust company is an insurer of the tax which would otherwise be due. Thus, resorting to a court amounted to an additional abusive act. The court disagreed. It found that a trust office may use legal process to defend itself without being viewed as further obstructing the Tax and Customs Administration. The trust company did nothing wrong when it sought legal protection for the benefit of its other clients and for its own interest. This implies that in future cases trust companies can defend their own position.

As a final point, the case dealt only with the trust office's legal liability. It did not address damages. With regard to the extent of the loss and the extent to which the Tax and Customs Administration is to blame for that loss, as well as whether the unlawful act is causally related to the loss at all, the court deferred any decision, preferring the matter to be the subject of follow-up proceedings. Consequently, the amount for which the trust office would be liable is yet to be determined. Undoubtedly, there will be more to report as this case develops.

"Advisers may no longer be able to claim a defense based on lack of knowledge or awareness of the results of a client's activity."

CONCLUSION

Recent developments show that there has been a change in attitude regarding the adviser's role. Advisers are being held accountable for their services and the consequences of actions carried out by clients. There is a movement in government, nongovernmental organizations, and the press to shift the loyalties of advisers from strict focus on interests of the client. Instead, the movement is towards putting the public interest ahead of loyalty to the client. When this approach is carried to its ultimate conclusion, advisers may no longer be able to claim a defense based on lack of knowledge or awareness of the results of a client's activity. Simple disclaimers may no longer shield an adviser from risk. Sophisticated advisers providing aggressive but arguably justifiable plans to a client may be held civilly or criminally liable for their plans. Client confidentiality is in the cross-hairs, and it is not clear that the ultimate answer will be the same in Europe and the U.S.

NEW TAX TREATY BETWEEN FRANCE AND LUXEMBOURG: FRENCH TAX IMPLICATIONS FOR INVESTORS

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INTRODUCTION

France and Luxembourg signed a new double tax treaty on income and capital (the "New D.T.T.") on March 20, 2018. The New D.T.T. is awaiting ratification by the parliaments of both countries, which is expected to occur this year. If the target date for ratification is met, some provisions will enter into force as of January 1, 2019.

The New D.T.T. comes 60 years after the passage of the current double tax treaty on income and capital (the "Current D.T.T."), which was signed on April 1, 1958, and has been amended four times since it entered into force, in 1970, 2006, 2009, and 2014.

One significant change resulting from the New D.T.T. is the increase in the withholding tax rate on distributions made by certain French real estate investment vehicles from 5% to a potential 30%. These structures are currently heavily used by institutional real estate investors. It is likely that the real estate industry will be busy this year, searching for ways to cope with the increased tax burden.

Many of the provisions of the New D.T.T. are modeled after the O.E.C.D. Model Tax Convention (the "O.E.C.D. Model"). However, due to the trade history between France and Luxembourg, there are notable departures. Interestingly, several provisions of the New D.T.T. are directly inspired by the Multilateral Instrument ("M.L.I."), even though Luxembourg reserves the right to exclude some of these provisions in its Covered Tax Agreements, which include double tax treaties already in force and therefore encompass povisions that are now part of the New D.T.T.

RESIDENCY – ARTICLE 4 OF THE NEW D.T.T.

In accordance with the latest 2017 version of the O.E.C.D. Model, the New D.T.T. defines the term "resident" as "a person who is liable to tax."

In addition to the provisions found in the O.E.C.D. Model, the New D.T.T. addresses *sociétés de personnes* (French partnerships), *groupements de personnes* (groups of individuals), and similar entities that can be deemed resident if

- the place of effective management is situated in France,
- they are liable to tax in France, and
- the shareholders, partners, or members, are all personally subject to tax in France on their respective portions of profits.

The New D.T.T. adds that a trustee or fiduciary, as such, is not considered a resident of a contracting state even if he or she were to qualify as a resident of one of the contracting states under the general definition. This applies when and to the extent that he or she is only the apparent beneficiary of the income so that another person who cannot be deemed a resident of that particular contracting state receives the benefit.

Collective Investment Vehicles ("C.I.V.'s") established in France or Luxembourg, which are generally tax-exempt, should a priori not be treated as residents under the New D.T.T., because the liable-to-tax test cannot be met by the C.I.V. However, Paragraph 2 of the accompanying Protocol to the New D.T.T. (the "Protocol") provides that C.I.V.'s that are established in one contracting state and are comparable to domestic C.I.V.'s under the law of the other state may receive the benefit of the dividends and interest provisions (Articles 10 and 11) of the New D.T.T. These benefits apply to the fraction of C.I.V. income corresponding to the rights of persons who reside in one of the contracting states or a state that has a treaty of administrative assistance for the purpose of preventing tax evasion and avoidance with the source contracting state.

In sum, the addition of residency provisions is a major novelty of the New D.T.T., as the Current D.T.T. contains only a very short and old definition of "tax domicile" and not "residence."

PERMANENT ESTABLISHMENT – ARTICLE 5 OF THE NEW D.T.T.

The New D.T.T.'s permanent establishment definition closely follows the O.E.C.D. Model and incorporates elements contained in the Current D.T.T.

A notable departure from the Current D.T.T. relates to *commissionaire* arrangements. Under the New D.T.T., *commissionaire* arrangements may be deemed a permanent establishment when, *inter alia*, the party is acting in one "Contracting State on behalf of an enterprise and, in so doing, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise." The New D.T.T. foresees that when a person acts exclusively or almost exclusively on behalf of one or more closely-related enterprises, that person will not be allowed to use the independent-agent exemption to a permanent establishment.[1]

The New D.T.T. also incorporates Option B under Article 13(3) of the M.L.I. with respect to permanent establishment exemptions for specified activities. It provides that the maintenance of a fixed place of business solely for the purpose of carrying on activites of a "preparatory or auxiliary character" is generally not deemed to be a permanent establishment. The New D.T.T. also adds an anti-fragmentation provision for the case of activities between closely-related parties.[2]

Permanent establishments are also addressed under the business profits provision (Article 8) of the New D.T.T. This provision follows the long-standing principle that the profits of an enterprise located in one contracting state are taxable only in that contracting state, except when the enterprise carries on business in the other contracting state through a permanent establishment situated therein. This is a more

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1 These provisions are modeled after Article 12 of the M.L.I.

2 Article 13(4) of the M.L.I.

modern wording than the Current D.T.T., which states that under specific rules, business profits are only taxable in the country in which the permanent establishment is situated.

DIVIDENDS – ARTICLE 10 OF THE NEW D.T.T.

New Withholding Taxes

Although the principle that provides "the right to tax a dividend belongs to the country of the recipient of the dividend" remains, both the New D.T.T. and the Current D.T.T. grant a general withholding tax rate of 15% to the source country.

The domestic French withholding tax rate is 12.8% for dividends distributed to individuals and 30% for those distributed to companies (subject to exceptions). In the latter case, for financial years beginning on or after January 1, 2020, the withholding tax rate will equal the normal corporate income tax rate. The marginal corporate tax rate is due to be reduced gradually, from the current rate of 33 1/3% to: 31.0% as of 2019, 28.0% as of 2020, 26.5% as of 2021, and 25.0% as of 2022.

Under the Current D.T.T., there is a preferential withholding tax rate of 5% on dividends. This rate generally applies where the beneficial owner holds a substantial participation of at least 25% of the capital of a distributing company. The New D.T.T. improves upon this preferential regime. Consistent with Article 8 of the M.L.I., the New D.T.T. provides a full exemption from withholding tax on dividends paid by a company of one treaty country to a company resident in the other treaty country that holds at least 5% of the capital of the distributing company throughout a 365-day period from the date of dividend payment. No account is taken of changes of ownership that directly result from a corporate reorganization, such as a merger or divisive reorganization, of the shareholder company or the company paying dividends.

French domestic law allows for a similar exemption of withholding tax. The benefit applies if, among other conditions, the Luxembourg parent holds at least a 10% shareholding in the French subsidiary or at least a 5% shareholding if it cannot impute the French withholding tax.

Distributions from Real Estate Investment Vehicles

A novelty of the New D.T.T. and its practical repercussions for Franco-Luxembourg business relations is the addition of a new provision concerning distributions from real estate investment vehicles.

Under the new provision, when the majority of tax-exempt dividends derived from real estate income or gains are paid out on a yearly basis by an investment vehicle in one contracting state to a resident of the other contracting state, they are taxable in that other state. However, the dividends can be taxed in the source country, but the withholding tax rate is dependent on the following:

- If the beneficial owner either directly or indirectly holds less than 10% of the distributing vehicle then a 15% withholding tax rate under the treaty can be applied.
- If the beneficial owner either directly or indirectly holds 10% or more of the distributing vehicle, the dividends are taxed up to the domestic withholding tax rate, rather than at a beneficial treaty rate.

This treatment is a significant change to the current market practice. Several French real estate investment structures are organized to allow a Luxembourg vehicle to hold an interest in French (i) *organismes de placement collectif en immobilier* (undertakings for collective investments in real estate or "O.P.C.I.'s") structured as *sociétés de placement à prépondérance immobilière à capital variable* (real estate investment companies with variable capital or "S.P.P.I.C.A.V.'s") or (ii) s*ociétés d'investissement immobilier cotées* (real estate investment trusts or "S.I.I.C.'s"), the latter being listed investment vehicles. Both the S.P.P.I.C.A.V.'s and S.I.I.C.'s are exempt from corporate income tax in France unless otherwise specified.

"Royalty payments are taxable in the country where the recipient is a resident, and the source country may apply a general withholding tax rate of 5%."

