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Who’s Afraid of the Big Bad Wolf?

by Stuart Gibson

Depending on where you stand, public country-by-country (CbC) reporting is either the best part of BEPS, or the worst BEPS nightmare. For tax administrators and NGOs, this reporting tool can shed a bright light on how multinational enterprises structure their business operations to achieve maximum tax efficiencies, a euphemism for profit shifting. For large MNEs and their advisers, the reports are fraught with potential for misunderstanding by the public and abuse by organizations whose agenda may be antithetical to profit-driven enterprises, not to mention exploitation by competitors.

Australia and Europe have taken the lead in requiring companies to publish their CbC reports. Australia acted in response to published reports about how many of its largest corporations earn hundreds of millions, yet pay little or no income taxes. European governments, stung by public criticism over leaked rulings granting sweetheart tax deals to some MNEs, are now moving swiftly to require MNEs with annual revenue exceeding €750 million to publish their reports.

The United States seems to be struggling just to require MNEs to file reports in the first place, let alone make them public. While Treasury expects to publish final regulations before July 1, some observers expect a court challenge to its authority to require the reports. Many in Congress have also expressed concerns. The business community has talked openly about not only whether Treasury has the statutory authority to require CbC reporting, but also whether exchanging the reports with countries that publish CbC reports will violate tax confidentiality. This latter concern would appear to be a red herring, as both Europe and Australia require the corporations themselves to publish their CbC reports, avoiding any potential problems under section 6103.

If these MNEs resist public reporting, they will be perceived as having something to hide. What seems odd here is that the MNEs, many of which are publicly held, already report much of this information to shareholders, government securities regulators, and others. Instead of resisting the inevitable, MNEs would be well advised to get out in front of this wave of tax transparency, lest they be swamped by it. They could publish the CbC reports along with an explanatory narrative, glossary of terms, and set of FAQs. Public corporations do this already when they publish their glossy annual shareholder reports. Why not with CbC reports?

While the U.S. dithers, the rest of the world embraces CbC reporting. In January Mexico joined 30 other countries in signing the OECD’s multilateral competent authority agreement (MCAA), setting out the legal framework for automatic exchange of CbC reports. Santiago Chacón and Alejandro Gordillo Rousse provide a Mexican perspective on the MCAA and its implementation in that country (p. 67).

As countries work together to address global challenges, they are increasingly resorting to multilateral agreements, not just on taxation but also on trade. Mindy Herzfeld reviews the tax provisions of the Trans-Pacific Partnership and discusses some of the pitfalls they can pose for tax administrators (p. 7).

The world is well aware of Puerto Rico’s looming fiscal and debt crisis. In a rambling, 109-page decision, a federal court struck down the island’s AMT as unconstitutional (p. 56). But the news is not all bad for the territory. Denise Flores-Caldera discusses the success of two Puerto Rican tax incentives, one for companies that provide export services, and the other for foreign investors who relocate to Puerto Rico (p. 75).

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Stuart Gibson is editor of Tax Notes International.
NEWS ANALYSIS

Tax Implications of the Trans-Pacific Partnership

by Mindy Herzfeld

The tax community is learning about the potential for trade and other non-tax agreements to adversely affect tax policy and practice. The European Commission’s state aid cases provide one example of that risk. An important lesson to be learned from those cases is that trade agreements must be analyzed carefully to understand their potential effect on the ability of the trading partners to write and administer their own tax laws.

The Trans-Pacific Partnership (TPP) is the most recent trade agreement negotiated by the United States. Covering 12 countries that produce 40 percent of the world’s GDP, the TPP is viewed as a model for expanding regional agreements at a time when it’s becoming harder to conclude global trade agreements.

The TPP is the first comprehensive agreement to include digital commerce. It covers more trade and contains fewer restrictions on free trade than any previous agreement. Although its fate in Congress is uncertain, the TPP will likely provide a blueprint for future trade negotiations.

While it seems likely that the TPP will affect tax laws and tax practice, the extent is uncertain. For example, it includes an exceptions article that carves out specific legal areas, including taxation, from the general scope of the agreement. Yet the scope of that article is unclear.

The Office of the U.S. Trade Representative, on its website, promotes the benefits of the TPP and explains its main provisions but doesn’t explain the tax provisions. Neither Treasury nor the trade office responded to multiple requests for information about the tax provisions. It’s unlikely that Congress would focus on the tax exceptions in light of the many substantive trade-related issues the agreement raises.

Trade and Tax: GATS History

The General Agreement on Trade in Services (GATS) entered into force in 1995. It extends to the services sector the principles of the General Agreement on Tariffs and Trade, first signed in 1947. GATS and GATT generally prohibit countries from discriminating against residents of other countries in the trade of goods and services. Through the most favored nation provision and the national treatment clause, these agreements seek to put residents of different countries on a level playing field in cross-border trade.

GATS Article XIV includes exceptions to the principles of most favored nation treatment and national treatment. Paragraphs (d) and (e) generally provide that GATS cannot be construed to prevent countries from adopting or enforcing direct tax measures.

But this general exception contains its own caveats. Tax measures cannot be applied in an arbitrary or unjustifiably discriminatory way between countries where like conditions prevail, or as a disguised way to restrict trade in services. Tax measures won’t be considered inconsistent with the requirements of national treatment if differences in treatment are designed to ensure the “equitable or effective imposition or collection” of direct taxes. And tax measures may be inconsistent with the requirements of most favored nation treatment if the difference in treatment stems from an agreement included in a tax treaty.

Footnote 6 to Article XIV(d) explains when measures are designed to ensure the equitable or effective imposition or collection of direct taxes. This includes when a country adopts measures that apply to consumers of services supplied from another country, to ensure the imposition or collection of taxes on those consumers. The footnote also says that in interpreting Article XIV(d), tax terms or concepts are determined under the domestic law of the country taking the measure.

Most direct tax measures that don’t apply against specific countries on a discriminatory basis may satisfy the tax exception requirements of GATS and therefore would not be subject to the free-trade requirements of GATS. (See Secretariat Note to GATS MTN.GNS/W210 (December 1, 1993), available at https://www.wto.org/gatt_docs/English/sulpdf/92140133.pdf.) But even though the tax exception clause in GATS is strong, it is not foolproof. A WTO panel recently ruled that Argentina violated GATS by penalizing countries that failed to adopt effective exchange of information provisions. The decision is under appeal. (Prior analysis: Tax Notes Int’l, Oct. 26, 2015, p. 291.)
The conflict between tax sovereignty and trade agreements was a hot topic when GATS was being negotiated. California’s laws asserting unitary taxation over companies’ worldwide tax bases were a source of tension between the United States and many of its trading partners. The dispute was litigated all the way to the Supreme Court. (See John Turro, “German Finance Committee Warns White House Against Supporting California’s Unitary Method,” Tax Notes, July 19, 1993, p. 259.) U.S. trading partners were also unhappy with the new section 482 regulations implementing U.S. transfer pricing rules. (See Leslie B. Samuels, “Treatment of Tax Measures Under International Trade and Investment Agreements: The GATS Compromise,” in proceedings of the 102nd annual meeting of the American Society of International Law (2008).)

Those tensions played out in the negotiations over GATS. Samuels, who was Treasury assistant treasury secretary for tax policy at the time, noted that “given the frustrations over these U.S. tax policies . . . some European Union tax officials thought that they could bring the United States to heel by having the GATS limit, to some extent, U.S. tax sovereignty.” But that didn’t happen. Instead, the GATS negotiations resulted in an agreement that gave broad deference to tax sovereignty.

**A Harsher Lesson**

GATT has no provision corresponding to the tax exception of GATS Article XIV. Perhaps as a result, a series of disputes over U.S. tax laws arose and lasted until the enactment of section 199 in 2004. (See Joint Committee on Taxation, “Background and History of the Trade Dispute Relating to the Prior-Law Foreign Sales Corporation Provisions and the Present-Law Exclusion for Extraterritorial Income and a Description of These Rules” (JCX-10-02).)

Soon after the domestic international sales corporation regime was enacted in 1971, it was challenged as a prohibited export subsidy. The challenges were sustained by a GATT panel in 1976. The panel’s rulings were controversial, and although the United States did not concede that the DISC regime violated GATT, it agreed in 1981 to adopt the general findings of the panel, subject to a 1981 GATT Council decision. (See Gary Clyde Hufbauer, “A Critical Assessment and an Appeal for Fundamental Tax Reform,” Peterson Institute for International Economics (Oct. 8, 1999).)

Under that decision, GATT signatories were not required to tax export income attributable to economic processes taking place outside their territorial limits; arm’s-length transfer pricing principles had to be observed in transactions between exporting enterprises and related foreign buyers; and GATT was understood not to prohibit the adoption of measures to avoid the double taxation of foreign-source income.

In 1984 the DISC regime was replaced with the foreign sales corporation (FSC) regime, which was considered to be compliant with GATT and the GATT 1981 Understanding. In 1998, fourteen years after its enactment, the European Union brought a case against the FSC regime, after EU countries had suffered a series of losses at the WTO. (See statement of William A. Reinsch of the National Foreign Trade Council at House Ways and Means Committee hearing, June 13, 2002.)

The lesson from this is that trade agreements may apply to direct taxes far more broadly than the parties may have contemplated when the agreements were signed, and that changing circumstances and international disagreements may prompt a reexamination of well-settled principles.

**Trans-Pacific Partnership**

Like GATS, the TPP addresses tax laws generally in an exceptions article, article 29, which limits the TPP’s application to tax measures — paragraph 2 states the general rule that except as otherwise provided in article 29, nothing in the TPP shall apply to taxation measures. While article 29 appears to ensure signatories’ sovereignty on tax matters, the details are ambiguous and may leave room for broader application of the trade agreement to tax matters.

**Priorities**

TPP article 29.4(3) provides that in a conflict between a tax treaty and the trade agreement, the tax...
treaty generally governs. But the paragraphs that follow include exceptions to this general rule. For instance, paragraph 5(a) states that, paragraph 3 notwithstanding, article 2.3 of the TPP (on national treatment) and such other provisions of the TPP ‘‘as are necessary to give effect to that Article shall apply to taxation measures to the same extent as does Article III of GATT 1994.’’ Article III of GATT generally prohibits tax export subsidies and import tariffs. Article 2.3 of the TPP incorporates Article III of GATT into the TPP. Article 2.3(2) of the TPP generally applies these concepts to regional governments.

**Expropriation**

Article 29(8) provides that article 9.8, which generally prohibits expropriation without compensation, applies to tax measures. Investors have looked to trade agreement and investment agreement protection as a final resort when the mutual agreement procedures of tax treaties are not productive. The TPP seems to preserve that flexibility.

**Tax Exceptions**

Paragraph 6 of article 29 contains subparagraphs that apply ‘‘subject to paragraph 3.’’ If a tax treaty contains a relevant provision, that treaty governs; otherwise, the TPP governs.

Paragraph 6(a) says that article 10.3 and article 11.6.1 apply to tax measures on income, on capital gains, on the taxable capital of corporations, or on the value of an investment or property that relate to the purchase or consumption of specific services. Article 10.3 is the general rule requiring each signatory to accord to services and service suppliers of another country treatment no less favorable than that it accords, in like circumstances, to its own services and service suppliers. Article 11.6.1 applies these principles to financial services. Thus, paragraph 6(a) suggests that the TPP principles of national treatment may overrule income tax measures.

Paragraph 6(a) is subject to an exception whereby the general rule may not prevent a signatory from conditioning the receipt or continued receipt of a party under a tax convention. Article 9.5 applies to income taxes, while paragraph 6(b) says it does not.

Paragraph 6(c) contains an exception for the provision addressing digital products, often described as the most innovative part of the agreement. It states that article 14.4 will apply to tax measures on income, on capital gains, on the taxable income of corporations, or on the value of an investment or property that relate to the purchase or consumption of specific digital products. Paragraph 6(c) includes an exception similar to that in paragraph 6(a) — it won’t prevent a signatory from conditioning the receipt or continued receipt of an advantage related to the purchase or consumption of specific digital products on requirements to provide the digital product in its territory.

It’s unclear why the provisions enumerated in paragraph 6(b) apply to non-income taxes, while the non-discrimination clause for digital products also applies to income taxes. Nor is it clear why the special reference to the taxable income of corporations in paragraph 6(c) is needed — presumably a measure taxing income covers corporate income taxes.

Collectively, paragraphs (a) through (c) raise more questions than they answer as to how far the TPP extends to tax measures. And they aren’t the end of the story. The next paragraphs, (d) through (j), provide for exceptions to the first three paragraphs. Under paragraph (d), nothing in paragraphs (a) through (c) applies to any most favored nation obligation regarding an advantage accorded by a party under a tax convention. Paragraph (e) says that nothing in the articles referred to in paragraphs (a) through (c) applies to any existing tax provision.

Paragraph (h) says that nothing in the articles referred to in paragraphs (a) through (c) applies to:

- the adoption or enforcement of any new taxation measure aimed at ensuring the equitable or effective imposition or collection of taxes, including...
any taxation measure that differentiates between persons based on their place of residence for tax purposes, provided that the taxation measure does not arbitrarily discriminate between persons, goods or services of the Parties.