As a result, French real estate investment vehicles distributing dividends to Luxembourg vehicles with a 10% or greater interest could be subject to French withholding tax of up to 30% – as opposed to the 5% treaty rate under the Current D.T.T. for dividends distributed to a 25% or greater owner, which, under certain conditions, were not subject to tax in Luxembourg. This is dicussed in the commentary on Article 22, below.

Fortunately, French domestic law may provide a saving grace in this respect. The withholding tax rate may be reduced to 15% if distributions are made from S.P.P.I.C.A.V.'s and S.I.I.C.'s to certain Luxembourg C.I.V.'s. However, for S.I.I.C.'s, a 20% domestic levy could also apply when, subject to certain conditions, distributions are made to a 10% or greater tax-exempt investor that is not an individual.

In addition, because a S.I.I.C. is not necessarily categorized legally as an O.P.C.I. (*i.e.*, a form of C.I.V.), the question arises as to whether a tax-exempt S.I.I.C. can receive the benefit of Article 10 of the New D.T.T. in accordance with Paragraph 2 of the Protocol. This can be compared to the current treaty between France and the United States, which expressly grants treaty-resident status to both S.I.I.C.'s and S.P.P.I.C.A.V.'s. Further commentary is needed to better assess the question.

INTEREST AND ROYALTIES – ARTICLES 11 AND 12 OF THE NEW D.T.T.

The New D.T.T. stipulates that interest is taxable in the country where the recipient is a resident and will no longer allow the imposition of withholding tax on interest income. This is preferable to the treatment under the Current D.T.T., which calls for a general treaty withholding tax rate of 10%. This change has little impact from a French perspective, as interest payments are in principle not subject to withholding taxes when paid to Luxembourg residents.

Under the New D.T.T., royalty payments are taxable in the country where the recipient is a resident, and the source country may apply a general withholding tax rate of 5%. This is a new condition when compared to the Current D.T.T., which does not provide the source country with a general treaty withholding rate.

Generally, French domestic law applies a withholding tax on royalties equal to the corporate income tax rate, currently 33 1/3%, which is set to be reduced gradually to 25% by 2022. Under certain conditions, an exemption may apply, such as when the Luxembourg recipient is a 25% or greater shareholder.

CAPITAL GAINS – ARTICLE 13 OF THE NEW D.T.T.

The capital gains article of the New D.T.T. is similar to the O.E.C.D. Model in that capital gains are generally taxed by the country where the person disposing of the assets is a resident. In contrast, the Current D.T.T. does not have a standalone capital gains clause. This section provides commentary on the most important capital gains taxable in the source country under the New D.T.T.

Capital Gains Derived from Interests in Real Estate

The New D.T.T. stipulates that a gain derived from the alienation of immovable property is taxable in the country where it is situated. This is similar to the treatment under the Current D.T.T.

The New D.T.T. further provides that gains derived by a resident of a contracting state from the alienation of shares or other participations in a company, trust, or other institution or entity, may be taxed in the other contracting state if, at any time during the preceding 365 days, these shares or comparable interests directly or indirectly derived more than 50% of their value from immovable property in that other contracting state. Immovable property used to carry on one's own trade activities is excluded. In this respect, the New D.T.T. merely modifies the Current D.T.T. by extending its scope to include a 365-days look-back period.

In general, the French withholding tax rate levied on occasional capital gains realized upon the sale of real estate can be either 19% or the applicable corporate income tax rate, subject to specific conditions. Occasional gains on the disposition of shares in a S.P.P.I.C.A.V. or S.I.I.C. are subject to French domestic withholding taxes if the nonresident investor has a shareholding of at least 10%. Additional social security charges and taxes may apply depending on the situation. For habitual gains, withholding tax is the corporate income tax. As a reminder, the corporate income tax rate will be gradually reduced from 33 1/3% to 25.0% by 2022.

Substantial Participation Clause for Individuals

The New D.T.T. provides that capital gains realized by an individual resident in one contracting state on the sale of shares of an entity that is a resident of the other contracting state are taxable in that other contracting state if he or she directly or indirectly holds, either alone or with related persons, at least 25% of the rights to the profits of such entity. This rule applies only if the individual was a resident of the other contracting state in which the entity is a resident of at any time during the five years preceding the disposition of the participation. Such a rule is not included in the Current D.T.T. and goes beyond the scope of the capital gains clause found in the O.E.C.D. Model.

In general and excluding gains derived from real estate interests and any French exit tax implications, the French withholding tax could be 12.8% for individuals in such situations.

TAXATION OF CAPITAL – ARTICLE 21 OF THE NEW D.T.T.

The New D.T.T. follows the O.E.C.D. Model in that capital owned by a resident of a contracting state and situated in the other contracting state is taxed in that other state. The Current D.T.T. also has a similar result.

This provision would allow France to subject Luxembourg residents to the new

French tax on real estate wealth known as the *impôt sur la fortune immobilière* ("I.F.I."). The aforementioned provision of the New D.T.T. seems to exclude indirect holdings through companies when not deemed constituting real estate under French law. However, further commentary is needed to confirm this position.

ELIMINATION OF TAXATION – ARTICLE 22 OF THE NEW D.T.T.

For French Tax Residents

The New D.T.T. employs a tax credit method, where the Current D.T.T. relied on the exemption with progression method with a few exemptions (*i.e.*, for partnership income, dividends, and interest). Consequently, the New D.T.T. provides that:

- Income or capital that is taxable in Luxembourg remains taxable in France, and double taxation is eliminated via a tax credit equal to the amount of tax paid in Luxembourg, but which cannot exceed the amount of French tax owed.
- Income or capital that is only taxable in Luxembourg remains taxable in France, and double taxation is eliminated via a tax credit equal to the amount of French tax owed. However, if the French tax resident is not effectively subject to tax in Luxembourg, he or she cannot be granted the benefit of the French tax credit.

For Luxembourg Tax Residents

Under the New D.T.T., Luxembourg keeps a general application of the exemption with progression method when the income or capital is taxable in France, provided the amount is neither tax exempt in France nor subject to withholding tax under the treaty.

For dividends, royalties, and income from artistes and athletes, a tax credit is granted for the amount of French tax paid. This amount is limited to the Luxembourg tax owed. This is a change from the Current D.T.T., which does not tax French-source dividends if the Luxembourg company holds at least 25% of the share capital of a French company.

LIMITATION ON TREATY BENEFITS – ARTICLE 28 OF THE NEW D.T.T. AND PARAGRAPH 7 OF THE PROTOCOL

The New D.T.T. contains new limitation on benefits provisions in accordance with Article 7(1) of the M.L.I. Under the limitation, the benefits of the New D.T.T. will not be granted with respect to an item of income or capital if it is reasonable to conclude, considering all relevant facts and circumstances, that obtaining the benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in the creation of that benefit. This limitation stands unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the New D.T.T.

In addition, Paragraph 7 of the Protocol provides that the following French tax code (Code générale des impôts or "CGI") provisions will not be barred by the provisions of the New D.T.T.: (i) Article 115 quinquies (Branch Tax), (ii) Article 123 *bis* (Individual Tax Residents With Holdings in Certain Offshore Investments), (iii) Article 155 A (Remunerations Paid Abroad), (iv) Article 209 B (C.F.C. Rules), (v) Article 212 (Intragroup Interest Deduction Rules), (vi) Article 238 A (Limitations on Deductions for Payments Made to Low Tax Jurisdictions), (vii) Article 238-0 A (Noncooperative States or Territories).

ENTRY INTO FORCE – ARTICLE 30 OF THE NEW D.T.T.

The New D.T.T. will enter into force once both countries complete the ratification process and notify each other of its completion.

For France, the provisions of the New D.T.T. will apply as follows:

- For income taxes levied through withholding taxes, the provisions apply to taxable amounts after the calendar year in which the New D.T.T. enters into force.
- For income taxes not levied through withholding taxes, the provisions apply to all the income of a calendar year or fiscal year that start after the calendar year in which the New D.T.T. enters into force.
- For the other taxes, the provisions apply to taxable events that occur after the calendar year in which the New D.T.T. enters into force.

"Some provisions of the New D.T.T. could apply as early as January 1, 2019."

For Luxembourg, the provisions of the New D.T.T. apply as follows:

- For withholding taxes, the provisions apply to income attributed on or after the January 1 immediately following the calendar year in which the New D.T.T. enters into force.
- For the other taxes, the provisions apply to any tax due for an entire taxable year starting on or after the January 1 immediately following the calendar year in which the New D.T.T. enters into force.

Should the ratification process be completed in 2018, which is likely, some provisions of the New D.T.T. could apply as early as January 1, 2019.

CONCLUSION

Several issues exist for businesses and the financial services sector:

- The New D.T.T. provides no transitional relief allowing the business and financial sectors time to revise structures.
- The new dividend treatment of French real estate vehicles increases the tax cost of current real estate investment structures.

As a result, the Luxembourg financial services sector will need to act quickly to revise structures commonly used to invest in French real estate.

G.D.P.R. IS IMMINENT – IS YOUR U.S. BUSINESS PREPARED?

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Tags
Data Protection
E.U.