A footnote to paragraph (h) says, “This subpara-
graph must be interpreted by reference to the footnote to Article XIV(d) of GATS.” As explained above, foot-
note 6 to GATS Article XIV(d) contains an extensive
list of measures that meet the requirement of ensuring the equitable or effective imposition or collection of direct taxes.

Paragraph (h) appears intended to protect the right
of countries to enact different tax laws for domestic and foreign residents, as long as the differences are not based on “arbitrary discrimination.”

**TRIPS**

The Agreement on Trade-Related Aspects of Intel-
lectual Property Rights, or TRIPS, sets minimum stand-
ards of protection for copyrights, trademarks, patents,
and other intellectual property rights. TRIPS is the
most comprehensive international agreement on IP to
date. The WTO is responsible for enforcing it.

Unlike GATS and the TPP, TRIPS has no tax ex-
ception article. TRIPS also uniquely applies to protect
the owner of IP. Because there is no tax exceptions
clause in TRIPS, and because it protects the legal
owner rather than an affiliated group, it is unclear how
transfer pricing rules that applied to shift income from
the legal owner of IP to another affiliate might hold up
under it.

**Conclusion**

The tax exceptions in the TPP are interpreted pri-
marily under the principles of trade, not tax, law. The
myriad cross-references and exceptions to exceptions
make it difficult to clearly determine their scope or the
degree to which the nondiscrimination provisions of
the TPP may limit the United States’ ability to enact
new tax laws in the future.

Without fully understanding how these provisions
will be interpreted and the background to the agree-
ment negotiations, it is difficult to assess the implica-
tions of the TPP for U.S. international tax laws and
the tax affairs of multinationals. Like other trade agree-
ments, it raises the question of who has the ultimate
authority to interpret and validate countries’ tax laws.

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**NEWS ANALYSIS**

**Treaty Relief for Unregulated Investment Funds?**

by Lee A. Sheppard

Yahoo Inc. has been a big subject of discussion in
these pages for its failed spinoff, which earned CEO
Marissa Mayer a place in the 2015 International Tax
Review 50 for the year’s biggest tax blooper. Yahoo
recalibrated and announced that it would spin off its
core business — whatever that is — instead of its Ali-
bara Group investment.

What core business? Does Yahoo even have a busi-
ness left? Yahoo’s business model may have been
eclipsed over time anyway, but years of meddling by
hedge fund investors did not help. Incredible as it
seems now, the company refused a $45 billion purchase
offer from Microsoft Corp. in 2008. Now Yahoo is
shopping itself to everyone from private equity to
phone companies.

A hedge fund installed Mayer in the first place. She
began her disastrous reign by telling employees who
worked at home — presumably including mothers of
young children like herself — that they had to come to
the office. Then she did a Vogue shoot, posing provoca-
tively in expensive dresses. If only the earnings were as
glamorous!

Yahoo’s basic business is shrinking, but its earnings
per share were flattered by recent buybacks. Then
again, buybacks might make sense for a company that
is essentially in liquidation mode. Yahoo’s share price
is 30 percent lower than it was 15 months ago.

Now another hedge fund, which owns roughly 2
percent of Yahoo, has begun a proxy contest to replace
Yahoo’s entire board, including Mayer, with the aim of
merging it with AOL Inc., another moribund walled
garden of Internet search and email for unsophisticated
users. La Cucaracha, as AOL is nicknamed, happens
to own The Huffington Post. But other than that, it’s not
clear what AOL’s business is either, or what a merger
with Yahoo would accomplish. Yahoo responded by
filling two board vacancies without talking to investors.

The moral of the story is that investment fund man-
ger’s can sometimes be, as the British would say, too
clever by half. They turn out not to be that good at
running the companies they criticize or take over. Ya-
ho’s tormentor dismantled the board of the proprietor
of Olive Garden just as middle-class restaurant patron-
age hit the wall. Maybe if the breadstick munchers
could be persuaded to do all their searches on Ya-
ho . . .

Fund managers have been too clever by half in tax
and regulatory matters as well. They’ve argued that
governments should trust them even though they’ve set
themselves up in tax and banking haven arrangements that would suggest that they should not be trusted.

Unregulated investment funds don’t want regulation, but they want access to the institutional money and retail investors for which regulation is warranted. Investment fund managers don’t want to pay taxes or subject their investors to taxes. But they want their investors not to be inconvenienced by withholding taxes. Investment funds want anonymity for their investors. But they want withholding tax refunds for them too. They want treaty benefits for their investors without doing anything to prove they are deserving.

Except, of course, being large and controlling vast amounts of investment capital that gives them political sway in world financial capitals. When we last dis-
cussed investment fund whinges about treaty benefits and apparent tightening of treaty abuse concepts in the OECD’s base erosion and profit-shifting project, we saw officials empathizing but having difficulty fitting funds within the accepted rules. (Prior analysis: Tax Notes Int’l, Feb. 9, 2015, p. 473.)

Now the OECD has put out a consultation about how to accommodate unregulated investment funds with treaty benefits. This call for comments comes on top of treaty commentary calling for recognition of regulated investment funds as treaty residents of the countries in which they are organized. Are unregulated investment funds any closer to treaty relief? Only if they manage to construct a narrative that makes tax administrators feel better about recommending it.

A parallel worry for unregulated investment funds is treaty relief for dividends and entitlement to the benefits of the EU parent-subsidiary directive, 2011/16/EU. Substance requirements inspired by the BEPS project and put into practice in the form of recent amendments to the parent-subsidiary directive and the proposed EU antiavoidance directive, COM(2016) 26 final, are creating real problems for the business model of unregulated investment funds.

**Treaty Relief**

Basically, unregulated investment funds are asking for the same treatment as regulated investment funds, which are theoretically eligible for treaty withholding relief as beneficial owners of investment income. Regulated funds are perceived as deserving because they are regulated, diversified, widely held by ordinary citizens in their country of organization, and file tax returns. The OECD’s TRACE project was modeled on the U.S. qualified intermediary program in that investor information would be bottled up at the intermediary level and not passed on to governments except in cases of an information request (2010 OECD report, “The Granting of Treaty Benefits With Respect to the Income of Collective Investment Vehicles”).

The project was translated into extensive additions to the OECD model commentary recommending that regulated investment funds be treated as beneficial owners and treaty residents on their own (paras. 6.8 to 6.34 of the OECD model commentary on article 1). The draft treaty language in the commentary leaves room for competent authorities to grant treaty benefits to unregulated investment funds (para. 6.17). But given that regulated investment funds, many of which are large and visible, aren’t getting much relief, the case for discretionary relief for unregulated funds appears weak.

The regulatory and enforcement justification for treating regulated funds as treaty residents doesn’t apply to unregulated funds, which have flitted in and out of countries where they invest without filing returns or paying tax on capital gains. They have done everything possible to escape the jurisdiction of the countries.
where their mind and management is, and everything possible to keep their investor lists secret from the governments of those countries. The countries where these funds are organized and tax resident are flags of convenience that maintain a veneer of regulation for the protection of creditors, which do not include tax authorities.

Unregulated investment funds don’t have to be organized in any particular form. Fund feeders catering to U.S. investors are usually organized as partnerships. For this reason, the United States persuaded other OECD countries to agree to look through partnerships to permit treaty benefits for eligible partners (OECD 1999 report “The Application of the OECD Model Tax Convention to Partnerships”).

Consistent with that report, the OECD amended commentary to article 1 of the model treaty to say that the entitlement to treaty benefits should be determined by looking through to the investors in a transparent entity (paras. 2-6 of the commentary on article 1). The commentary advises source countries to look through tax haven partnerships to their treaty-country investors to grant treaty benefits (para. 6.5). The source country should be treating investors as though they earned the income items directly. Nonetheless, funds are unable or unwilling to give investor information to source countries. (Prior analysis: Tax Notes Int’l, Dec. 22, 2014, p. 1063.)

Unregulated investment funds organized as passthroughs can’t prove that they are residents of the jurisdictions in which they are organized and can’t or won’t indentify their owners. The consultation document recognizes those problems and puts the onus on fund representatives to address them. Commentators suggested as an alternative proof of substantial connection to the country of claimed residence, which did not get a warm reception because it would still permit treaty shopping.

Substantial connection would be defined according to Dutch standards of residence for intermediary companies. The Dutch standard for substance is contained in two decrees that exalt job creation for Dutch professional service providers over actual substance. Half the entity’s board members must be Dutch residents qualified to do their jobs, and board meetings must be held in the Netherlands. The entity must have staff at its disposal — with no requirement that they be resident or employees. Bank accounts and bookkeeping have to be Dutch. The entity cannot be a dual resident and should have €2 million equity.

U.S.-managed fund feeders catering to foreign investors and tax-exempt investors are usually organized as companies to spare them from U.S. effectively connected income and debt-financed income, respectively. Tax haven corporations, by definition, are not eligible for treaty relief anywhere unless the haven is Ireland or Luxembourg. Why do U.S. funds insist on using the Cayman Islands? Because it has fund-friendly laws and infrastructure, and it is easily reachable from New York. Readers, the whole treaty relief argument is about the convenience of New York fund managers.

Moreover, deferral is not on the OECD’s list of desirable attributes prompting sympathy for investors. The consultation document wants to prevent both tax avoidance by investors not entitled to treaty relief and deferral on the part of those who are. Hedge funds, private equity funds, and even socially deserving venture capital funds hang onto investors’ money for a long time, and some make no current distributions. The consultation document asks for proof of investor taxation on undistributed income.

Regulated investment companies, in contrast, may be legally required to distribute all their income (e.g., section 852). The consultation document’s proposed elective global-streamed regime would require current distributions. Along the lines of the EU savings directive, 2008/48/EC, the proposal contemplates collection by the investor’s country of residence and remittance of tax proceeds to the country that is the source of the income or gain. This would be extremely clumsy outside the EU even if funds were able to qualify for it.

The best argument that the unregulated funds have is that the bulk of their investors are institutions in treaty countries, and the OECD BEPS negotiators are willing to give treaty benefits to pension funds, which do invest in unregulated funds (see, e.g., article 22(2)(e) of the 2016 U.S. model treaty). Following through on this argument would still require providing investor information to source countries. But the consultation document worries about long chains of ownership, which are typical, and taxable investors tagging along for the ride.

**Substance Requirements**

As previously noted, the outlook for holding companies in Europe is bleak. But it is bleaker for the kind of hollow entities used by investment funds. At the opposite end of the scale is that certain local activities undertaken by investment funds could create a permanent establishment.

BEPS discussions usually conjure thoughts of multinationals that produce physical products or sell services to identifiable market countries. No personnel in that stripped-risk distributor? That Swiss principal company is being managed out of Omaha and not Zug? Move some people! For the very largest groups, substance requirements are unlikely to be a barrier.

For them, showing substance to newly empowered European tax administrators is a matter of moving bodies around or reassigning the bodies already in the suspect location. These giants can also reassign activities. Group finance and intellectual property management can be put in holding companies, as the discussion showed at the recent International Bar Association annual conference on current international tax issues in cross-border corporate finance and capital markets in London.
“It is very difficult for pure passive holding companies to survive,” said Michel Collet of CMS Bureau Francis Lefebvre in London.

Unregulated investment funds have an intractable problem. They often have a number of entities between investors and investments for the purpose of avoiding capital gains and withholding taxes, and ensuring entitlement to dividend exemptions. Many of these entities, set up in tax havens, have no personnel or premises. Nor can they possibly have them, given that every private equity acquisition has its own clump of entities.

Many of these entities are in Luxembourg, a fund-favoring jurisdiction that appears to be the last place on earth anyone wants to put personnel. In the case of a private equity fund, there would be no business managers in Luxembourg, and the local managers of the portfolio companies would not be part of the chain of ownership. That leaves only back-office personnel eligible for Luxembourg duty. Would that be enough? It depends on the tax authority. For the French, yes. For the Danes, no.

Discussions at the recent annual conference on tax planning strategies for the United States and Europe hosted by the American Bar Association, International Fiscal Association, and IBA in Milan reached some conclusions. Put some bodies in the Luxembourg entities. Try to have a nontax business reason for each of them. Think about consolidating the entities for many investments into a single master holding company with substance. It might be better to fund acquisitions with third-party debt instead of shareholder debt.

In a private equity acquisition of a target company in an EU country, there can be as many as four hollow entities between the investment fund and the target. The entities closest to the investors are in a tax haven like the Cayman Islands, the Netherlands, or Luxembourg. The entities closest to the target are in its country of residence.

What do they all do? The acquisition or bidding company, which acquires the shares of the target directly, is in the target’s home country. Above it, there may be a home country holding company that does the acquisition borrowing. The holding company or acquisition company is owned by a Dutch BV or Luxembourg SARL. The BV or SARL would be owned by a Dutch co-op or another Luxembourg SARL, respectively, that is owned by the fund. The Dutch entities are passthroughs. The Luxembourg entities are opaque and checked, and also financed with hybrid debt, private equity certificates (PECs), or convertible private equity certificates (CPECs).

None of these entities, a set of which exists for every deal, would usually have any substance. They automatically pay interest or dividends received to the next level. Local managers run the target companies, but they have no connection to the ownership or the investment managers who tell them what to do.


The parent-subsidiary directive’s prescription for a common minimum antiabuse rule permits EU member countries to adopt a safe harbor. The amended directive commands that the benefits of the directive not be granted to arrangements that have as a main purpose obtaining a tax advantage that defeats the objects of the directive. It excuses arrangements that have valid commercial reasons that reflect economic reality (16633/14). The concepts are similar to the proposed EU antiavoidance directive (COM(2016) 26).

As vague as that wording appears, the point is that the payee have substance and be the beneficial owner of the dividend for the payer’s country of residence to grant withholding relief under the directive. The preamble to the amendment counsels that when faced with a multistep arrangement, tax administrators can attack the hokey part and leave the genuine part alone. That means that even if the entities have substance, the tax administrator can deny benefits when the payee is not the beneficial owner of the dividend payment.

In Milan, Nikolaj Bjørnholm, a private practitioner, commented that in analyzing eligibility for exemption from withholding under the parent-subsidiary directive, Denmark looks for the recipient’s obligation to pass on the payment. The tax authorities require withholding on payments to entities that they consider conduits. The question rattled through the Danish courts, which have recently referred questions to the Court of Justice of the European Union. The Danish Ministry of Taxation has admitted that the beneficial ownership rules conflict with freedom of establishment.

Andrea Silvestri of Bonelli Erede Pappalardo explained that Italy employs a substance test to determine eligibility for exemption from withholding under the parent-subsidiary directive when the payer of a dividend is ultimately owned by a non-EU resident. The burden is on the taxpayer to demonstrate the main purpose of the arrangement. Italy also has an administrative practice for beneficial ownership, and the arrangement may be challenged. If the payee automatically distributes the dividend, that may belie beneficial ownership, Silvestri noted. (Prior analysis: Tax Notes Int’l, Dec. 23, 2013, p. 1133.)

Albert Collado de Garrigués explained that the Spanish treatment is similar to the Italian treatment. Before the 2015 Spanish tax reform, no exemption from withholding under the parent-subsidiary directive was available when the payer of a dividend is directly or indirectly controlled by a non-EU resident: unless the parent carried on a business related to the subsidiary’s business in Spain; or the parent managed the subsidiary using real human resources; or had a valid
business reason for the arrangement. The tax authorities were very restrictive in their interpretation of the requirements. (See the Aromatics cases — Supreme Court, April 4, 2012, March 21, 2012, and March 22, 2012; RHI case — National Appellate Court, November 25, 2010; Pilbrico case — Asturias High Court, April 11, 2011; and Enbridge case — National Appellate Court, June 3, 2015.)

The recent Enbridge decision affirmed that narrow interpretation, Collado observed. In that case, a Canadian company owned a Danish company that owned 25 percent of a Spanish company and had no other assets. The Danish company’s two employees were in Spain and Colombia. There was no substance in Denmark and no purpose for the company’s formation. Therefore the benefit of the parent-subsidiary directive was denied. (Prior coverage: Tax Notes Int’l, May 9, 2011, p. 501.)

Spanish law was recently changed to accommodate owners with AIFMD licenses. Exemption from withholding under the parent-subsidiary directive is available when the EU resident owner owns at least 5 percent or has invested at least €20 million. Mirroring the EU parent-subsidiary directive, the Spanish implementing antiabuse rule would not apply when “the formation and operations of the recipient of the dividend or royalty are based on valid economic grounds and business reasons with substance.” The new Spanish law also introduced an antiabuse rule for royalties. (Prior analysis: Tax Notes Int’l, Sept. 29, 2014, p. 1112.)

An AIFMD license would help in the argument that there is a business reason for a holding company, but if it were in Luxembourg, substance would need to be demonstrated. Collado explained that it is not clear which entity must have substance — the Luxembourg vehicle closest to the Spanish acquisition, or perhaps a single Luxembourg holding company that had substance, servicing all of the fund’s portfolio companies. There is no Spanish guidance on what is required for substance.

If the arrangement does not qualify for the parent-subsidiary directive, it may also fall out of the pertinent treaty, should a general antiabuse rule as required by the proposed EU antiavoidance directive come into force, Collado warned. The current OECD model commentary states that domestic general antiabuse rules do not conflict with treaties and may be applied to treaty abuse when there is a main purpose to get benefits, which would conflict with the object and purpose of the treaty provision (paras. 22-27 of the model commentary on article 1).

“We’re all talking about BEPS action 6, but no one’s doing anything about it,” said Catherine Sear of Proskauer Rose London. Sear predicted that the United Kingdom would sign the principal purpose clause that will feature in the multilateral instrument.

Internal Finance

The biggest users of European holding companies are Americans. PECs and CPECs were created for them, and Americans love them. PECs and CPECs get equity treatment for U.S. tax purposes and debt treatment in Luxembourg despite their boatload of equity features. Theoretically, these hybrids could get banged up under the BEPS action 2 hybrid mismatch report.

“PECs are sacred,” Ayzo van Eysinga of Stibbe commented in London. Even if the antiavoidance directive becomes EU law, Luxembourg would only put it into force vis-à-vis EU entities. The target’s home country may deny an interest deduction, Sam Kaywood of Alston & Bird LLP noted, but there is no problem with equity treatment under U.S. law.

In a typical private equity setup, the target is likely to be paying current interest on straight debt to the same-country acquisition company, with which it may join in a combined return. The acquisition company issues PECs or CPECs to its Luxembourg owner. PECs or CPECs are issued all the way up the chain of Luxembourg entities, which are checked for U.S. tax purposes. So in the U.S. view, only the ultimate payee matters, and the payment is a dividend given the predominant equity features of PECs and CPECs.

Treaty-benefited dividends are not the whole rationale for the chain of entities. The investors want a handy entity that can be sold or liquidated when they want to monetize their investment the target. When the target is sold, the lower-tier Luxembourg SARL either liquidates into the upper-tier Luxembourg SARL or pays it a dividend, incurring no withholding either way. Kevin Keyes of KPMG LLP explained that for a partial exit, the parties repay the CPECs. The United States treats the repayment as a dividend out of the CPEC issuer’s earnings and profits.

Keyes explained that if the acquisition company were in the same jurisdiction as the target company, a direct shareholder loan from the former to the latter should not be used if equity treatment for U.S. purposes could not be achieved under the local country law. In these cases, a separate finance company organized in Luxembourg to issue PECs to the fund could be considered. The acquisition company would issue the shareholder loan to the finance company, which would issue the CPECs to the fund or its holding company.

Some countries have listing exceptions to withholding on interest. The United Kingdom would withhold on interest payments unless the debt is listed, so funds typically list on a Channel Islands exchange. Otherwise, the finance company should be located in a treaty jurisdiction to be eligible for reduced withholding. Keyes advised. There will inevitably be questions whether the finance company is the beneficial owner of interest payments it receives.
Silvestri explained that Italy requires that the finance company be the beneficial owner of the interest payments it receives. Under Italian beneficial ownership guidance, a beneficial owner must achieve an economic benefit from the transaction; must have legal title and access to the income; and must have adequate structure and ability to manage its financial risks. There is no guidance on the first element, the amount of spread, which would be a transfer pricing question. But the finance company should be able to manage its financial risks and should not pay the interest income over to its owners too quickly, according to Silvestri.

An unpublished Italian tax ruling was issued for a French special purpose vehicle (SPV) that owned EU subsidiaries, which it financed with bank loans and debt sales. It had no employees, but it was part of a larger group that had employees. The loans between the French SPV and the subsidiaries did not have commercial terms, that is, the terms did not mirror those of the third-party loans to the SPV. An Italian subsidiary borrower did not guarantee the third-party loans. Taking a very strict approach, the tax authorities used those factors to deny beneficial ownership, emphasizing the absence of employees at the level of the French SPV.

Collado noted that in Spain, beneficial ownership is not a concept of the law, but tax authorities do raise it to challenge some back-to-back structures. Spain is one of the countries that asserts the right to tax gains on shares issued by its companies, and, as Collado described, bonds issued to finance Spanish assets. In a tax ruling he called scary, Spanish tax authorities asserted the right to tax bonds issued by a Dutch issuer on a Dutch platform but used to finance Spanish assets. There was no beneficial ownership under Spanish law, the argument having lost in court.

Distressed Debt Buying

Everything in Europe is for sale. And many European lenders — which, unlike U.S. lenders, really do lend to businesses — have books full of garbage loans that they want to sell to investors. What happens when investment funds buy pools of dodgy loans from their originators, then try to work them out with same-country borrowers?

What if the fund takes equity in the borrowers? Does such a fund have a dependent agent PE in the country? In the United States, the IRS has made its views on private investment in public equity (PIPE) funds clear (ILM 201501013). Keyes noted that debt funds are now using special purpose Irish entities to purchase and work out debt, so that they could have the advantages of the treaty in the event there is a dependent agent PE. (Prior analysis: Tax Notes Int’l, Jan. 19, 2015, p. 201.)

If the fund is buying its dodgy debts in the United Kingdom, it can rely on the investment management exemption and the Luxembourg treaty — unless it plans to work out the debts, in which case that would fall into the category of trading and create a PE. As in U.S. law, only passive investors are excused from being in a trade or business (section 864(b)(2)(A)(ii)). In the United Kingdom, lending can be conducted through an independent agent without the nonresident lender being liable subject to tax (section 127, Finance Act 1995; section 148(3)/Schedule 26, Finance Act 2003; and HMRC Statement of Practice 1/01).

Italy recently enacted laws to help banks get rid of their bad loans, but those laws focus on the sellers and not the nonresident purchasers (Law Decree 91). Investment funds can now lend into Italy without tax obstacles, but activities on the ground still raise questions. Local servicing of distressed loans would create a dependent agent PE in Italy. Therefore, according to Silvestri, debt investors should go into Italy using a SPV that is not organized in a blacklisted tax haven like the Caymans. Ireland would be acceptable for that purpose. (Prior analysis: Tax Notes Int’l, Aug. 11, 2014, p. 447.)

Working out a debt would also create a PE in Spain, making all associated interest and gain taxable, according to Collado. Moreover, once a PE is created, every asset it holds is part of the PE. The Spanish tax authorities and courts have been very active in using the PE concept to generate nexus in Spain, so investors must consider this in planning debt portfolio investments.

Funds generally use Luxembourg or Irish vehicles to buy debts in Spain, so that interest is exempt from withholding when the payee is an EU resident. Spanish law permits specialized funds to invest in debt portfolios, which are taxed at a corporate rate of 1 percent. However, investors must factor in Spain’s domestic withholding tax on interest, which, although it is recoverable, is an additional financial cost, Collado explained.

Manager Compensation

What about the part that really matters to the managers — the top of the fund? After hammering citizens with unnecessary austerity and corporate income tax cuts, the British Conservative government is doing something about lightly taxed investment fund manager compensation. You have to hand it to those upper-class dilettantes — all that time spent in the country enables them to recognize a pitchfork when they see one.

Under the latest budget, carried interest — British managers borrow to purchase real capital interests in their fund — is taxed as ordinary income unless it is subject to a hurdle rate. All income from trading or lending is taxed at the ordinary rate of 47 percent to prevent recharacterization as carried interest. If the general partner waived fees, amounts received will be tested to see if they were received for services. In a
separate change, capital gains from proceeds of sales will be taxed at 28 percent, which is higher than the normal capital gains rate.

Populism is raising its head in the usually tone-deaf American political system, and presidential candidates from both parties have said they would tax profits interests as ordinary income. Profits interests are income strips. Unlike British managers, American managers do not invest their own or anyone else’s capital to support them. Investors shift 20 percent of the profits of a typical fund to the managers, which has the effect of a deduction even for tax-exempt investors.

Even Senate Finance Committee member Charles E. Schum er, D-N.Y., who represents the financier class, now supports ordinary treatment of profits interests for as many industries as possible, which is code for exempting real estate. It’s a quick and easy way to be seen as caring about fairness while hitting a generally despised class of financiers.

Fund managers accept that enactment of legislation, which has been kicking around for a decade, is inevitable. There are two competing bills ready to be enacted. The older version, introduced by House Ways and Means ranking minority member Sander M. Levin, D-Mich., would treat all income and gain on profits interests as ordinary and would fence off losses from use against other income. Service partners would be treated as partners on their own capital investments in the fund (Carried Interest Fairness Act of 2015, H.R. 2889 and S. 1686).

The newer version is contained in the extensive tax reform draft released by then-House Ways and Means Committee Chair Dave Camp. This version would impute income to the service partner on a deemed loan of the capital that supports the profits interest. To the extent that it exceeds that imputed interest, the service partner’s net capital gain, whether allocated or from disposition of his interest, would be treated as ordinary. It’s more convoluted than this capsule description because the service partner would have a running account balance for recharacterization. (Prior analysis: Tax Notes, Mar. 10, 2014, p. 1137.)