In Europe, an individual's right to the protection of his or her personal data is a fundamental right.[1] The E.U. General Data Protection Regulation ("G.D.P.R."), which takes effect on May 25, 2018, is aimed at protecting that right.[2]

The G.D.P.R. is notable because it applies to all companies processing personal data of persons residing in the European Economic Area ("E.E.A.") (comprising E.U. Member States as well as Iceland, Liechtenstein, and Norway) regardless of the company's location and irrespective of whether the company has a physical presence in these countries.[3]

Since the G.D.P.R. was promulgated in the form of a "Regulation," and not a "Directive," it automatically becomes law in each E.U. Member State, without the need to pass transposing domestic legislation.[4]

The G.D.P.R. replaces Directive 95/46/EC, a 1995 Directive that, until now, constituted the European framework for personal data protection. Directive 95/46/EC did so mainly by placing a compliance burden on "Controllers" of personal data (*i.e.*, legal persons requesting data processing services).[5]

Adding to the 1995 Directive, the G.D.P.R. also places a compliance burden on "Processors" (*i.e.*, legal persons providing services to the Controllers). Its purpose is to increase E.U. citizens' control over their own data by, *inter alia*, providing for more transparency, stronger data security, and protection requirements on Controllers and Processors. G.D.P.R. also implements a mechanism that can result in penalties equal to the greater of €20 million or 4% of annual worldwide turnover.[6]

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1. Article 8(1) of the Charter of Fundamental Rights of the European Union; Article 16(1) of the Treaty on the Functioning of the European Union.
2. Chapter 1, Article 1(2) of Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation).
3. Note that under Article 7(a) of the Main Part of the E.E.A. Agreement, all E.E.A. States are obliged to adopt the G.D.P.R. Hence, the G.D.P.R. also applies to E.F.T.A. Member States Iceland, Liechtenstein, and Norway. (While a member of the E.F.T.A., Switzerland did not join the E.E.A.)
4. This does, however, not apply to E.E.A. countries, where the procedure for incorporation into domestic law consists of five phases governed by Article 102 (1) to (6) of the E.E.A. Agreement in conjunction with Regulation (EC) No 2894/94 concerning arrangements for implementing the agreement in the E.E.A.
5. Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the procession of personal data and on the free movement of such data.
6. Article 83 of the G.D.P.R.; Clause 37 to the Preamble to the G.D.P.R.

During an address in New York on March 28, Mrs. Isabelle Falque-Pierrotin, president of the French Data Protection Authority (the *CNIL*), stated that the G.D.P.R. constitutes a "legal framework for trust." She explained that data protection is no longer only a legal issue. It has now also become an operational issue and must thus be viewed in an interdisciplinary way.

Translated into plain English, it means that a U.S. company like Tumblr, which is owned by Oath, a subsidiary of Verizon Communications, and targets E.U. customers, may be liable to a penalty of 4% of Verizon Communications' worldwide turnover (notably not its taxable income) for violating the G.D.P.R. This monetary penality is also accompanied by damage to the company's reputation. U.S.-owned apps that are available to E.U. customers are similarly caught by the G.D.P.R. On a smaller scale, any U.S. business with an email list that includes European customers is affected by the G.D.P.R. As a result, E.U. Member State regulators are afforded the power to prosecute a breach of the G.D.P.R. beyond the borders of the E.U.

In order to achieve clarity, the balance of this article is written in question and answer format, laying out the fundamentals of the G.D.P.R. and its impact on U.S. businesses.

RIGHTS PROTECTED BY THE G.D.P.R.

Q1: What rights are protected by the G.D.P.R.?

The Regulation protects individuals located in the E.U. ("Data Subjects") with regard to the protection of their personal data.[7] It provides rules for the processing and the free movement of personal data.

Under the G.D.P.R., processing of personal data must comply with all **six general data quality principles**. In particular, personal data must be

- processed fairly and lawfully;
- collected for specific, explicit, and legitimate purposes (and not processed in a manner incompatible with those purposes);
- adequate, relevant, and not excessive;
- accurate and, where necessary, up to date;
- kept in an identifiable form for no longer than necessary; and
- kept secure.[8]

Q2: What is personal data?

Personal data is any information relating to the identification of an individual. More precisely it is information relating to (i) identified individuals and (ii) identifiable individuals, where "identifiable" means that an individual can be directly or indirectly identified.[9] Relevant identifiers are an individual's name, identification number, loca-

[7] Article 1 of the G.D.P.R.

[8] Article 5(1) of the G.D.P.R.

[9] Article 4(1) of the G.D.P.R.

tion data, or online identifier. Also included are factors such as physical, physiological, genetic, mental, economic, cultural, or social identities of an individual.

Q3: What is the processing of personal data?

The processing of personal data means an operation or several operations on personal data.[10] It includes collecting, recording, organizing, structuring, storing, adaptating or altering, retrieving, consulting, using, disclosing by transmission, disseminating, otherwise making available, aligning or combining, restricting, erasing, or destroying. It is irrelevant whether such processing takes place by automated means or not. Accordingly, the G.D.P.R. applies to personal data irrespective of whether it is processed electronically or as part of a paper filing system.

Q4: Are there different types of personal data?

Yes. In addition to the general definition provided under Q3, certain more sensitive types of personal data are identified by the G.D.P.R.[11] Such sensitive data are subject to more stringent protection requirements. Among this sensitive data are

- racial or ethnic origin,
- political opinions,
- religious or philosophical beliefs,
- trade union memberships,
- genetic data,
- biometric data,
- data concerning health, or
- data concerning an individual's sex life or sexual orientation.

PERSONAL SCOPE OF THE G.D.P.R.

Q5: Who does the G.D.P.R. apply to?

The G.D.P.R. applies to certain Controllers and Processors.

Q6: What is a Controller?

A Controller is essentially the legal person that asks for the data collection. It is the legal person determining the purpose and the means of processing personal data.[12]

Q7: What is a Processor?

A Processor is the legal person who processes personal data on behalf of the Controller.[13]

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[10] Article 4(2) of the G.D.P.R.

[11] Article 9 of the G.D.P.R.

[12] Article 4(7) of the G.D.P.R.

[13] Article 4(8) of the G.D.P.R.

“Processors and Controllers not established in the E.U. must generally designate a representative in the E.U. in writing.”

Q8: What are examples of a Controller and a Processor?

The European Commission’s website provides the following example:

> A brewery has many employees. It signs a contract with a payroll company to pay the wages. The brewery tells the payroll company when the wages should be paid, when an employee leaves or has a pay rise, and provides all other details for the salary slip and payment. The payroll company provides the IT system and stores the employees’ data. The brewery is the data controller and the payroll company is the data processor.[14]

Further, the Article 29 Working Party provides the following examples:

> Example No. 2: Mail marketing
>
> Company ABC enters into contracts with different organisations to carry out its mail marketing campaigns and to run its payroll. It gives clear instructions (what marketing material to send out and to whom, and who to pay, what amounts, by what date etc). Even though the organisations have some discretion (including what software to use) their tasks are pretty clearly and tightly defined and though the mailing house may offer advice (*e.g.* advising against sending mailings in August) they are clearly bound to act as ABC instructs. Moreover, only one entity, the Company ABC, is entitled to use the data which are processed – all the other entities have to rely on the legal basis of Company ABC if their legal ability to process the data is questioned. In this case it is clear that the company ABC is the data controller and each of the separate organisations can be considered as a processor regarding the specific processing of data carried out on its behalf.
>
> Example No. 3: Company referred to as data processor but acting as controller
>
> Company MarketinZ provides services of promotional advertisement and direct marketing to various companies. Company GoodProductZ concludes a contract with MarketinZ, according to which the latter company provides commercial advertising for GoodProductZ customers and is referred to as data processor. However, MarketinZ decides to use GoodProducts customer database also for the purpose of promoting products of other customers. This decision to add an additional purpose to the one for which the personal data were transferred converts MarketinZ into a data controller for this processing operation.[15]

Q9: Are all Controllers and Processors subject to the G.D.P.R.?

No. The G.D.P.R. applies to Processors and Controllers that process data and that have an establishment in the E.U., regardless of whether their processing of

[14] European Commission, “What is a Data Controller or a Data Processor?”

[15] Opinion 1/2010 on the Concepts of “Controller” and “Processor” (WP 169).

personal data takes place in the E.U. or not.[16] The G.D.P.R. also applies to Processors and Controllers that are not established in the E.U. but that process personal data of individuals located in the E.U., when such processing is related to the following:

- Offering goods or services, free of charge or not, to individuals located in the E.U.
- Monitoring behavior of individuals located in the E.U., if such behavior takes place in the E.U.

Processors and Controllers not established in the E.U. must generally designate a representative in the E.U. in writing.[17] Further, Controllers can only use Processors that are in compliance with the G.D.P.R.[18]

PROTECTION MECHANISM

Q10: Under what circumstances can personal data be lawfully collected and processed under the G.D.P.R.?

Personal data can generally be collected when processing is necessary for one of five reasons:

- The performance of a **contract** to which the Data Subject is party or in order to take steps at the request of the Data Subject prior to entering into a contract
- Compliance with a **legal obligation** to which the Controller is subject
- Protection of **vital interests** of the Data Subject or of another natural person
- The performance of a **task** carried out in the **public interest** or in the exercise of official authority vested in the Controller
- The purposes of the **legitimate interests** pursued by the Controller or by a third party, except where such interests are overridden by the interests or fundamental rights and freedoms of the Data Subject that require protection of personal data, in particular where the Data Subject is a child

When none of these reasons exist, personal data can generally be collected only based on **consent**.[19] Note that consent can be withdrawn at any time.[20]

Q11: Do Data Subjects have any legal remedies under the G.D.P.R.?

Yes. Data Subjects whose personal data has been processed in violation of the G.D.P.R. can file a complaint with the appropriate Member State's authority in

[16] Article 3 of the G.D.P.R.

[17] Article 27(1) of the G.D.P.R.

[18] Article 28(1) of the G.D.P.R. For Processors that have less than 250 employees, certain record keeping requirements are waived (Article 30.5 of the G.D.P.R.).