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NEWS ANALYSIS

Expatriation Transfer Tax: A Reform Proposal

by Ajay Gupta

In this final look at the U.S. taxation of expatriates, we consider a reform proposal for taxing property transfers. In two earlier articles, we examined the changes wrought by the Heroes Earnings Assistance and Relief Tax (HEART) Act of 2008 to the tax treatment of individuals giving up their U.S. citizenship and long-term residency. (Prior analysis: Tax Notes Int’l, Mar. 28, 2016, p. 1075; and Tax Notes Int’l, Mar. 21, 2016, p. 991.)

We saw that while the section 877A exit tax on income represents an improvement over the alternative tax regime of section 877 by discarding a 10-year compliance window in favor of a one-time tax, the section 2801 special transfer tax creates an open-ended regime. While it is unlikely to yield significant additional revenue, section 2801 nonetheless requires worldwide monitoring of transfers of all foreign situs property for the life of the covered expatriate. It thus seems possible to reform this transfer tax to make it more of an exit tax — in line with the principles underlying the HEART Act’s approach to taxing the income of expatriates — and also achieve revenue gains.

Seeking Tax Neutrality

Section 877A seeks to make an individual’s decision to expatriate income tax-neutral. The House Ways and Means Committee report accompanying the HEART Act noted that although the code should not be used to stop U.S. citizens and long-term residents from relinquishing citizenship or terminating residency, it should also not provide a tax incentive for doing so. Congress recognized that the code provided a twofold income tax incentive for expatriation: perpetuating ongoing deferral of gains on U.S. assets, and converting deferral of gains on foreign assets into permanent exclusion.

To remove both incentives, section 877A(a) posits the sale of a covered expatriate’s worldwide assets at their fair market value. And although the statute doesn’t explicitly assume a deemed reacquisition at FMV, it states that “proper adjustment shall be made in the amount of any gain or loss subsequently realized.” In other words, the covered expatriate is treated as if he had sold and then immediately repurchased all his assets at their then-current FMV. The jurisdictional hook for taxing the resulting gains is the time of the deemed sale and repurchase — “the day before the expatriation date.” On that day, the covered expatriate remains subject to U.S. taxation on his worldwide income. That deemed sale ends all deferral of gains. Additional gains on assets subject to U.S. taxation would,
of course, continue to receive deferral until their eventual disposition, as they would for any other nonresident alien.

But deferral can play no part in any transfer tax benefits accruing from expatriation. That is because U.S. transfer taxes — both gift and estate taxes — are imposed on the transferred property's current FMV, not historical cost basis. To put it another way, the contrivance of a deemed sale and repurchase at FMV is already built into the scheme of transfer taxation. Expatriation simply removes foreign situs assets from the reach of U.S. gift and estate taxes.

Instead of requiring acceleration of gains, the decision to impose a special transfer tax on expatriation must grapple with the uncertainty over which, if any, foreign situs assets the covered expatriate might transfer. Section 2801 seeks to resolve that uncertainty by extending the period in which the tax is imposed for the remaining life of the covered expatriate. During that period, section 2801 imposes a tax on gifts and bequests from a covered expatriate, except for transfers of property shown on timely filed gift or estate tax returns.

The net result is a special transfer tax on gifts and bequests of foreign situs assets, made at any time after expatriation. These post-expatriation asset transfers would have otherwise escaped U.S. gift and estate taxation. The jurisdictional hook for imposing this tax is supplied by reversing the general U.S. transfer tax principle of taxing the transferor and, instead, taxing U.S. citizen and resident recipients of these transfers. Acknowledging the jurisdictional and enforcement limitations precluding taxing offshore transfers between foreigners, the statute exempts gifts and bequests from covered expatriates to non-U.S. persons.

**Designing an Exit Transfer Tax**

Keeping open the period in which the special transfer tax is imposed until the expatriate dies squarely contradicts the principle of a one-time exit tax embodied in section 877A. A one-time exit transfer tax on expatriation is both conceptually defensible and practically feasible. Designing it, however, would require settling two basic and interrelated issues: whether the tax should be imposed on all assets the covered expatriate holds at expatriation, or only those with a foreign situs; and what assumptions should be made about the extent to which the covered expatriate will consume these assets over his remaining life.

As an NRA, a covered expatriate would remain subject to U.S. gift and estate taxes on transfers of all real and tangible personal property located within the United States, and some intangible property. Specifically, to the extent they exceeded the annual exclusion of section 2503(b) (now $14,000), the covered expatriate's inter vivos transfers of U.S. real estate and tangible personal property located in the country during any one year would be subject to tax at the marginal rates of section 2001(c). The lifetime exemption is not available to NRAs.

The covered expatriate’s testamentary transfers would be governed by the rules of sections 2101 through 2108, which impose an estate tax on NRAs’ transfers of U.S. real estate and tangible personal property located in the country, as well as intangible property with a U.S. situs determined under sections 2104 and 2105. Section 2106 limits the availability to NRAs of some of the deductions allowed to U.S. citizens and residents in computing the taxable estate from the gross estate. More important, section 2102 allows NRAs a unified credit against the estate tax of only $13,000, which under the marginal rates of section 2001(c) exempts the first $60,000 of the gross estate. For U.S. citizens and residents, the unified credit against the estate tax of section 2010 (now $2.1 million) provides an exemption that is nearly 100 times higher (now $5.45 million).

By carving out a covered expatriate’s transfers timely reported on a gift or estate tax return, section 2801(e) limits the base of the special transfer tax to foreign situs assets, leaving transfers of U.S. situs assets to be taxed under the rules applicable to NRAs outlined above. Stacked against this limited base are features that make the section 2801 special transfer tax onerous when compared with the gift and estate taxes.

Instead of applying at a graduated rate schedule, the section 2801 special transfer tax is a flat tax, imposed at the highest section 2001(c) marginal rate of 40 percent. While the mandatory use of the nonrefundable unified credit against the gift tax under section 2505 also renders the gift tax a flat 40 percent tax, the estate tax is imposed at the marginal rates specified in section 2001(c), ranging from 18 to 40 percent. Further, the section 2801 special transfer tax does not allow the gift tax deductions of section 2503(e) for educational and medical expenses. Although an annual exclusion does apply, it is limited to the section 2503(b) amount per recipient for gifts and bequests from all covered expatriates.

Finally, the absence of a unified credit against the section 2801 special transfer tax perversely discriminates in favor of taxpayers who had planned their expatriation by exhausting the section 2505 lifetime exemption with earlier inter vivos transfers. Conversely, those who expatriate without fully using the lifetime exemption amount stand to lose the unused portion.

Expanding the base of the tax to cover all assets held by the covered expatriate at expatriation may be justified if the tax itself is reconfigured to conform to the transfer taxes under chapters 11 and 12, with the availability of similar deductions and credits. That would also help transform the tax from a special transfer tax that applies to actual gifts and bequests to U.S. citizens and residents from expatriation until death into an exit tax that would apply to a deemed transfer at expatriation. In particular, the availability of a unified credit may have a bearing on what proportion of the total assets should be deemed transferred at expatriation.
A Deemed Bequest

The flip side of imposing a tax on a deemed transfer of assets held at expatriation would be excluding those assets earmarked for consumption. All assets that a covered expatriate holds at expatriation would either be consumed by him or transferred to others during his lifetime or at death. An exit transfer tax would necessarily and arbitrarily decide what proportion of the total assets would have been consumed, and deem the remainder transferred.

The section 877A exit tax on income confronts a similar imponderable. Not all built-in gains in assets held at expatriation are destined to be realized and recognized by the covered expatriate. He may well transfer many assets with built-in gains in nonrecognition transactions, including inter vivos and testamentary transfers. Yet section 877A assumes an FMV sale and repurchase of all of these assets, and presumably accounts for any nonrecognition transfers with an arbitrary exclusion from gain (set at $600,000 in 2008 and adjusted annually for inflation; now $693,000).

Perhaps the availability of a section 2010 unified credit against an exit transfer tax would be generous enough to obviate the need to exclude any assets from a deemed transfer to allow for consumption. In that case, the exit transfer tax would operate as a sort of wealth tax at expatriation. Alternatively, an arbitrary amount, indexed for inflation, could be excluded from the FMV of all assets held at expatriation, before applying the exit transfer tax.

The exit transfer tax would postulate that the covered expatriate had bequeathed to himself all assets he had held the day before the date of expatriation, less any exclusion amount. That would parallel the section 877A FMV deemed sale and repurchase and match its timing. Moreover, the only new construct required is this hypothetical “testamentary” self-transfer. With that in place, the estate tax rules would take over and supply the necessary results.

The day before the date of expatriation, the covered expatriate would still have been subject to the estate tax on his worldwide assets. Thus, to the extent not earlier exhausted under section 2505 with inter vivos transfers, the section 2010 unified credit would be available to shield assets with an FMV of up to $5.45 million (in 2016) from the exit transfer tax. The rest would be subject to tax at the graduated rate schedule of section 2001(c).

Following expatriation, the covered expatriate’s NRA status would determine the applicability of U.S. transfer taxes to his asset transfers. Specifically, the NRA rules for gift and estate taxes outlined above would continue to apply to transfers of his U.S. situs assets. Thus, despite the imposition of an exit transfer tax on his worldwide assets, any post-expatriation transfers of U.S. situs assets would once again attract U.S. gift and estate taxes, subject to the allowable (limited) deductions and credits. Transfers of his foreign situs assets, however, would now be free of U.S. transfer taxes, even when the recipients are U.S. citizens or residents.

Avoiding double taxation of the U.S. situs assets that were subject to the exit transfer tax would require an adjustment to the unified credit provisions for NRAs, much like section 877A(a) adjusts the basis of assets deemed sold and repurchased at FMV to eliminate taxing the same built-in gains twice. Specifically, an NRA’s $60,000 section 2102 exemption from gross estate would have to be increased for a covered expatriate by the FMV of U.S. situs assets in the gross estate of his deemed bequest. And unlike the rule for other NRAs, this exemption would have to be made available for inter vivos transfers as well.

As a result of those two simple changes, U.S. situs assets with an FMV equal to those subject to the exit transfer tax could be transferred free of additional gift or estate taxes during the covered expatriate’s remaining life or at his death. Any intervening increase in the value of these assets at the time of transfer would, of course, give rise to an additional estate or gift tax liability, as it should. Post-expatriation transfers of foreign situs assets would continue to be free of additional gift or estate taxes, as they are for all NRAs.

This scheme would potentially create planning opportunities by, for example, encouraging a covered expatriate to contribute U.S. situs assets to a foreign corporation and transferring that corporation’s stock to the intended ultimate recipient of the assets. But those opportunities exist for all NRAs, even the ones who never expatriated. The existing gift and transfer tax rules for NRAs tolerate these techniques, presumably concluding that the eventual recognition of U.S.-source gains will compensate for the loss of revenue. The proposed exit transfer tax would in fact be a step up, taking at least one bite at the covered expatriate’s U.S. situs assets.

Doctrinal and Administrative Improvements

The results of the proposed exit transfer tax outlined above are logically coherent. As with the section 877A exit tax on income, for purposes of an exit transfer tax, expatriation should signal the termination of the covered expatriate’s ongoing benefits under the U.S. tax system. Also as with section 877A, that termination is best achieved by forcing a transfer of the covered expatriate’s worldwide assets to himself. In the case of an exit transfer tax, that deemed transfer should be seen as a bequest to use up all of the remaining unified credit.

This exit transfer tax can also benefit from administrative cost efficiencies. The deemed FMV sale of section 877A requires the IRS to track down and value the covered expatriate’s worldwide assets, including illiquid assets. Those exercises may well generate disputes. Because the exit transfer tax would rely on the same FMVs of those very same assets, the IRS must track down and value these assets, and resolve any disputes, only once.
As for ordering rules, the section 877A exit tax on income should apply before the exit transfer tax, lest an argument be made that the deemed bequest of the latter results in a step-up in basis in the hands of the covered expatriate under section 1014, and thus wipes out any built-in gains. Alternatively, section 1014 should expressly be made inapplicable to the deemed bequest.

As proposed here, the exit transfer tax would eliminate many of the doctrinal and enforcement objections to the section 2801 special transfer tax. The tax would be consistent with the U.S. transfer tax principle of taxing transferees and not transferees. And it would be a one-time event, compared with the lifelong reach of section 2801. Because it would not apply after expatriation, the proposed exit transfer tax would exempt all post-expatriation asset acquisitions and increases in value. (Acquisitions and increases in value of U.S. situs assets after expatriation would be subject to the existing gift and estate tax rules for NRAs.) In sharp contrast, the section 2801 special transfer tax covers acquisitions and increases in value of worldwide assets, even those occurring decades after expatriation, dramatically extending the reach of U.S. transfer taxes.

Further, the proposed exit transfer tax would make redundant many of the planning techniques around section 2801. The availability of the deductions and credits under chapters 11 and 12 would no longer force U.S. citizens and long-term residents to retain their status merely to avail themselves of these benefits. And there would be no more need for pre-expatriation transfers to use up the lifetime exemption. Any unused portion would now be available to shield an equivalent amount of assets from tax on the deemed bequest. That amount, whether reflected in the FMV of U.S. situs or foreign situs assets in the gross estate of the deemed bequest, would not be subject to U.S. transfer taxes again.