[19] Article 6 of the G.D.P.R.

[20] Article 7(3) of the G.D.P.R.

charge of supervising the application of the G.D.P.R.[21] Further, Data Subjects can also bring legal action against Controllers or Processors that violate their rights under the G.D.P.R.[22]

Q12: Do Data Subjects have the right to have their personal data deleted?

Yes. Often referred to as "the right to be forgotten," Article 17(1) of the G.D.P.R. provides that a Data Subject has the right to obtain deletion of his or her personal data in one of the following circumstances:

- The personal data is no longer necessary in relation to the purposes for which it was collected or otherwise processed.
- The Data Subject withdraws consent on which the processing is based, and there is no other legal ground for the processing.
- The Data Subject objects to the processing on grounds relating to his or her particular situation pursuant to Article 21(1) of the G.D.P.R. and there are no overriding legitimate grounds for the processing, or the data subject objects to the processing of his or her personal data for direct marketing purposes, pursuant to Article 21(2) of the G.D.P.R.
- The personal data has been unlawfully processed.
- The personal data must be erased to comply with a legal obligation under E.U. or Member State law to which the Controller is subject.
- The personal data has been collected in relation to the offer of information society services directly to a child, as referred to in Article 8(1) of the G.D.P.R.

The data must be deleted "without undue delay." Currently, no definition of "undue delay" exists for this purpose. Further, the Controller must inform Processors within a "reasonable time" that the Data Subject has requested the erasure of his or her personal data. Again, no definition of "reasonable time" currently exists for this purpose.

Q13: Can the right to be forgotten be refused?

Yes. If processing of the personal data is necessary for one of the following reasons, the right to be forgotten does not apply:[23]

- Exercising the right to **freedom of expression and information**
- Compliance with a **legal obligation** that requires processing under E.U. or Member State law to which the Controller is subject or for the performance of a task carried out in the public interest or in the exercise of official authority vested in the Controller
- Certain reasons of **public interest** in the area of public health[24]

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[21] Article 77 of the G.D.P.R.

[22] Article 79 of the G.D.P.R.

[23] Article 17(3) of the G.D.P.R.

[24] See points (h) and (i) of Article 9(2) and Article 9(3).

- **Archiving purposes** in the public interest, for scientific or historical research purposes, or for statistical purposes[25] in so far as the right to be forgotten is likely to render impossible or seriously impair the achievement of the objectives of that processing

- The establishment, exercise, or defence of **legal claims**

TERRITORIAL SCOPE AND U.S. REACH OF THE G.D.P.R.

Q14: Can personal data be transferred to the U.S.?

As a general rule, personal data can only be transferred outside the E.U. if the Controller and Processor are otherwise in compliance with the G.D.P.R. and one of the following requirements is met:[26]

- The European Commission has decided that (i) the third country, (ii) a territory in such country, (iii) one or more specified sectors within such country, or (iv) the international organization to which the data is to be transferred, ensures an adequate level of protection.[27]

  Note that the U.S. has not been deemed as meeting an adequate level of protection.

- Data Subjects have enforceable rights and legal remedies, and the Controller or Processor provides appropriate safeguards.

  No specific authorization from a supervisory authority is required if one of the following safeguards exist:

  - A legally binding and enforceable instrument between public authorities or bodies
  - Binding corporate rules in accordance with Article 47
  - Standard data protection clauses adopted by the Commission in accordance with the examination procedure referred to in Article 93(2)
  - Standard data protection clauses adopted by a supervisory authority and approved by the Commission pursuant to the examination procedure referred to in Article 93(2)
  - An approved code of conduct pursuant to Article 40 together with binding and enforceable commitments of the Controller or Processor in the third country to apply the appropriate safeguards, including as regards Data Subjects' rights
  - An approved certification mechanism pursuant to Article 42 together with binding and enforceable commitments of the Controller or

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25 See Article 89(1) of the G.D.P.R.

26 Article 44 of the G.D.P.R.

27 Article 45 of the G.D.P.R.

Processor in the third country to apply the appropriate safeguards, including as regards Data Subjects' rights

Here, a specific authorisation from a supervisory authority is required:

- ○ Contractual clauses between the Controller or Processor and the Controller, Processor or the recipient of the personal data in the third country or international organization
- ○ Provisions to be inserted into administrative arrangements between public authorities or bodies that include enforceable and effective Data Subject rights

"U.S. companies with European operations or European customers should ensure adequate processes with respect to storage and processing of data under the G.D.P.R."

If any of the above requirements are met, the transfer of personal data to the U.S. is allowed. In addition to the G.D.P.R., U.S. companies can also transfer personal data to the U.S. under the new E.U.-U.S. Privacy Shield adopted in 2016, provided they are within its scope.

CONCLUSION

While the G.D.P.R. targets all entities collecting personal data from E.U. individuals, it has particular impact on all U.S. companies with an E.U. customer base, including tech companies. Given the significance of the penalties, compliance is essential and advisors in the cross-border field should familiarize themselves with G.D.P.R.

If actions have not already been taken, the immediate steps would be for affected U.S. companies to reach out to their existing E.U. customer base, take action to comply with the requirements of the G.D.P.R. in their communications, and request consent to the processing of their personal data by May 25, 2018. Moreover, internal processes for data security and protection should be implemented. Amongst others, these would comprise

- appointing a data protection steering committee;
- assigning a data protection officer, if required;
- performing data discovery checks with respect to data storage (identifying what, where, and how data is stored);
- performing a risk and gap analysis; and
- obtaining a legal opinion on obligations to assess exposure under the G.D.P.R.

In any event, U.S. companies with European operations or European customers should ensure adequate processes with respect to storage and processing of data under the G.D.P.R. With the May 25, 2018 deadline approaching, immediate attention to this matter is of the essence.

CODE §962 ELECTION OFFERS BENEFITS UNDER U.S. TAX REFORM

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Tags
C.F.C.
Code §962
G.I.L.T.I.
T.C.J.A.
Transition Tax

AN INTRODUCTION TO CODE §962

Under Code §962, an individual U.S. Shareholder may elect to be treated as a domestic C-corporation for the purpose of computing income tax on its share of Subpart F Income. This special election was enacted in 1962, and Treasury Regulations followed in 1965 and 1976. As a result of certain international provisions of the Tax Cuts and Jobs Act of 2017 ("T.C.J.A.") and the lowering of the corporate income tax rate to 21%, it has recently gained more attention. Specifically, the Code §962 election has garnered importance with respect to the transition tax under Code §965 and the new tax on global intangible low-taxed income ("G.I.L.T.I.") under Code §951A.

The controlled foreign corporation ("C.F.C.") rules impose an anti-deferral regime that requires a U.S. Shareholder to recognize certain income, known as Subpart F Income, in a current tax year. This income inclusion is applicable regardless of whether the C.F.C. made an actual distribution to the U.S. Shareholder during the tax year. Subpart F Income generally includes passive-type investment income. However, other types of income may also be caught. A U.S. Shareholder is a U.S. person who directly, indirectly, or constructively owns 10% or more of a foreign corporation's vote or, beginning January 1, 2018, value. A C.F.C. is a foreign corporation in which more than 50% of the vote or value is owned by one or more U.S. Shareholders.

Code §962 generally allows an individual U.S. Shareholder (including a trust or estate) to elect to be treated as a domestic C-corporation for the purpose of computing the individual's income tax on its share of Subpart F Income. As a result

- the amount will equal the tax imposed under Code §11 (relating to corporations), rather than under Code §1 (relating to individuals), and
- the individual may obtain an indirect foreign tax credit for the foreign taxes paid or accrued by the C.F.C. with respect to the Subpart F Income under Code §960.

The election is beneficial when an individual U.S. Shareholder's graduated income tax rate is higher than the corporate income tax rate. It also allows the taxpayer to obtain a deemed-paid deduction, which otherwise would not be available to an individual.

LOWER TRANSITION TAX RATE

In order to create a level playing field for all earnings accumulated abroad in C.F.C.'s and certain other non-U.S. corporations, the T.C.J.A. imposes a transition tax on post-1986 deferred earnings and profits.

Under Code §965, an individual or corporate U.S. Shareholder must include in taxable income its *pro rata* share of accumulated post-1986 deferred foreign earnings of a deferred foreign income corporation ("D.F.I.C.") (the "Code §965(a) inclusion"). This amount is included in a U.S. Shareholder's income as Subpart F Income. A D.F.I.C. is a C.F.C. or any foreign corporation with respect to which one or more domestic corporations is a U.S. Shareholder[1] with positive earnings and profit that have not been subject to U.S. tax. The calculation of the Code §965(a) inclusion relies upon to the greater of a D.F.I.C.'s post-1986 deferred foreign earnings as of November 2, 2017, or December 31, 2017. Taxpayers may use the earnings as of October 31, 2017, instead of November 2, 2017.

The Code §965(a) inclusion is eligible for a dividends received deduction under Code §965(c) (the "Code §965(c) deduction"). The calculation of the Code §965(c) deduction is based on the highest rate of tax applicable to corporations under Code §11 in the taxable year of the inclusion, even if the U.S. Shareholder is an individual. As a result of the Code §965(c) deduction, transition tax on the Code §965(a) inclusion generally applies at two rates: (i) 15.5% for earnings treated as cash or cash equivalents ("cash position") and (ii) 8% for the balance of the earnings. However, because the calculation is based on the corporate rate, the Code §965(c) deduction would result in a higher tax rate for individuals in the highest tax bracket (for whom the current tax rate at 37%). To mitigate this result, the Code §962 election is expected to be made by many individuals.