Conclusion

The HEART Act propounded the principle of rendering the decision to expatriate income tax-neutral by accelerating the recognition of built-in gains. But for transfer tax purposes, acceleration of built-in gains is already presumed at every transfer. The transfer itself should instead be accelerated at expatriation. And given that the taxpayer is relinquishing his U.S. citizenship or terminating his lawful permanent resident status, that accelerated transfer should logically take the form of a bequest — from a U.S. taxpayer to an NRA. That simple setup of a deemed bequest would allow the existing machinery of chapters 11 and 12 to take over and reduce tax-driven expatriations, but without the damage the section 2801 special transfer tax does to the existing transfer tax regime.

NEWS ANALYSIS

European Greens and IKEA: The €1 Billion Question

by Ryan Finley

The OECD’s final base erosion and profit-shifting project reports and the European Commission’s proposed anti-tax-avoidance directive have done nothing to quiet the controversy in Europe over the tax rates paid by multinational enterprises and the avoidance techniques they use to reduce them. The outcry is particularly poignant in the European Parliament, which has responded by summoning representatives from a long list of major multinationals before its TAXE II committee to defend their tax arrangements.

The latest contribution to the controversy is a February report published by the European Parliament Greens/European Free Alliance (Greens) titled “IKEA: Flat Pack Tax Avoidance,” which alleges that the multinational furniture retailer uses a complex array of artificial arrangements to engage in large-scale tax avoidance.

Although it addresses a number of arrangements, the report estimates that one in particular — the franchise relationship between the IKEA brand owner and the entities that operate IKEA stores — cost EU countries €1 billion in lost revenue over the 2009-2014 period. According to the report, neither the OECD’s BEPS project recommendations nor the commission’s proposed anti-tax-avoidance directive are adequate to prevent multinationals from engaging in similar practices. (Prior coverage of the IKEA report: Tax Notes Int’l, Feb. 22, 2016, p. 643. Prior coverage of the final BEPS project recommendations: Tax Notes Int’l, Oct. 12, 2015, p. 103. Prior coverage of the commission’s proposed anti-tax-avoidance directive: Tax Notes Int’l, Feb. 1, 2016, p. 394.)

The report featured prominently in the TAXE II committee’s intense questioning of Inter IKEA Holding S.A. CEO Sören Hansen at a March 15 hearing. (Prior coverage: Tax Notes Int’l, Mar. 21, 2016, p. 997.) The report’s conclusions were accepted and cited as authoritative by committee members from across the political spectrum, with committee Chair Alain Lamassoure of the center-right group of the European People’s Party commending it as “a very detailed, precise report, [and a] very well turned-out one.”

However, the report has faced criticism as well, including by Hansen in his statements before the TAXE II committee. “The so-called report,” he described it, is based on “wrong assumptions leading to wrong conclusions,” especially regarding the franchise relationship between the IKEA and Inter IKEA groups. Forbes contributor Tim Worstall titled his opinion piece on the report “The Green Party Doesn’t Grasp EU
Tax Laws Concerning IKEA” and concluded that “as is usually wise, we can just ignore the Greens on this subject as on so many others.” Nevertheless, Worstall found the report sufficiently noteworthy to address it in his column (http://goo.gl/HaNsqZ).

Given its political impact, the methods and assumptions used to calculate the €1 billion EU revenue loss estimate warrant careful examination.

Are IKEA and Inter IKEA One Entity?

Critical to the report’s headline €1 billion revenue loss estimate is the premise that “IKEA is paying royalties to itself.” However, Hansen argued before the TAXE II committee that this claim is based on “misunderstandings regarding the IKEA franchise systems and [mix-ups] between the different so-called IKEA companies.”

The IKEA business is based on a franchising system under which Inter IKEA Holding S.A., through a group subsidiary, licenses the IKEA trademark and “concept, franchises systems, methods, and solutions” to the franchisees that operate IKEA stores. By far the largest of those franchisees is the IKEA group, which as of the end of each group’s 2014 fiscal year operated 315 of the 365 IKEA stores (86 percent). If, as Hansen insisted, IKEA and Inter IKEA are two independent groups with an arm’s-length franchise relationship, this would undermine the Greens’ argument that the payments are part of a single overall tax avoidance strategy.

The parent company of the IKEA group is INGKA Holding B.V., which is wholly owned by the Stichting INGKA Foundation. Both entities are resident in the Netherlands. The parent company of the Inter IKEA group, Inter IKEA Holding S.A., is located in Luxembourg and wholly owned by Interogo Foundation in Liechtenstein. Inter IKEA Holding’s franchising division is operated by Inter IKEA Systems B.V. in the Netherlands.

The Greens’ report dismisses the claim that the IKEA and Inter IKEA groups operate independently, largely on the basis of the relationships it identifies between directors on both foundations’ boards with the Kamprad family: Stichting INGKA Foundation and Interogo Foundation were both created by INGKA B.V. founder Ingvar Kamprad, and members of the Kamprad family are guaranteed minority representation on each board. Two of the founder’s sons sit on Stichting INGKA Foundation’s five-person board, and another sits on Interogo Foundation’s seven-person supervisory council. Most of the remaining seats on both foundations’ boards are held by close business associates of the Kamprad family, and multiple individuals are former IKEA or Inter IKEA executives who have gone back and forth between the two during their careers.

For the IKEA group’s parent company, Kamprad is senior adviser to the board, and one of his sons is among the board’s seven directors. Another of Kamprad’s sons is the chair of the five-person board of Inter IKEA Holding.

Based on those relationships, the Greens’ report concludes that “the private foundations that own both corporate groups are controlled by members of the Kamprad family and a small circle of trusted associates,” and attributes the division between the two groups to a single tax avoidance strategy.

A similar conclusion was reached by Peter Sundgren, a former director with the Swedish Institute for Foreign and Commercial Law and author of the WebJournal on International Taxation in Sweden, who in 2012 wrote (http://goo.gl/lulzFA) that the boards of IKEA and Inter IKEA shared multiple directors, and that “Mr. Kamprad and his family have total control of the financial affairs of the Interogo group.”

Under article 9 of the OECD’s model tax convention, association exists when one entity (or a shared third entity) “participates directly or indirectly in the management, control or capital” of another. The Kamprad family has only minority representation on the boards of IKEA and Inter IKEA, with the remaining directors generally being close business associates, which could potentially present an obstacle to approaching the two groups as associated enterprises for tax purposes. Nevertheless, the substantial influence of Kamprad family members in both groups may lend some support to the Greens’ approach.

The Franchise Fee: Mispriced or Artificial?

As noted above, the report’s most prominent claim is that the 3 percent franchise fees paid by IKEA franchisees, including by the IKEA group, have resulted in an estimated €1 billion in lost tax revenues by EU tax authorities over the 2009-2014 period.

Because the reported effective tax rate of the Inter IKEA group is lower than that of the IKEA group (13 percent vs. 18 percent for the 2009-2014 period), payments from the latter may result in an aggregate tax benefit. However, even assuming that IKEA and Inter IKEA are associated, that royalties are paid by one to the other does not by itself establish inappropriate tax avoidance under the standards set by the OECD and incorporated into bilateral tax treaties. Entities selling under the IKEA trademark would have to pay royalties to the trademark’s owner, whether related or not, regardless of the group’s intangible holding structure. For the royalties to represent inappropriate avoidance according to current rules, they would have to be mispriced or subject to nonrecognition.

Although Inter IKEA’s largest franchisee by far is IKEA, it does have what appear to be independent franchisees as well. That Inter IKEA charges all of its franchisees the same 3 percent royalty may provide support using the comparable uncontrolled price method. However, more detailed information than is publicly available would be needed to fully assess the
comparability of those licenses and to determine the best transfer pricing method. It is possible that the prices Inter IKEA charges on its wholesale sales (accounting for €7.6 billion of its total €15.3 billion in revenue from 2009-2014) to what may be its independent franchisees in the Middle East and Asia alter the parties’ returns and render the CUP method inapplicable.

However, even if the royalty rate itself is arm’s length, the transaction may still be mispriced if Inter IKEA’s role is limited to legal ownership of the IKEA brand intangibles and it does not control any of the important risks or functions that contribute to their value. Under the guidance provided by the OECD in its report on actions 8-10 of the BEPS project, legal ownership does not by itself entitle the owner to retain any share of the returns from the intangibles. Those returns are ultimately due to the party or parties that control the risk of intangible development and the functions related to the development, enhancement, maintenance, protection, and exploitation of the intangibles. (Prior coverage: Tax Notes Int’l, Oct. 12, 2015, p. 122.)

Hansen told the TAXE II committee that Inter IKEA has more than 1,000 employees and “conducts a substantial and important business in and from the Netherlands with qualified staff, training facilities, etc.” Responding to suggestions that Inter IKEA is a conduit entity, he said, “I know it will make my colleagues at Inter IKEA Systems B.V. — a thousand of them — sad to hear that someone thinks they do not contribute to the development of the IKEA brand and rollout globally of the IKEA stores.” Inter IKEA’s website sends a consistent message, stating that Inter IKEA has “specialist competence in areas such as marketing & sales, retail logistics, store design and establishment, communication & interior design, customer relations, market research, competitor monitoring, market surveillance of new and existing markets, [and] logistics and media production.”

Assuming the accuracy of those claims, it may be difficult to argue that Inter IKEA is nothing more than a legal owner due little, if any, of the returns from the brand intangibles it licenses. According to Michael McDonald, financial economist (business and international taxation) with the U.S. Treasury Department’s Office of Tax Analysis and delegate to the OECD’s Working Party 6, control of risk is a threshold question and tax authorities shouldn’t engage in a “worldwide search for control.”

Regarding the possibility that tax authorities may disregard the transaction altogether, the OECD’s transfer pricing report approves of nonrecognition only when the transaction as structured is “commercially irrational,” and OECD officials have emphasized that this power should be exercised only under the most exceptional circumstances in which the transaction makes no economic sense. Given this restrictiveness, it may be difficult to establish that the arrangement between IKEA and Inter IKEA meets this standard. Assuming that the parties are treated as related but that the transaction is recognized, any adjustment would be limited to a reduction of the 3 percent franchise fee.

**Lost Revenue Calculations**

However, the Greens have been clear that they are unsatisfied with the standards set by the OECD’s BEPS project and the commission’s proposed anti-tax-avoidance directive, and one of the purposes of their report was to highlight the shortcomings of the rules currently in place. If the rules on selection of transfer pricing methods, entitlement to returns from intangibles, or nonrecognition were different, or if the system were changed entirely to something like formulary apportionment, a different outcome may result.

Assuming that the franchise fees are mispriced, subject to nonrecognition, or part of an inappropriate avoidance strategy permitted under current rules, questions remain regarding the way the Greens calculate revenue loss. The €1 billion figure is based on an estimate of gross franchise fees received for sales in the EU, multiplied by the average of EU countries’ statutory corporate tax rates weighted by IKEA’s number of stores in each country. For this purpose, EU sales were estimated by calculating the percentage of IKEA stores in EU countries (stated to be 61.9 percent) and multiplying that percentage by Inter IKEA’s reported revenue from franchise fees and sales through the IKEA catalog (€6.1 billion). This results in an estimate of about €3.8 billion.

Calculating lost revenue in this way makes some assumptions, the most important of which are that Inter IKEA’s franchise fees from all sources are suspect, there are no costs associated with Inter IKEA’s franchising activities that should be deducted against franchise fee revenue, and all franchise fees are deductible at the full statutory rate for IKEA group entities but face no tax at all when received by Inter IKEA.

As explained in the report, total franchise fees were calculated by multiplying the 3 percent royalty rate by the sum of Inter IKEA’s franchise fees and catalog sales. This approach assumes that all of Inter IKEA’s franchise fee revenue is associated with a tax avoidance strategy, not just the fees paid by the IKEA group. Some of the franchisees do appear to be truly independent, particularly those in Australia, southeastern Europe, the Middle East, and Asia (with the exception of the IKANO Group, which is owned by the Kamprad family).

It’s not clear why Inter IKEA’s global franchise fee revenue from both related and independent franchisees should be grouped together and then allocated back to EU countries based on the number of stores. Given the report’s focus on the fees paid specifically by “IKEA to itself,” the IKEA group, and the resulting revenue loss specifically for EU countries, multiplying 3 percent by the IKEA group’s EU sales may have been the more direct and reliable approach.
Royalty payments to an associated enterprise located in a tax haven that in all likelihood controls few, if any, of the core risks or functions relating to the licensed intangible clearly raises the income-shifting concern that the OECD’s report on actions 8-10 was meant to address. However, the post-2011 other operating charges do not include a royalty element, and at least some portion of the 2009-2011 charges is likely unrelated to those payments.