"An individual U.S. Shareholder that makes an election under Code §962 is eligible for an indirect foreign tax credit . . . which will lower the overall effective tax rate."

It should be noted that the determination of the "cash position" is made based on the balance sheet by reference to cash measurement dates. For calendar year taxpayers, the cash position is the higher of (i) the amount on December 31, 2017, or (ii) the average on December 31, 2016, and December 31, 2015.

In recently issued guidance, the I.R.S. stated that an individual U.S. Shareholder, or an individual investor in a U.S. Shareholder that is a pass-thru entity, can make an election under Code §962 to be subject to the corporate tax rates for the year of the inclusion.[2] In that case, the Code §965(c) deduction will apply to the tax imposed under the corporate income tax rates, rather than the individual income tax rates. As a result, the transition tax rates of 15.5% on the cash position and 8% rate in all other cases will apply.

In the case of a U.S. Shareholder that is a pass-thru entity, the I.R.S. guidance clarifies that the Code §965(a) inclusion and the Code §965(c) deduction are determined at the level of the entity, and the owners of the entity will be subject to tax on their allocable share of the inclusion regardless of whether they are U.S. Shareholders with respect to the foreign corporation. However, the guidance states that regulations will provide that a Code §962 election will be available for individual owners (including trusts and estates) with respect to their share of the income inclusion only if they themselves are U.S. Shareholders with respect to the foreign corporation – meaning only individuals who own directly or indirectly 10% or more of the vote or value in the foreign corporation may make a Code §962 election.

The I.R.S. guidance also provides that the Code §965(c) deduction allowed in determining the taxable income and the tax due as a result of the Code §962 election cannot be used to reduce the individual's tax under Code §1 (*i.e.*, the individual's other taxable income).

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1 Code §965(e)(1).

2 Notice 2018-26, §5.

Additionally, as with a corporate U.S. Shareholder, an individual U.S. Shareholder that makes an election under Code §962 is eligible for an indirect foreign tax credit attributable to foreign taxes paid or accrued on the C.F.C.'s Code §965(a) inclusion (although the credit is subject to a haircut),[3] which will lower the overall effective tax rate applicable for the Code §965(a) inclusion.

INDIRECT FOREIGN TAX CREDIT & DEDUCTION FOR G.I.L.T.I.

G.I.L.T.I. Basics

Very broadly stated, the G.I.L.T.I. provision under Code §951A effectively adds a new category of income that is subject to the Subpart F Income rules for which deferral will not be available. This provision applies to U.S. Shareholders of a C.F.C. and is intended to counter the incentive to shift profits, not otherwise included as Subpart F Income, outside the U.S. due to the newly implemented participation exemption system.[4]

The G.I.L.T.I. calculation starts with the C.F.C.'s gross income. The regime provides a "safe zone" based principally on a hypothetical yield generated by the C.F.C. on its adjusted basis in its tangible property (*i.e.*, plant, property, and equipment), determined on a pre-tax basis. Once the safe zone is computed, all items of the C.F.C.'s gross income that are (i) not otherwise taxed as income effectively connected with a U.S. trade or business or under Subpart F and (ii) not otherwise specifically excepted by Code §951A are considered to be attributable to G.I.L.T.I. As a result, and despite its name (global intangible low-taxed income), G.I.L.T.I. includes more than the C.F.C.'s earnings from intangible property.

When a U.S. Shareholder is a corporation, several rules apply. First, a deemed-paid foreign tax credit is allowed under Code §960 for foreign income taxes allocable to G.I.L.T.I. at the level of the C.F.C. Second, the portion of G.I.L.T.I. subject to Subpart F treatment (the "G.I.L.T.I. inclusion") includes a "gross-up" under Code §78 for the foreign income taxes claimed as a credit. Third, the corporate U.S. Shareholder is entitled to a 50% deduction (reduced to 37.5% in tax years beginning in 2026) on its G.I.L.T.I. inclusion under Code §250 (the "Code §250 deduction"), which results in an effective tax rate of 10.5% up to, and including, tax year 2025.

The deemed-paid foreign tax credit applicable to G.I.L.T.I. is subject to limitations generally not found in the U.S. foreign tax credit rules. For these purposes, G.I.L.T.I. is in a separate credit limitation basket, and excess credit is not allowed to be carried forward or carried back. Under the provision, a corporate U.S. Shareholder is permitted a credit of up to 80% of its *pro rata* share of the income taxes paid or accrued on the C.F.C.'s G.I.L.T.I.

The Effects of the Code §962 Election on G.I.L.T.I.

An individual U.S. Shareholder may make a Code §962 election with respect to a G.I.L.T.I. inclusion. The election will permit the individual U.S. Shareholder to be

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3 Code §965(g).

4 Under the T.C.J.A., Code §245A provides a corporate U.S. Shareholder with a 100% deduction for the foreign-source portion of dividends received from a specified 10%-owned foreign corporation.

taxed on the G.I.L.T.I. inclusion at the 21% corporate income tax rate. This may be a considerable benefit for the individual U.S. Shareholder, since the current highest individual income tax rate is 37% and individuals generally are subject to net investment income tax at a rate of 3.8% but corporations are not.[5] Further, if such an election is made, the individual U.S. Shareholder will be permitted to claim a deemed-paid foreign tax credit with respect to foreign taxes paid or accrued by the C.F.C. on earnings attributable to the G.I.L.T.I. inclusion.

"When a U.S. Shareholder receives an actual distribution from a C.F.C. that is or was subject to tax as Subpart F Income, the distribution is treated as P.T.I. and is not taxed again."

While the application is not free from doubt, it is sensible that an individual U.S. Shareholder who makes a Code §962 election would be allowed to take the Code §250 deduction on its G.I.L.T.I. inclusion. Uncertainity around the Code §250 deduction stems from regulations promulgated under Code §962, which provide that in computing the tax due as a result of a Code §962 election no deductions of a U.S. Shareholder will be allowed.[6]

In recent I.R.S. guidance on Code §965, the I.R.S. stated that it intends to issue regulations clarifying that the Code §965(c) deduction applicable to domestic corporations will apply to an individual making a Code §962 election. The I.R.S. states that these anticipated regulations will not apply to other deductions and that the above mentioned limitation under Code §962 will continue to apply. As a result, practitioners remain divided on the availability of the Code §250 deduction to individuals making the election. Some argue that this regulatory limitation seems to refer to deductions otherwise available to the U.S. Shareholder and not to deductions available to the hypothetical domestic corporation, which are geared at getting to an applicable corporate tax rate. Others argue that the guidance specifically applies to the Code §965(c) deduction and hints that it will not be available for other deductions, including corporate deductions. The industry eagerly awaits further I.R.S. guidance on the application of these principles to the G.I.L.T.I. regime.

EFFECT OF CODE §962 ON ACTUAL DISTRIBUTIONS

Generally, under the C.F.C. rules, earnings attributable to amounts included in the gross income of a U.S. Shareholder are not included in gross income again when actually distributed. The amount already taxed is referred to as "previously taxed income" ("P.T.I.").[7] This provision ensures that the same earnings attributable to Subpart F Income are not subject to double taxation at the time of an actual distribution. Thus, when a U.S. Shareholder receives an actual distribution from a C.F.C. that is or was subject to tax as Subpart F Income, the distribution is treated as P.T.I. and is not taxed again.

When an individual U.S. Shareholder makes a Code §962 election with respect to a C.F.C., an actual distribution to the U.S. Shareholder in a subsequent year is treated as a distribution from the C.F.C. to the individual U.S. Shareholder. The hypothetical dividend will be reduced by the tax paid on the G.I.L.T.I. inclusion by the hypothetical U.S. corporation. As result, the G.I.L.T.I. inclusion is subject to tax (i) at the level of the hypothetical U.S. corporation and then again (i) in the hands of the individual U.S. Shareholder when actually distributed (minus the tax already paid by the hypothetical U.S. corporation). Thus, the Code §962 election may result in additional tax.

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5 Code §1411.

6 Treas. Reg. 1.962-1(b)(1)(i).

7 Code §959.

The following examples illustrate how the Code §962 election affects an actual disitribution of earnings attributable to a G.I.L.T.I. inclusion. For simplification purposes, during the tax year of the actual distribution, the C.F.C. has no current year G.I.L.T.I. inclusion, and the only other earnings it has are G.I.L.T.I. from the prior taxable year.

The regulations under Code §962 provide ordering rules for cases in which the C.F.C. has income not subject to the election (but possibly subject to the P.T.I. rules) and income from the current and prior taxable years.[8]

Example 1

In tax year 1, the taxpayer ("T"), a U.S. citizen, owns 100% of C.F.C. X, which has no income other than $100 of G.I.L.T.I. T makes a Code §962 election for tax year 1. As a result of the election, the effective tax rate on T's G.I.L.T.I. inclusion is 5%, resulting from the deemed-paid foreign tax credit and the 50% Code §250 deduction. Therefore, T pays $5 of tax on the $100 G.I.L.T.I. inclusion for tax year 1.

In tax year 2, when C.F.C. X has no current year G.I.L.T.I. and no other income, it makes an actual distribution of $100 to T attributable to its tax year 1 earnings. T makes a Code §962 election for tax year 2. T will be subject to tax on $95 (i.e., the $100 actual distribution minus the $5 of income tax paid on the amount subject to the election). If the dividend from the C.F.C. is a qualified dividend, T's tax rate on the actual distribution is 23.8% (income tax of 20% and an additional 3.8% net investment income tax, or N.I.I.T.). T's tax on the $95 is $23 (rounded up). T's total tax on the $100 of tax year 1 G.I.L.T.I. inclusion is $28 ($5 + $23). If the dividend is not a qualified dividend, it is taxed at the rates for ordinary income, plus the N.I.I.T.

Example 2

Assume the same facts as before, except that T did not make a Code §962 election for any tax year. In tax year 1, T must pay tax on its G.I.L.T.I. inclusion at the ordinary individual tax rate. Assume T's ordinary tax rate is 37%. In addition, T is subject to the 3.8% tax on net investment income. As a result, T's total tax on the G.I.L.T.I. inclusion will be $41 (rounded up). In tax year 2, the actual disitribution will be P.T.I. and thus not subject to further taxation.

In the examples, the taxpayer pays less overall tax under the Code §962 election and can control the timing of the taxation by delaying an actual distribution. However, such a result may not occur under other circumstances, such as where the hypothetical corporation's tax rate on the G.I.L.T.I. inclusion is higher and the taxpayer's individual tax rate on ordinary income is lower.

IN SUMMARY

The T.C.J.A. made Code §962 more significant, particularly with respect to the transition tax and G.I.L.T.I. Depending on the facts, an individual U.S. Shareholder may achieve substantial tax savings by accessing corporate tax treatment under Code §962. The application of the election raises certain questions that call for I.R.S. guidance. The guidance will ultimately confirm the extent to which tax savings avail-able to an individual U.S. Shareholder using the Code §962 election.

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8 See, Treas. Reg. §1.962-3.

A COMPARATIVE VIEW OF THE PRINCIPAL PURPOSE TEST – U.S. TAX COURT V. B.E.P.S.

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Tags
Culbertson Test
Peking Investment Fund LLC
Principal Purpose Test

INTRODUCTION

In the procedural maze that leads to a trial in the U.S. Tax Court, motion practice is an important part of tailoring issues presented to the court. In particular, motions to grant summary judgment are often filed by the I.R.S. to preclude a full trial. According to Rule 121(a) of the U.S. Tax Court Rules of Practice and Procedure, either the taxpayer or the I.R.S. may submit a motion for summary judgment in its favor regarding all or any part of the legal issues in controversy. The motion is granted and an order is issued if the party requesting summary judgment shows that no genuine dispute exists as to any material fact and the moving party is entitled to a favorable decision based solely on the law and the undisputed facts. While the reasoning of the court in granting the motion is not binding, it is informative of the state of the law.

In *Peking Investment Fund et al v. Commr.*, the I.R.S. submitted a motion for summary judgment in a case involving losses claimed in a distressed asset fund. The court denied the motion in an order dated February 12, 2018.[1] The court determined that material facts were in dispute – the I.R.S. failed to demonstrate that the partnership was a sham or that the principal purpose was to generate a loss. The taxpayer was entitled to its day in court.

The I.R.S. argument in support of its motion was similar to the principal purpose test ("P.P.T.") under the B.E.P.S. initiative and the P.P.T. described in the Anti-Tax Avoidance Directive ("A.T.A.D.").[2] To that extent, the court's ruling may be of interest to European and Canadian tax advisers who face application of a P.P.T. standard under domestic law or a tax treaty.

P.P.T. IN PRACTICE IN THE U.S. TAX COURT

Facts

China Cinda Asset Management Corporation ("Cinda") held a portfolio of nonperforming loans originated by China Construction Bank (the "C.C.B. N.P.L. Portfolio"). From the development of the case and the deduction ultimately claimed by the taxpayer, the aggregated face amount of the loans in the portfolio appears to have been $245.45 million.

During late 2001, Chenery Associates Incorporated ("Chenery") promoted an investment program to invest in the Asian distressed security market, which is similar

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[1] Peking Investment Fund L.L.C., Peking Investment Holdings L.L.C., Tax Matters Partner v. Commr., (Docket No. 12772-09).

[2] Council Directive (EU) 2016/1164 of 12 July 2016.

to “Distressed Asset/Debt” or “D.A.D.” transactions. These were transactions in assets with low value and high basis that were transferred to a U.S. partnership by a tax-indifferent party, typically an entity formed outside the U.S. Other partners were U.S. taxpayers. Ultimately, the partnership recognized huge losses when the high basis assets were sold or otherwise disposed of in a transaction that was recognized for U.S. tax purposes. Those losses were allocated to U.S. partners.[3]

On December 10, 2001, Cinda contributed to Peking Investment Fund LLC (“P.I.F.”) an 11.06836% interest in the CCB NPL portfolio in exchange for a 99% interest in P.I.F. As a result of its contribution, Cinda received a capital account credit of $774,999. Under U.S. partnership rules, the capital account credit reflected fair market value at the time of contribution.[4] At that time, Chenery Management Incorporated (“C.M.I.”) owned the remaining 1% interest in P.I.F.

On December 24, 2001, Cinda contributed to Peking Investment Holdings LLC (“P.I.H.”), another Delaware L.L.C., a 98% interest in P.I.F. in exchange for a 99% interest in P.I.H. On that same date, Cinda sold its entire interest in P.I.H. to four individuals (collectively referred to as “the U.S. investors”), who paid Cinda an aggregate purchase price of $767,170 ($774,999 × 98 ÷ 99).

P.I.F. filed Form 1065, *U.S. Return of Partnership Income*, for the taxable year beginning on December 25, 2001, and ending on December 31, 2001. The partnership reported a loss of $26,903,619. The claimed loss represented the excess of a claimed basis of $27,678,617 in P.I.F.’s interest in the CCB NPL portfolio over an amount realized of $774,998.[5] These losses were allocated to the U.S. individuals.

As the loss was recognized at the partnership level, the I.R.S. examination focused on the partnership tax return. The I.R.S. disallowed the losses, and the partnership filed a petition for redetermination in the U.S. Tax Court disputing the disallowance of the deduction by the I.R.S.

Pre-Trial Motions

The case has not yet been tried. However, in pre-trial motions, the I.R.S. requested summary judgment. As mentioned above, for the motion to be granted, the I.R.S. must show that there is no genuine dispute as to any material fact and that a decision may be rendered as a matter of law.

In support of its position that no material question of fact existed in the case, the I.R.S. argued that the partnership was a “sham partnership.” According to a Supreme Court case that addressed whether a partnership should be recognized for

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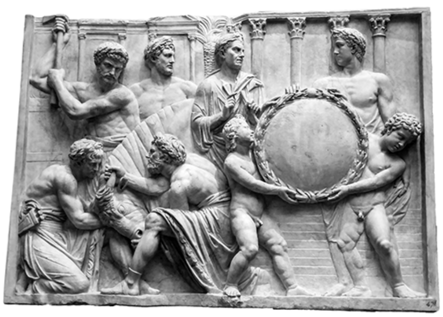
3 Similar D.A.D. transactions were addressed in *Superior Trading, LLC v. Commr.,* 137 T.C. 70, 71 (2011), affd, 728 F.3d 676 (7th Cir. 2013), and *Russian Recovery Fund Ltd. v. U.S.*, 122 Fed. Cl. 600, 601 (2015), affd, 851 F.3d 1253 (Fed. Cir. 2017).

4 Code §704(c); Treas. Regs. § 1.704-3(a).

5 The American Jobs Creation Act of 2004 (“AJCA”), Pub. L. 108-357, sec. 833, 118 Stat. 1589, amended Code §§ 704, 734, and 743 effective for transactions entered into after October 22, 2004. The statutory changes were intended to prevent shifting a built-in loss from a tax indifferent foreign entity to a U.S. taxpayer through the use of a partnership.

U.S. income tax purposes, *Commissioner v. Culbertson*,[6] the purported partners must act in good faith and, with a business purpose, intend to join together in the present conduct of the enterprise. The I.R.S. argued that no good faith intent to carry on a partnership existed under facts asserted in the pleadings and not disputed. In support of its position that P.I.F. and P.I.H. were sham partnerships, the I.R.S. submitted the following three legal arguments:



- **The Generation of Losses to Reduce Tax Without Risk Was the Principal Purpose of Forming the Partnership.** P.I.F. and P.I.H. were formed to implement a "tax scheme" intended to allow the U.S. investors to claim tax losses without being exposed to an economic risk of loss. Correspondence from Chenery's managing director to prospective investors highlighted the fact that Chenery would allow fund members the opportunity to request the sale of specific investments through December 31, 2001.

- **Cinda Had No Intent to Be a Partner.** Cinda did not intend to become a partner in P.I.F. or P.I.H. or to conduct the business of collecting non-performing loans for P.I.F. and had only a nominal interest in P.I.F., with no real participation in the profits or activities of P.I.F. In support of that claim, the I.R.S. pointed to Cinda's contribution of a 98% interest in P.I.F. to P.I.H. and its prompt sale of P.I.H. to the U.S. investors. Cinda took no action to collect on the non-performing loans and had only a fleeting, nominal interest in P.I.F.

- **The Intent of the Partners Was Limited to the Enhancement of Outside Basis.** Neither P.I.F. nor the P.I.H. partners intended to conduct the business of collecting non-performing loans. The partnerships were formed for the purpose of allowing the P.I.H. investors to increase their outside bases in P.I.H. solely to claim the benefit of tax losses.

Alternatively, the I.R.S. claimed that Code §482 provided the authority to reduce Cinda's basis in the CCB portfolio of non-performing loans, so that P.I.F. acquired its interest in the portfolio with a basis of $774,999. According to the I.R.S., both entities were government-owned in China and for that reason were under common control.