Using other operating charges as a percentage of sales for 2012 through 2014 to estimate the non-royalty portion of other operating charges for 2009 through 2011, 79 percent of those charges (€2.1 billion) consist of royalties paid to Interogo Foundation in those years. This implies a trademark royalty rate of 70.4 percent of franchise fee and catalog revenue (the royalty revenue base assumed by the Greens’ report), consistent with the 70 percent royalty cited by Sundgren in his 2012 article:

By means of what appears to be a back-to-back royalty agreement between Inter Ikea Holding and Interogo — but there could be additional agreements and companies interposed in this stratagem — 70 percent of the royalties are subsequently passed on to Interogo.

Assuming a 70 percent royalty rate and allocating the other costs to EU franchise activities based on revenue results in a cost allocation of €584 million for the 2009-2014 period, reducing the estimate of shifted income from about €3.1 billion to about €2.5 billion.

Regarding the rates at which the EU franchise fees paid by IKEA are deductible and taxable, the report’s store-weighted average tax rate estimate was between 26.7 and 27.7 percent in each year over the period compared to the IKEA group’s aggregate effective tax rate of 18.2 percent. However, much of this discrepancy is attributable to the IKEA group’s significant amounts of tax-exempt income. After removing the impacts of adjustments for tax-exempt income, non-deductible expenses, and recovered and unrecovered net operating losses, the IKEA group’s effective tax rate was 23.7 percent for the 2009-2014 period. If the goal is to estimate revenue loss resulting from the rate differentials rather than to determine what rate should have been applied as a policy matter, using this rate may be a more appropriate approach.

As noted above, the report assumes a tax rate of 0 percent on Inter IKEA’s franchise fee income, which differs significantly from the Inter IKEA group’s reported weighted-average effective tax rate of 13 percent for 2009-2014. It is likely that Inter IKEA’s reported rate is inflated by non-arm’s-length pricing of transactions with associated entities that are not included in its consolidations, and the report justifies the zero rate assumption by adding back total other operating charges and interest paid to Interogo Finance S.A. and dividing income tax paid by that amount. The resulting...
While this suggests the Greens’ estimate may be overstated by a factor of more than 250 percent, the amount (an average of €65 million each year) is still significant enough to make it difficult to “just ignore the Greens on this subject,” as Worstall advised.

**Royalties to Interogo Foundation**

Although the Greens’ report arguably overstates revenue loss strictly from the franchise fee payments from IKEA to Inter IKEA, other transactions undertaken during the same period in connection with the same overall arrangement may have resulted in additional revenue loss. Broadening the scope to include two related transactions in particular — Inter IKEA’s pre-2012 trademark royalties payments to Interogo Foundation and its post-2011 interest payments to Interogo Finance — may narrow the gap between the report’s estimate of lost tax revenue and the estimate reached above.

One implication of assuming that Inter IKEA has a tax rate greater than zero is that there is a tax arbitrage opportunity in shifting income from Inter IKEA to Interogo Foundation in Liechtenstein. Using the same 70 percent royalty rate and revenue base (franchise plus catalog revenue) assumptions used to analyze franchise fees paid by IKEA results in an estimate of €1.1 billion in shifted income.

Because the estimate of Inter IKEA’s effective tax rate on its franchise fee income discussed above is a function of those payments and the relevant period is 2009-2011, the company’s reported effective tax rates for each year during that period (ranging from 7.7 to 22.1 percent), may better reflect the rate at which it would be taxed if the payments were not made. Those estimates imply lost revenue to EU countries of €136 million over the 2009-2011 period, bringing the estimate of total avoided tax up to €525 million. If the Dutch statutory tax rate is used instead of Inter IKEA’s effective tax rate, the estimate rises to €258 million, raising the total tax avoidance estimate to €647 million.

Alternatively, as Sundgren has argued, it’s possible that the franchise fees should have triggered withholding tax. Based on the inference that there was in effect a back-to-back royalty arrangement, Sundgren has argued that Interogo Foundation was the beneficial owner of the franchise fee royalties before 2012. Because the royalties would then be treated as having been paid to an entity in Liechtenstein rather than to Inter IKEA Systems B.V. in the Netherlands, they would have been subject to source-country withholding in many countries.

Under this scenario, franchise fees paid to Inter IKEA Systems B.V. by IKEA group entities in most EU countries in which it has a major presence (including Germany, France, Sweden, and the United Kingdom) and low rates in the others (5 percent in Italy and 6 percent in Spain). In contrast, if the royalties

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**HIGHLIGHTS**

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were paid directly from IKEA group entities to Interogo Foundation, they would have triggered source-country withholding tax (generally in the range of 10 to 30 percent) in many EU member states. Liechtenstein had no double tax treaties providing for 0 percent withholding in force with EU countries that had IKEA stores during the 2009-2011 period.

According to Sundgren, Inter IKEA Systems B.V. was merely a conduit for royalties ultimately paid to Interogo Foundation, and the royalties should be treated as paid from IKEA group entities directly to Interogo Foundation.

Using a store-weighting approach (as the Greens’ report does for other allocations) to allocate estimated total EU royalties to individual member states, and applying each country’s withholding tax rate (if any) on royalties to those amounts, results in weighted-average withholding rates of about 1.7 percent for royalties paid to the Netherlands and 17.2 percent for royalties paid to Liechtenstein. This rate differential implies that over the 2009-2011 period, the IKEA group would have owed an additional €226 million in withholding tax if Interogo Foundation had been treated as the beneficial owner of the franchise fee income. Adding this to the total revenue lost from franchise fees paid to Inter IKEA brings the total to €615 million.

Interest Paid to Interogo Finance S.A.

When Inter IKEA purchased the trademark from Interogo Foundation for €9 billion in 2012, it financed the transaction in part with a €5.4 billion loan from Interogo Finance S.A., an entity associated with Interogo Foundation but excluded in Inter IKEA’s consolidations. The loan bears an interest rate of 6 percent, resulting in an interest deduction for Inter IKEA of €324 million each year. With average after-tax profit of about €323.9 million each year during the 2012-2014 period, Interogo Finance S.A.’s other sources of income, costs, and taxes represent a trivial percentage of its income. Depending on whether the interest payments were deductible at Inter IKEA’s reported effective tax rates in each year or at the full Dutch statutory rate of 25 percent, this arrangement resulted in total tax savings of between €132 million and €242 million.

The Greens’ report regards this transaction — in which Interogo Foundation appears to have indirectly financed its own sale of the IKEA trademark to Inter IKEA — as entirely artificial. By financing the purchase of the same trademark, the transaction conveyed similar intangible exploitation rights to Inter IKEA. But instead of paying royalties that will never be taxed to one “Interogo” entity under a license, Inter IKEA pays interest that will never be taxed to another “Interogo” entity under a loan agreement. Nevertheless, the transaction is unlikely to satisfy the strict standards for nonrecognition adopted in the OECD’s BEPS report on transfer pricing.

Although the actions 8-10 report provides for the reallocation of the risk and returns of intangible development based on the concept of control, there are no corresponding provisions for the risks and returns on capital, despite the overlap in concepts and the ability of companies like Inter IKEA to convert one type of transaction into the other. OECD officials and delegates to Working Party 6 have stressed that “respect for capital” is at the heart of the separate-entity approach, which was ultimately retained in the final BEPS reports. As a result, any transfer pricing-based adjustment would be limited to lowering the interest rate on the loan.

Instead, the OECD chose to address base erosion through interest payments using deductible expense limitations based on the ratio of net interest to earnings before interest, taxes, depreciation, and amortization. The OECD’s action 4 report recommends that countries adopt net interest-to-EBITDA caps of 10 to 30 percent, or if they so choose, the corresponding ratio for the multinational group as a whole (if higher). The commission’s proposed antiavoidance directive adopts the top of this range.

On a consolidated basis, Inter IKEA Holding’s net interest-to-EBITDA ratio was -3.2 percent (indicating net interest income) in 2009, 9.9 percent in 2010, and 20 percent in 2011, none of which would run afoul of the directive’s proposed cap. However, the ratio increased dramatically following the loan from Interogo Finance and the corresponding €324 million in annual interest payments, resulting in ratios of 38.2 percent in 2012, 38.6 percent in 2013, and 34.4 percent in 2014. Interest paid to Interogo Finance alone exceeded 30 percent in 2012 and 2013, falling to 29.1 percent in 2014. Assuming that Inter IKEA Holding’s property, finance, and retail divisions (which operate through different subsidiaries) had positive EBITDA each year on an aggregate basis, these ratios would increase if the analysis were applied solely to Inter IKEA Systems B.V.

If a 30 percent cap were in effect for 2012 through 2014 and applied to the Inter IKEA group as a whole, €78.8 million in interest expense would have been disallowed in 2012 and 2013, and €46.4 million would have been disallowed in 2014. If the disallowed deductions were taxed at Inter IKEA Holding’s reported effective tax rate in each year, it would have owed additional tax of €9.1 million in 2012, €10.8 million in 2013, and €7.2 million in 2014 for a total of €27.2 million. Depending on whether the disallowed interest expense would have been taxable at Inter IKEA’s effective tax rates or the Dutch statutory rate, the 30 percent cap would have eliminated €27 million to €51 million (or about 21 percent in either case) of the tax benefit resulting from the loan, increasing its 2012-2014 effective tax rate from 13.7 percent to between 15.4 and 16.9 percent. Its 2009-2011 rate would not have been affected.
These increases are likely too modest to satisfy the Greens. But as the commission’s proposed anti-tax-avoidance directive says, its purpose is to set minimum standards, and member states are free to adopt stricter limitations in their domestic laws. If the lower bound of 10 percent applied during the period, Inter IKEA’s 2012-2014 effective tax rate would have risen to between 20.4 and 26 percent, depending on the rate assumptions. Between €111.4 million and €201.8 million of the benefit, which in each case would have accounted for between 83 and 85 percent, would have been eliminated.

Conclusion

For the reasons discussed above, the Greens’ €1 billion estimate may be inflated, especially to the extent that it relates only to the franchise fees paid by IKEA group entities to Inter IKEA. However, even a critical assessment of their approach results in an estimate of between €657 million and €890 million if the Inter IKEA and IKEA groups are treated as related parties and the royalties paid to Interogo Foundation and interest paid to Interogo Finance are taken as part of the same overall arrangement. Nothing in the OECD’s BEPS report on transfer pricing makes it clear whether IKEA and Inter IKEA should be treated as associated enterprises, and the 3 percent franchise fee may be supportable even if they should. Assuming, as is likely, that the arrangement doesn’t satisfy the strict criteria for nonrecognition, any adjustment would have to be made on the basis of pricing. If Inter IKEA’s franchise relationships with unrelated parties are comparable to its franchise relationship with the IKEA group, the uniform 3 percent royalty may be difficult to challenge under current standards. If the royalty rate can in fact be supported as arm’s length, the estimated €389 million aggregate tax benefit would remain.

Regarding the royalties paid by Inter IKEA to Interogo Foundation before 2012, the standards adopted in the OECD’s transfer pricing report may warrant disallowing deductions for these payments. As owner of Inter IKEA Holding, there is no question whether the foundation is an associated enterprise. To the extent that Interogo Foundation’s role was limited to legal ownership of the trademark and Inter IKEA group entities controlled all of the important risks and functions related to the trademark, they would be entitled to the entire return associated with it. Alternatively, the royalties could have been subject to source-country withholding under either the standards in place at the time, those in the OECD’s action 6 report, or the proposed EU antiavoidance directive. Depending on which approach is appropriate, the estimated total tax benefit would be reduced by between €136 million and €258 million.

Given its mechanical application, the OECD’s BEPS report on action 4 would restrict Inter IKEA’s 2012-2014 interest expense regardless of its relationship with other entities. Depending on the fixed ratio adopted and tax rate assumptions, the tax benefit of €132 million to €242 million could be reduced by between €27 million and €202 million if applied to Inter IKEA on a consolidated basis. Under any tax rate assumptions, the 30 percent interest expense limitation in the commission’s proposed antiavoidance directive would eliminate only about 21 percent of the tax benefit resulting from these payments. In contrast, adopting a fixed ratio of 10 percent (the lower end of the OECD’s recommended range) would eliminate between 83 and 85 percent of the benefit.

These estimates imply that of the €657 million to €890 million in tax benefits, only €163 million to €460 million would have been eliminated had the post-BEPS standards applied during the period. This corroborates the Greens’ argument that under the BEPS project recommendations and the commission’s proposed anti-avoidance directive, multinational groups can still enjoy significant tax benefits using transactions between associated enterprises. Whether their calls for greater transparency and a common consolidated corporate tax base in the EU would be effective in significantly reducing these benefits is unclear, but the Greens may be right that the new standards will allow substantial tax avoidance to continue.

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Saying what others fear to say as only she can say it.

“A tax return is an attested document. It is signed by the taxpayer and the preparer under penalties of perjury. It is not an opening offer.”

— Lee Sheppard,
Contributing Editor
Only in the publications of Tax Analysts
Tax Analysts’ Transfer Pricing Roundup reports on transfer pricing controversies disclosed in SEC filings and from other sources, foreign and domestic.

Albemarle Corp.