In response, P.I.F. argued that *Culbertson* was applied incorrectly because the U.S. investors' interest in tax losses does not rebut P.I.F.'s over-arching profit-making business purpose. It also contended that Cinda retained an ongoing 1% interest in P.I.F. Finally, P.I.F. argued that, notwithstanding one report submitted by the I.R.S. that no steps were ever taken to collect outstanding claims, other reports show that loan proceeds were collected.

Denial of Motion for Summary Judgment

The court denied the motion for summary judgment. The burden of proof to demonstrate that no dispute exists as to material facts was on the I.R.S., as it proffered the motion. The I.R.S. failed to meet its burden.

- **Generation of Losses.** The court applied the reasoning of *Culberson* in determining whether P.I.F. could be viewed as a partnership for U.S. income tax purposes. According to the court, even if the main purpose of forming P.I.F. was to generate a tax loss, the partnership may have had a secondary

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[6] *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949).

purpose to conduct business. To prevail under the *Culbertson* test, the factual record must establish that the partners had no real interest in collecting non-performing loans. If the facts show an objective of profiting from collection, even though that objective may be outweighed by the investors' objective of realizing the benefit of substantial tax losses, the partnership should not be disregarded as a sham under *Culbertson* as a matter of law.

Carrying on a business necessarily involves economic risk. The I.R.S. failed to demonstrate that the U.S. investors intended to be protected against the risk of all loss in carrying on the business. Whatever documentation showed that the investors could minimize the risk of loss did not mean that all risk was eliminated.

- **Intent of Cinda to Be a Partner.** If Cinda is disregarded as a partner of P.I.F., it would have no partnership interest to transfer to P.I.H., causing P.I.F. to be disregarded altogether. A partnership must have more than one partner in order to exist. However, the record contained no evidence to support the I.R.S.'s claim that Cinda's partnership interest should be disregarded. Cinda retained a 1% interest in P.I.F. after it contributed most of its P.I.F. interest to P.I.H. and then sold its interest in P.I.H. to the U.S. investors. Cinda's prompt disposition of most of its interest in P.I.F. may have affected how much of Cinda's interest in P.I.F. should be recognized for tax purposes, but it does not support disregarding Cinda as a partner in P.I.F. altogether.

- **Enhancement of Basis.** Accepting that the U.S. investors were interested in tax losses does not establish that they had no other intent in joining P.I.H. If P.I.F. and P.I.H.'s partners were also motivated to an appreciable extent by the prospect of benefitting from the collection of the assets in P.I.F.'s portfolio of non-performing loans, *Culbertson* would not require disregarding P.I.F. as a sham. To the extent that the formal appraisal of the portfolio at the request of Chenery took into account concerns regarding enforceability, those concerns cannot be viewed as evidence that P.I.F., P.I.H., and their partners were indifferent to the prospects of collection on those loans.

- **Code §482 Issues.** The alternative I.R.S. argument is based on the arm's length transfer pricing rules of Code §482. The court determined that common ownership of both parties by the Chinese government was amorphous, at best, and did not meet the Code §482 standard. The "'bright line' between state ownership and enterprise management" allowed each entity to treat its property and assets as its own, and for that reason, it could not be assumed that a sufficient degree of direct or indirect ownership or control existed to justify application of Code §482.[7]

Path Forward

The denial of the motion for summary judgment does not mean that the deduction claimed for losses in the non-performing loan portfolio will be allowed. Indeed, quite the opposite. Case law cited above and in notes 3 and 7 suggest that the partners of P.I.F. face an enormous hurdle that must be overcome before the I.R.S. adjustment will be reversed by the U.S. Tax Court. However, P.I.F. will be entitled to its

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[7] *Southgate Master Fund v. U.S.,* 651 F. Supp.2d at 596, 647 (N.D. Tex. 2009), affd. on other issues, 659 F.3d 466 (5th Cir. 2011).

day in court and has a reasonable chance of success to settle or win on penalties that have been asserted by the I.R.S.

P.P.T. IN THE FRAMEWORK OF THE A.T.A.D. AND B.E.P.S.

The A.T.A.D. contains five legally-binding anti-abuse measures that identify common forms of aggressive tax planning. All E.U. Member States must transpose the directive into domestic law. Member States are required to apply these measures beginning on January 1, 2019. The A.T.A.D. is intended to create a minimum level of protection against corporate tax avoidance throughout the E.U., while ensuring a fairer and more stable environment for businesses.

"Tax avoidance is in the mind of the administrators."

One of the measures is the general anti-abuse rules ("G.A.A.R."), which contain a P.P.T. G.A.A.R. is designed to counteract aggressive tax planning when other rules don't apply, thereby preventing companies from utilizing loopholes to bypass the tax laws.

G.A.A.R. is contained in Article 6 of A.T.A.D. and reads as follows:

1. For the purposes of calculating the corporate tax liability, a Member State shall ignore an arrangement or a series of arrangements which, having been put into place for *the main purpose* or *one of the main purposes of obtaining a tax advantage* that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part.

2. For the purposes of paragraph 1, an arrangement or a series thereof shall be regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.

3. Where arrangements or a series thereof are ignored in accordance with paragraph 1, the tax liability shall be calculated in accordance with national law.[8]

As is readily apparent, G.A.A.R. is a one-way street in favor of authorities, as no standard is provided by which a genuine arrangement is distinguished from a non-genuine arrangement nor a valid commercial reason reflecting economic reality is distinguished from an invalid commercial reason. Taxpayers are cautioned that economic substance in a U.S. tax context may bear little resemblance to a valid commercial reason and economic reality. U.S. law allows for new and innovative commercial transactions that may take into account tax reasons and business reasons. The E.U. approach seems to be one that looks back to the time of a business that operates in a single location with no affiliates elsewhere. Any deviation is likely to be viewed as devoid of both valid commercial reasons and economic reality.

The A.T.A.D. language used for G.A.A.R. is similar to the language used by the O.E.C.D. in B.E.P.S. Action 6, except that G.A.A.R. under A.T.A.D. has a much broader scope than G.A.A.R. under B.E.P.S. In B.E.P.S. Action 6, G.A.A.R. is applied to treaty abuse, and in particular treaty shopping. A treaty benefit should not be granted, if one of the principal purposes of the transaction or arrangement is to obtain treaty benefits (a subjective test), unless it is established that granting these

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[8] *Id.*

benefits would be in accordance with the object and purpose of the provisions of the treaty (an objective test).[9] In this manner, Action 6 provides a two-step analysis for the application of G.A.A.R. in connection with a treaty. First, the principal purpose of the transaction must be to obtain a treaty benefit under a subjective test. If that test is met, the taxpayer is allowed to demonstrate that allowing a treaty benefit is consistent with the purpose of the treaty provision in.

CONCLUSION

Under the *Culbertson* test, a transaction can be respected even if it is tax motivated as long as economic substance is present – meaning a taxpayer can enter a transaction that provides tax benefits but also is a real transaction. In the E.U., the language is so broad as to be meaningless. Tax avoidance is in the mind of the administrators, who likely never ran an operating business. Under Action 6, the tax benefit is at risk if only one of the main purposes is to obtain a tax advantage.

9 O.E.C.D./G-20 B.E.P.S. Project, 2015.

I.R.S. NOTICE 2018-28 ANNOUNCES CODE §163(J) REGULATIONS ON INTEREST PAYMENT DEDUCTIONS

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REVISIONS TO CODE §163(J)

The I.R.S. recently issued Notice 2018-28, announcing that it intends to release regulations on various issues pertaining to the limitation on the deductibility of certain interest payments under Code §163(j), also referred to as the anti-earnings stripping rule. This rule attempts to prevent base erosion by limiting excess interest deductions.

Under the Tax Cuts and Jobs Act of 2017 ("T.C.J.A."), Code §163(j) was amended to provide that a taxpayer's annual business interest expense is limited to

- business interest income,
- 30% of adjustable taxable income ("A.T.I.") (roughly equivalent to earnings before interest, taxes, depreciation, and amortization ("E.B.I.T.D.A.")), and
- floor plan financing interest (relating to certain car dealers) for the tax year.

From 2022 onwards, depreciation and amortization will not be taken into account. Thus, a taxpayer's annual business interest expense will be based on 30% of earnings before interest and taxes ("E.B.I.T."). An exception applies to certain regulated public utilities and small businesses.[1]

Unlike the predecessor rule, the amended Code §163(j)

- is not limited to corporate interest paid to or guaranteed by a related party that is tax exempt, as under U.S. domestic law or an applicable income tax treaty,[2] and
- does not include a safe harbor rule (debt-equity ratio of 1.5:1).

FORTHCOMING REGULATIONS

Notice 2018-28 states certain issues will be addressed in forthcoming regulations:

1. **Clarification that Disqualified Interest Disallowed Under Pre-T.C.J.A. Code §163(j) May Be Carried Forward to the First Tax Year Under Amended Code §163(j)**

A taxpayer with disqualified interest disallowed under the pre-T.C.J.A. Code §162(j)

1 To qualify for the exemption, average gross receipts may not exceed $25 million (adjusted for inflation from 2018 onwards) for the prior three years.

2 In the case of a reduced withholding tax rate on interest payments, the limitation is applied on a *pro rata* basis.

rules for the last tax year beginning before January 1, 2018, ("pre-T.C.J.A. disqualified interest") may carry forward such interest as business interest to the taxpayer's first tax year beginning after December 31, 2017. The pre-T.C.J.A. disqualified interest will be subject to the rules of amended Code §163(j). Furthermore, the new Base Erosion and Anti-Abuse Tax ("B.E.A.T."), which is primarily applicable to large corporations, will apply to the pre-T.C.J.A. disqualified interest.

2. Clarification of the Application of Affiliation and Super-Affiliation Rules Under Amended Code §163(j)

Under the pre-T.C.J.A. Code §163(j), all members of the same affiliated group, within the meaning of Code §1504(a), were treated as one taxpayer for the purpose of applying the limitation. Under the "Super-Affiliation Rules" issued under proposed regulations of pre-T.C.J.A. Code §163(j), this treatment applied without regard to whether the affiliated group filed a consolidated return. The legislative history called on the I.R.S. to issue regulations for groups of commonly controlled U.S. corporations that would constitute an affiliated group but for the inclusion of one or more entities other than includible corporations.

Notice 2018-28 states that the forthcoming regulations will include rules for allocating business interest from a group treated as affiliated under the Super-Affiliation Rules of the pre-T.C.J.A. Code §163(j) regulations. As discussed in 5 below, the regulations likely will not include a general rule that treats an affiliated group that does not file a consolidated return as a single taxpayer for purposes of the amended Code §163(j).

3. Clarification that No Amount Previously Treated as an "Excess Limitation Carryforward" Under Pre-T.C.J.A. Code §163(j) May Be Carried to a Tax Year Beginning After December 31, 2017

Unlike pre-T.C.J.A. Code §163(j), amended Code §163(j) does not permit a taxpayer to add to its annual limitation any excess limitation carryforward from the prior tax year. The forthcoming regulations will affirmatively state that amended Code §163(j) does not include the excess limitation carryforward.

4. A C-Corporation's Business Interest Income Includes Investment Income and Its Business Interest Expense Includes Investment Interest Expense

The regulations will clarify that, solely for the purpose of Code §163(j), all interest paid or accrued by a C-corporation on its debt will be treated as business interest, and all interest on debt held by a C-corporation that is includible in gross income of the C-corporation will be business interest income. These provisions do not apply to S-corporations.

The regulations will address whether and to what extent the interest paid, accrued, or includible in gross income by a non-corporate entity (such as a partnership) in which a C-corporation holds an interest is properly characterized as business interest or business interest income.

5. Rules for Applying Amended Code §163(j) to Consolidated Groups at the Group Level

The regulations will address issues such as the following:

- The computation of A.T.I. as consolidated taxable income and disregard of intercompany obligations
- The allocation of the Code §163(j) limitation among group members
- The treatment of disallowed interest deduction carryforwards if a member is to leave or join a group, and whether carryforwards would be subject to a separate return limitation year (“S.R.L.Y.”) limitation
- The application of Treasury Regulation §1.1502-32 (providing rules for adjusting the basis of the stock of a subsidiary owned by another member) to disallowed interest deductions
- The application of Code §163(j) to a consolidated group with one or more members who conduct a trade or business excepted from the Code §163(j) limitation or whose members hold an interest in a non-corporate entity that conducts such a trade or business

Unlike pre-T.C.J.A. Code §163(j), the I.R.S. anticipates that the new regulations will not include a general rule to treat an affiliated group that does not file a consolidated return as a single taxpayer for purposes of amended Code §163(j).

6. A C-corporation’s Earnings and Profits (“E & P”) Are Not Impacted by the Disallowance and Carryforward of a Business Interest Expense Deduction

The regulations will clarify that the disallowance and carryforward of a deduction for a C-corporation’s business interest expense under amended Code §163(j) will not affect whether the business interest expense reduces the E&P of the payor C-corporation.

7. Rules for Partnerships and Partners and for S-corporations and Shareholders

Under amended Code §163(j), the annual limitation on the deduction for business interest expense must be applied at the partnership level. Any deduction for business interest must be taken into account in determining the non-separately stated taxable income or loss of the partnership. Although applied at the partnership level with respect to the partnership’s indebtedness, Code §163(j) may also be applied at the partner level in certain circumstances, such as for the purpose of calculating the partner’s carryforward.

The regulations will provide that, for purposes of calculating a partner’s annual deduction for business interest under amended Code §163(j), a partner cannot include the partner’s share of the partnership’s business interest income for the tax year. An exception to this rule applies to the extent of the partner’s share of the excess of (i) the partnership’s business interest income over (ii) the partnership’s business interest expense (not including floor plan financing).

Similar rules will be set forth for an S-corporation and its shareholders.

UPDATES AND OTHER TIDBITS

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Accounting
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Taxable Presence
T.C.J.A.
Wayfair

F.A.S.B. TO MONITOR QUARTERLY AND ANNUAL REPORTING TO REFLECT T.C.J.A. CHANGES

The Financial Accounting Standards Board ("F.A.S.B.") has yet to release proposed guidance on how the recent Tax Cuts and Jobs Act ("T.C.J.A.") reform should be reflected on companies' financial reports. However, the F.A.S.B. has decided to monitor quarterly and annual corporate filings to observe how companies are reporting in light of the amendments.

Notable changes to the tax law include the reduction of the corporate tax rate from 35% to 21% and the introduction of the Global Intangible Low Tax Income ("G.I.L.T.I.") regime and the Base Erosion Anti-Abuse Tax ("B.E.A.T.") as it relates to deferred taxes.

The F.A.S.B. has issued an accounting standard update that allows a reclassification from accumulated other comprehensive income to retained earnings for so-called stranded tax effects resulting from the T.C.J.A.[1] The stranded tax effects are eliminated and will improve the usefulness of information reported to financial statement users. The guidance, however, does not address the inclusion in income from continuing operations resulting from the change in the corporate tax law and rates. Also, certain transition disclosures about stranded tax effects must be made which include the nature and reason for the change in accounting principle, a description of the prior period's information that has been retroactively adjusted, and the effect of the change on affected financial statement line items.

The most widely used accounting methods under the G.I.L.T.I. and B.E.A.T. provisions will be identified. In the third quarter, the F.A.S.B. plans to release the results of its preliminary research.

T.C.J.A. EFFECTS: SOME WIN BIG, OTHERS LOSE

The T.C.J.A. has brought in profits for some businesses, while for others the reforms have increased expenses.

The big winners include FedEx and Couche-Tard. The new lower corporate tax rate has caused FedEx to raise its annual profit forecast for the second straight quarter. Couche-Tard declared a $196.3 million net benefit as a result of remeasuring its deferred income tax balance in accordance with the lower corporate tax income rate. The deduction allowable under the transition tax was a major contributor.[2]

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1 ASU 2018-02, *Reclassification of Certain Tax Effecrts from Accumulated Other Comprehensive Income (Topic 220)*.

2 Code §965.

In contrast, Jefferies, the global investment banking firm, reported a provisional T.C.J.A.-related charge of $164 million – $108 million of which was non-cash – and a net loss of $61 million after the provisional tax charge. Children's Place Inc., also falls into the losing caregory. It declared a $51.8 million tax expense for its fourth quarter of 2017. The charge consisted of $37.6 million in repatriation tax, $8.5 million in foreign and state withholding taxes for undistributed foreign earnings, and a $5.7 million charge resulting from a remeasurement of the company's deferred tax balances.[3]

SOUTH DAKOTA SUES TO COLLECT TAXES FROM ONLINE RETAILERS

Under a decision of the U.S. Supreme Court, state authorities are prohibited from collecting sales tax on retail purchases made through the internet or other e-commerce routes if the seller has no physical presence in the state.[4] This ruling is based on the Commerce Clause of the U.S. Constitution.[5] State tax authorities have argued that the advent of digital transactions makes this clause obsolete. In *South Dakota v. Wayfair, Inc.*, which is pending before the Court, the state of South Dakota is seeking to have the Supreme Court uphold its law calling for the collection of sales tax on digital sales to South Dakota residents.

As one of seven states without an income tax, South Dakota is heavily dependent on its 4.5% sales tax. In March 2017, South Dakota enacted Senate Bill 106 calling for the collection of sales taxes by out-of-state vendors for purchases made by instate residents. The law applies to vendors who make sales of over $100,000 during the year or who had more than 200 different transactions during the year with residents in the state. South Dakota sent notices to defendants Wayfair, Overstock.com, and Newegg reminding them of the obligation to collect and pay over the sales tax. The companies refused to comply with Sout Dakota state law, contending there was insufficient presence under the standard established in *Quill Corp v. North Dakota*.

A lower court struck down the South Dakota law as it violated the standard in the *Quill* decision. The Supreme Court agreed to hear the case. Fifteen briefs were submitted in support of South Dakota, and twenty-three briefs were submitted in support of Wayfair. Oral arguments have been heard by the Supreme Court.

The stakes in the case are high. Today, consumers conduct nearly 10% of all shopping online, and states collect relatively litte tax revenue from these sales. Smaller online retailers may be unable to navigate the state tax systems. Moreover, it is not clear which side will win no matter what decision is reached. If South Dakota wins, retailers may push for a national sales tax that will be shared on an apportioned basis with the various sates. If Wayfair wins, states may double their efforts to have the Quill decision legislatively reversed. Whether that can occur other than through a national sales tax is an open question.

A ruling is expected by end of the Supreme Court's current term in June.

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3 Lydia O'Neal et al., "Daily Tax Report," *Bloomberg BNA*, March 21, 2018.

4 *Quill Corp v. North Dakota*, 504 U.S. 298 (1992).

5 U.S. Const. art. I, §8, cl. 3.

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We provide a wide range of tax planning and legal services for foreign companies operating in the U.S., foreign financial institutions operating in the U.S. through branches, and U.S. companies and financial institutions operating abroad. The core practice of the firm includes tax planning for cross-border transactions. This involves corporate tax advice under Subchapter C of the Internal Revenue Code, advice on transfer pricing matters, and representation before the I.R.S.

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