Albemarle Corp., a chemical company headquartered in Baton Rouge, Louisiana, reported in a March Form 10-K that its liabilities related to uncertain tax positions were reduced by $50.9 million in 2015 and $22.1 million in 2014 because of offsetting benefits due in part to the effects of potential transfer pricing adjustments.

Jurisdiction(s): Undisclosed

Allergan PLC

Allergan PLC, a global pharmaceuticals company headquartered in Dublin, Ireland, reported in a February Form 10-K that it recorded a $14 million increase in 2015, largely attributable to a U.S. federal tax issue regarding transfer pricing. The company believes it is reasonably possible that it will resolve the issue for 2014-2015 during the next 12 months, for which it has an unrecognized tax balance of $15 million.

Jurisdiction(s): United States

AmTrust Financial Services Inc.

AmTrust Financial Services Inc., a property and casualty insurance company based in New York, reported in a February Form 10-K that during 2015, its provision for income tax benefited from a return to provision adjustment during the third quarter of approximately $80 million. The return was driven primarily by changes in permanent transfer pricing tax adjustments.

Jurisdiction(s): Undisclosed

Baxter International Inc.

Baxter International Inc., an American healthcare company headquartered in Deerfield, Illinois, reported in a February Form 10-K that factors adversely affecting the company’s effective tax rate in 2015 included charges related to contingent tax matters regarding transfer pricing and the separation of its biopharmaceuticals business Baxalta.

Jurisdiction(s): United States

Denali Holding Inc.

Denali Holding Inc., a Delaware holding company for Dell Inc., reported in a March Form S-4/A that as of January 29, 2016, accrued interest and penalties were $950 million, offset by tax benefits of $372 million from transfer pricing, interest deductions, and state income tax.

Jurisdiction(s): Undisclosed

Marriott International Inc.

Marriott International Inc., a hospitality company and hotel chain headquartered in Bethesda, Maryland, reported in a February Form 10-K that it recorded a $14 million increase in 2015, largely attributable to a U.S. federal tax issue regarding transfer pricing. The company believes it is reasonably possible that it will resolve the issue for 2014-2015 during the next 12 months, for which it has an unrecognized tax balance of $15 million.

Jurisdiction(s): United States

Mosaic Co.

Mosaic Co., a specialty products mining company headquartered in Plymouth, Minnesota, reported in a February Form 10-K that it received a benefit of $14.5 million primarily related to changes in estimates associated with an advance pricing agreement.

Jurisdiction(s): Undisclosed
SL Industries Inc.

SL Industries Inc., an American manufacturing company headquartered in Mount Laurel, New Jersey, reported in a March Form 10-K that its effective tax rate from continuing operations during 2015 decreased from 33 percent to 31 percent from 2014, partially due to a favorable settlement with the U.S. Treasury department regarding the company’s transfer pricing policies in China.

Jurisdiction(s): China, United States

Voltari Corp.

Voltari Corp., a commercial real estate business based in New York, reported in a March Form 10-K that in 2016 it received notification of a tax assessment from Indian tax authorities asserting underreported transfer pricing income by the company’s subsidiary, Motricity India Pvt. Ltd., for the fiscal year ended March 31, 2012. The assessment could result in tax, penalties, and interest totaling approximately $400,000.

Jurisdiction(s): India

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Call for Entries:

Tax Analysts’ Annual
Student Writing Competition

Tax Analysts is pleased to announce the opening of its annual student writing competition for 2016. This global competition enables students who win to publish a paper in Tax Notes, State Tax Notes, or Tax Notes International and receive a 12-month online subscription to all three weekly magazines after graduation. Submissions are judged on originality of argument, content, grammar, and overall quality.

- Students must be enrolled in a law, business, or public policy program.
- Papers should be between 2,500 and 12,000 words and focus on an unsettled question in federal, international, or U.S. state tax law policy.
- Papers must not have been published elsewhere.
- Deadline for entries is May 31, 2016.

Submissions should be sent to: studentwritingcomp@taxanalysts.org

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Australia

Turnbull Seeks to Give States Authority to Levy Income Tax

Australian Prime Minister Malcolm Turnbull said he will ask Australia’s states to enter into an agreement that will allow them to impose personal income taxes in an amount equal to an as-yet unidentified reduction, by percentage, of the tax rate levied by the federal government.

Under the current system, only the federal government imposes tax on personal income. The government then makes grants to the states to provide funding for a variety of programs. “The states do not raise enough money and so every year, and often several times a year, they go cap in hand to Canberra and complain that the federal government is not giving them enough money,” Turnbull said. Giving states “real financial autonomy” would put an end to “this depressing blame game where no one really knows who is responsible for what,” he added.

While Turnbull didn’t specify the percentage of the tax rate that the federal government would forgo in favor of the states, he said he wants the states to eventually have even more latitude in their ability to levy taxes. “In future, of course a state should be free to lower that amount or indeed raise it, and then they are accountable to their own voters,” Turnbull said.

He said the Australian Taxation Office would continue to collect all personal income taxes under the plan being considered, with the federal government transferring to the states their share of the revenue once payments are received from taxpayers. Under the contemplated agreement, the federal government would no longer make grants to the states for certain programs, so there would be no net financial impact on the national budget, Turnbull said.

“The gain is greater accountability, greater transparency,” he said. “Australians will have a much better idea of who is responsible for what, who pays for what, and if a state government, over time, wants to raise more money by lifting taxes, well it will be answerable to the public just indeed as we are to the people of Australia.”

Criticism of the Plan

Turnbull apparently doesn’t expect his plan to come to fruition over the short term. “I’ve got great optimism that the premiers and the chief ministers will see the importance of this objective and, over the next few years, work to realize it so that our Federal Commonwealth of Australia works and serves the people of Australia better than ever,” he said.

According to the Australian Treasury Department, income taxes were levied at both the state and federal levels from 1915 to 1942, a practice that the government said led to complexity and inequitable taxation across states. In 1942 income taxation was consolidated by the federal government to increase revenue as a war-time measure, with the states receiving grants to meet their spending needs.

Sinclair Davidson of RMIT University said the states retained authority under the constitution to levy their own income taxes. “A major reform like [Turnbull’s proposal would] require a lengthy rollout period,” Davidson said. “It would simply require legislation to pass the Federal Parliament and various state parliaments. That could take time.”

Davidson said he favors Turnbull’s proposal, which he said mirrors a submission he made to the Senate in 2008. “If done well, this could be a very good policy,” he said. “Odds are, though, it won’t be.”

“The model assumes tax competition between the states will kick in to keep the rates low,” said Chris Evans of the University of New South Wales. Evans described the proposal, which he says would not go into effect until 2020 at the earliest, as neither sensible nor feasible. It “does not solve the tax mix issues and will only serve to complicate the system even more and make tax advisers even wealthier,” he said.

The premiers of at least two Australian states said Turnbull’s proposal is unworkable. ABC News, a publication of the Australian Broadcasting Corp., quoted South Australian Premier Jay Weatherill as saying that the plan isn’t practical. “I couldn’t imagine a state
would be interested in doing that,” Weatherill said. “It’d create a lot of confusion across the federation. It’d be very impractical to administer.” Tasmanian Premier Will Hodgman said his state might lose out to larger states under the plan. “We are a state that is small and with a demographic profile that would disadvantage us against other states,” ABC News quoted Hodgman as saying.

Alternate GST Increase Rejected

Turnbull’s proposal appears to replace a recently discarded plan to increase the goods and services tax rate, which is collected by the federal government for distribution to the states. Treasurer Scott Morrison ruled out any possibility of a GST increase before the next round of national elections, which must take place within the next 10 months. (Prior coverage: Tax Notes Int’l, Feb. 22, 2016, p. 639.)

Davidson said that allowing the states the authority to levy income taxes makes more sense than increasing the GST rate. “It makes the states more accountable for their own expenditure,” he said. “The GST is lazy policy; it is hard policy.”

Evans disagreed. “The solution to the current revenue inadequacy does not lie with shifting the tax blame from the federal government to the states, but with the removal of the massive amount of tax giveaways [such as] deductions, offsets, [and] reliefs that are currently available to the wealthy, combined with a small extension of the GST,” Evans said. The solution is a broader base and lower rates for the income tax, combined with a broader base “and the same low rate” for the GST, he said.

The system described by Turnbull appears somewhat similar to the system in Canada, where the federal and provincial governments have entered into agreements allowing the Canada Revenue Agency to collect personal income taxes for all provinces and territories except Quebec. The CRA also collects corporate income taxes on behalf of all provinces and territories except Alberta and Quebec.

Turnbull said the plan allowing states to tax incomes would not apply to companies, but Davidson said that authorizing the states to impose company tax as well is a theoretical possibility. “It would depend on what exactly the Commonwealth (federal government) stopped doing,” Davidson said. “If they stuck very strictly to their constitutionally mandated activities, they wouldn’t need very much revenue and then could share corporate tax revenue with the states.”

One complication to allowing the states to tax corporations is Australia’s dividend imputation system, Davidson said. Under that system, companies can pass credits for corporate tax paid as franking credits to their Australian shareholders, who can use them to reduce their own individual tax liabilities for any dividends received.

Brazil

Ex-President Calls for Tax Incentives To Grow Economy

Brazil’s former President Luiz Inácio Lula da Silva, whose recent appointment as chief of staff to his successor was blocked pending judicial review, said Brazil needs to implement tax incentives and increase consumer credit to pull its economy out of a prolonged slump.

However, da Silva didn’t provide any specifics about the tax incentives that he says President Dilma Rousseff’s government should try to push through Congress.

The Brazilian economy, which has been hammered by falling prices for key exports such as iron ore and oil, declined by 3.8 percent in 2015. On March 28 the Central Bank released the results of its weekly survey of 100 private-sector economists, who predicted that the economy will slump a further 3.66 percent in 2016. The bleak outlook is in sharp contrast to da Silva’s eight-year presidency, when the economy averaged annual growth rates in excess of 4 percent.

Da Silva has been under investigation for influence peddling in the years since he was succeeded by Rousseff as president in 2011. Da Silva allegedly received substantial economic benefits in return for lobbying on behalf of Odebrecht, Brazil’s largest construction company. Odebrecht’s president was sentenced on March 8 to 19 years in prison for his role in a wide-ranging scandal involving Petrobras, a publicly listed but government-controlled oil company. Prosecutors allege that Odebrecht and other companies entered into overpriced contracts with Petrobras and then funneled a large part of the overpayments back to the Workers’ Party, which was founded by da Silva. Police searched da Silva’s house on March 4 and later detained the former president for questioning. Da Silva has vehemently denied any wrongdoing. While not accused of any involvement in the Petrobras scandal, Rousseff chaired its board of directors between 2002 and 2009. She is also a member of the Workers’ Party.

On March 16 Rousseff appointed da Silva to the Cabinet-level post of chief of staff, a move that she said was necessary because he is a “skillful political negotiator” who could assure passage of critical economic reforms. However, many opponents say the appointment was made only to shelter her predecessor.
from indictment. Under Brazilian law, Cabinet members can be tried only by the Supreme Court, on which all but three of the 11 current justices were appointed by either da Silva or Rousseff. A Supreme Court justice blocked da Silva’s appointment as chief of staff until the full court can review the matter.

Rousseff is herself facing impeachment proceedings based on allegations by Brazil’s Federal Accounts Court that she manipulated fiscal accounts during the 2014 presidential election campaign to cover up a widening fiscal deficit that might have jeopardized her re-election. (Prior coverage: Tax Notes Int’t, Dec. 21, 2015, p. 1004.) On March 28 the Order of Attorneys of Brazil, the country’s bar association, filed a petition asking the National Congress to broaden its impeachment investigation to include a charge of obstruction of justice based on allegations that Rousseff made the appointment to help da Silva avoid prosecution. Both da Silva and Rousseff have likened the impeachment efforts to a political coup d’état.

Rousseff’s chances of surviving impeachment apparently worsened on March 29 with a decision by the Brazilian Democratic Movement Party (PMDB) to abandon the ruling coalition it had formed with Rousseff’s Workers’ Party. The rupture freed PMDB members to decide whether the president should be forced out of office.

Political Posturing

Some financial professionals weren’t surprised that da Silva failed to provide any specifics during a March 28 press conference about the tax incentives he thinks are necessary for the economy. “We believe he was only talking to ‘his audience,’ the Workers’ Party political base, and in practice, would not go any further in giving new tax breaks or exemptions as these were ‘considered’ the main drivers of today’s fiscal crisis,” Bruno Lavieri of 4E Consultoria, an economics consulting firm, said in an email.

With the close scrutiny being applied to Brazil’s fiscal and economic situations by financial markets and rating agencies, Lavieri said it is unlikely that any tax incentives will actually be implemented. Rousseff’s likely impeachment further scuttles the slim possibility that any tax incentive measures will be presented to Congress, he said.

Luis Eduardo Schoueri of the University of São Paulo agreed that the chances that any tax incentives will be proposed soon are extremely low. “[Da Silva] is a populist and he just says what he thinks people want to hear,” Schoueri said. “The government has no money, so talking about incentives doesn’t make sense. They should be talking instead about spending cuts.”

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Bulgaria

Supreme Court Interprets Law on Tax Evasion

The Supreme Court of Cassation of Bulgaria issued an interpretative ruling that clarifies substantive and procedural matters related to criminal misreporting and nonpayment of tax liabilities. The ruling, which is binding for all courts and executive bodies in Bulgaria, was requested by the chief prosecutor to address conflicting and inconsistent court practices regarding tax evasion.

According to the Penal Code of Bulgaria, tax evasion is treated and prosecuted as a criminal offense only if the unreported/unpaid amount exceeds BGN 3,000 (about $1,713). The general rule is that such criminal liability can arise only for individuals.

Considering that legal entities account for a huge percentage of tax evasion cases, the most crucial part of the Court’s ruling addresses the matter of who should be held liable for companies’ criminal tax non-compliance.

The Crime — Who’s Responsible?

The ruling states that the principal perpetrators of tax evasion may be not only officially appointed individuals holding representative powers within a company, such as managers and CEOs, but also any individual who is legally employed or formally commissioned to perform the tax-related duties of the company itself, such as filing tax returns, bookkeeping, and accounting. Proxies, assignees, agents, and accountants are examples of individuals who may be subject to criminal prosecution.

It is therefore crucial for employees and independent service providers who are responsible for accounting and other tax-related company duties to consider urgent steps to mitigate the risk of criminal prosecution.

Civil Lawsuit and Liability

The ruling further states that the criminal act of tax evasion also represents a delict that gives the state the right to a civil claim up to the evaded amount.

As a result, a duly proven crime of tax evasion simultaneously fulfills the elements of a delict and presents grounds for the state to seek repayment of the monetary damages.

1 Delict (civil law), a civil wrong consisting of an intentional/negligent breach of the general duty of care that inflicts loss or harm and leads to a liability. The term is generally comparable, though not necessarily identical, to the similar common law term “tort.”
According to the Court, it is permissible for such a civil lawsuit to be brought by the state in the criminal case and for that lawsuit to be reviewed jointly by the respective court in the same trial. Such a civil claim is distinct from the claim based on the tax assessment act issued by the revenue authorities to the respective company.

However, because the state seeks the repayment of the same amount through each of the two claims, the collection of the amount through either claim negates the other so as to prevent unjust enrichment.

Finally, full repayment or conservancy of the tax evasion damages is a prerequisite for remitting criminal liability and replacing it with administrative sanctions or reaching a resolution by settlement with the state. The application of those leniency measures does not require that the payment be made by the offender himself, but allows for payment by any other person.

♦ Ivan Filchev, associate, and Anelia Tatarova, tax attorney, Tatarova Law Firm, Sofia

China (P.R.C.)

Long-Awaited VAT Pilot Rules Cover All Sectors

As of May 1, all taxpayers in China — including those in the construction, real estate, financial, and living service sectors — will pay VAT in place of business tax under the country’s nationwide VAT pilot program.


Taxpayers and Withholding Agents

According to Circular 36, entities and individuals will be subject to VAT, and not business tax, on the provision of services and the sale of intangible assets and immovable property in China.

Taxpayers are divided into general taxpayers and small-scale taxpayers. As a rule, a taxpayer will be considered a general taxpayer if the amount of its annual transactions covered by the VAT pilot program is at least CNY 5 million (about $766,542), subject to possible adjustment by the Ministry of Finance and State Administration of Taxation (SAT). Those that do not meet that minimum threshold are small-scale taxpayers.

Circular 36 states that taxpayers that do not meet the CNY 5 million threshold may register as general taxpayers with the competent tax authorities if they can set up and maintain accounting books in accordance with the country’s uniform accounting system and provide accurate tax documents.

If foreign entities and individuals carry out taxable transactions in China but have no business entities there, Chinese buyers (or Chinese recipients of services) will be the statutory withholding agents and must withhold and pay the VAT, unless provided otherwise by the MOF and SAT.

Taxable Scope

Services

Services covered by the VAT pilot program are:
- transportation by road, water, air, and pipeline;
- postal services;
- telecommunication services;
- construction, installation, repair, and decoration services;
- financial services, including insurance services and the sale of financial products;
- research and development services; information technology services; logistics ancillary services; lease services; certification and consulting services; radio, film, and television services; business ancillary services; and other “modern services”; and
- living services, including culture, sports, education, healthcare, tourism, entertainment, meals, and accommodation.

Intangible Assets

The sale of intangible assets refers to the transfer of ownership or of the right to use intangibles. For that purpose, intangibles are defined as any assets without physical form that can derive economic benefits, including patents, technical know-how, trademarks, copyrights, goodwill, and the right to use natural resources.

Immovable Property

Immovable property is defined as any property that is not movable or whose nature or physical form will change as a result of moving, including buildings and structures such as roads, bridges, tunnels, and dams.

Taxable and Nontaxable Events

Taxable Events

The provision of services or the sale of intangible assets or immovable property in China is subject to VAT, unless otherwise exempted.
Services other than the lease of immovable property will be considered to be provided in China if either the service provider or the service recipient is located in China. Similarly, intangible assets, other than the right to use natural resources, will be considered to be sold in China if either the seller or the buyer is located in China.

The sale or lease of immovable property situated in China will be considered to occur in China. Similarly, the transfer of the right to use natural resources located in China will be treated as occurring in China.

Nontaxable Events
Foreign entities and individuals will be excluded from VAT in China on:
- the provision of services to domestic entities and individuals if the services occur entirely outside China;
- the sale of intangible assets to domestic entities and individuals if the intangibles are used entirely outside China;
- the lease of tangible, movable property to domestic entities and individuals if the property is used entirely outside China; and
- other nontaxable transactions stipulated by the MOF and SAT.

Applicable Tax Rates
The VAT rates under the VAT pilot program are:
- 17 percent for the lease of tangible, movable property;
- 11 percent for the provision of transportation, postal, fundamental telecom, and construction services, the sale or lease of immovable property, and the transfer of land use rights;
- 6 percent for all taxable transactions covered by the VAT pilot program, other than those subject to the 17 percent, 11 percent, or zero rate; and
- zero for cross-border taxable services provided by domestic entities and individuals.

VAT Calculation

General Taxpayers
General taxpayers apply the general VAT calculation method that allows them to deduct input VAT from output VAT in computing VAT liability. The output VAT is equal to the sale amount (excluding the VAT itself) multiplied by an applicable VAT rate as listed above.

Small-Scale Taxpayers
Small-scale taxpayers apply the simplified VAT calculation method under which they cannot use input VAT as a credit, but will calculate their VAT liability by multiplying the sale amount (excluding the VAT itself) by a tax collection rate. The tax collection rate is 3 percent, unless otherwise provided by the MOF and SAT.

Foreign Taxpayers
If a foreign entity or individual carries out a taxable transaction in China but has no business entity there, the Chinese withholding agent will withhold and pay the VAT on the transaction by multiplying the amount of the payment (excluding the VAT itself) by an applicable tax rate as listed above.

Cross-Border Transactions
Cross-border services and intangible property transactions carried out by Chinese taxpayers are generally entitled to either a zero-rate VAT or a VAT exemption.

Under the zero-rate VAT treatment, Chinese general VAT payers are exempt from output VAT on qualifying services they provide to foreign entities, and are entitled to use input VAT paid on goods and services as a credit against the output VAT. The excess input VAT is refundable to the general taxpayers. Small-scale taxpayers are not entitled to the VAT credit or refund but can be exempt from VAT on those VAT transactions.

Under the VAT exemption treatment, all taxpayers are exempt from VAT on tax-exempt transactions but cannot use input VAT as a credit and receive no VAT refund for those transactions.

Zero-Rated VAT Transactions
According to Circular 36, domestic entities and individuals will be eligible for zero-rate VAT on the provision of international transportation services and aerospace transportation services. Transportation services are considered to be international if passengers or goods are transported out of mainland China or into mainland China from elsewhere, or if the transportation of passengers or goods occurs outside mainland China. For that purpose, international transportation services include transportation between mainland China and Hong Kong, Macau, and Taiwan, as well as transportation in the three regions.

Domestic entities and individuals will also be entitled to a zero-rate VAT on the provision of the following services, or the transfer of technology, to foreign entities if the service recipient, or the use of the technology, is located outside China and unrelated to domestic goods and immovable property:
- R&D services;
- contract energy management services;
- design services;
- the creation and issue of radio, film, and television products;
- software services;
- the design and testing of circuit products;
- information system services;
- business process management services; and
offshore outsourcing services, including offshore IT outsourcing services, business process outsourcing services, and knowledge process outsourcing services.

Tax-Exempt Transactions

Domestic entities and individuals (other than those qualifying for a zero-rate VAT) will be exempt from VAT on the provision of the following services:

- construction services for projects located outside China;
- construction supervisory services for projects located outside China;
- geographical and geological surveys and exploration for engineering projects and mineral resources outside China;
- services for conventions and exhibitions held outside China;
- warehousing located outside China;
- the lease of tangible, movable property used outside China;
- the broadcasting of radio, film, and television products outside China;
- culture, sports, education, healthcare, and tourism services provided outside China;
- postal, delivery, and insurance services for exported goods;
- financial services for foreign entities if the services are unrelated to domestic goods, intangible assets, and immovable property; and
- any other tax-exempt services stipulated by the MOF and SAT.

The provision of the following services or the sale of intangibles by Chinese entities or individuals to foreign entities will also be exempt from VAT if the service recipient, or the use of the intangibles, is located outside China and unrelated to domestic goods and immovable property:

- telecom services;
- intellectual property services;
- transportation ancillary services, excluding warehouse and delivery services;
- certification and consulting services;
- professional technical services;
- business ancillary services; and
- advertisements published outside China.

Jinji (Glen) Wei, certified tax adviser, attorney, and CPA

VAT Pilot Rules a Win for Real Estate, Practitioner Says

The real estate sector of the Chinese economy was the winner in the recent expansion of China’s VAT rules to cover all sectors of the economy, according to Sarah Chin of Deloitte’s Hong Kong office.

On March 24 China’s Ministry of Finance and State Administration of Taxation announced that the real estate, financial services, and living services sectors of the economy would be subject to VAT under the country’s pilot program. Previously, those sectors were subject to business tax and not VAT. The details of the program were laid out in Caishui [2016] 36 (Circular 36), dated March 23.

During a March 29 Deloitte webcast on indirect taxes in China, India, and Malaysia, Chin explained that Circular 36 will allow the input VAT on newly acquired real estate to be deducted over a two-year period, with 60 percent deducted in the first year and 40 percent in the second. “This is significant because under the old regulations, the input tax deductible spread over a 20-year period, so this brings a significant cash flow,” Chin said.

The real estate sector will also benefit from a provision allowing taxpayers in construction to pay VAT under a simplified method, Chin said. The simplified method will allow construction businesses to pay a flat VAT rate of 3 percent, but it does not allow for an input deduction, she said. “So, for constructors who have incurred limited VAT in the past, this is a significant planning idea,” she said.

Taxpayers involved in the leasing or sale of property acquired before April 30, 2016, can also opt for the simplified method under Circular 36, but they will be taxed at a 5 percent rate, Chin said, adding that this is a transitional rule.

A ‘Bold’ Decision

Circular 36 details how VAT will be applied to financial products, Chin said.

“This was a bold decision taken by China, and as a result, has been watched by many tax authorities across the world because it is fair to say that China will be one of the first countries to tax FS more expansively than others,” Chin said. “So if China implements this well, it will be interesting to see whether other countries will follow suit and try to apply more VAT on [financial services] transactions.”

The regulations for Circular 36 contain a lot of detailed comments regarding the taxation of financial services, such as when a service has been exempted or when invoices need to be generated, Chin said. “This particular section needs a lot of careful understanding of the regulations so that the exemptions can be maximized,” she said.
Any input VAT costs incurred on investments or financial advisory commission fees directly related to loans directly borrowed by a taxpayer will be disallowed, Chin said. “And knowing the complexity of the sector, the government has decided to allow banks, and this is only banks, to be able to file their VAT returns on a quarterly basis,” she said.

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VAT Expansion May Eliminate Exemption for Overseas Banks

While the business tax provided an exemption for transactions between Chinese financial institutions and overseas banks, the recent expansion of VAT to cover financial services transactions appears to limit the exemption to Chinese financial institutions, according to Sarah Chin of Deloitte’s Hong Kong office.

“If this is the case, it is going to create an impact, and probably quite a significant impact, on the banks,” Chin said during a March 31 webcast on China’s VAT reform and the implementation of Caishui [2016] 36 (Circular 36). “So this is something that many banks have voiced a concern over. The regulations are not clear, and it will be something that we will be taking to the government.”

On March 24 China’s Ministry of Finance and State Administration of Taxation released Circular 36, dated March 23, which laid out the final stage of the country’s pilot program for VAT reform. The circular details how the VAT will be applied to the real estate, financial services, and living services sectors of the economy. Those sectors had been subject to China’s business tax and not the VAT.

Chin said there will only be two situations when cross-border transactions will be exempt from VAT under Circular 36. The first will be insurance services for exported goods. The second will be finance services provided for transactions between overseas enterprises that are not related to any goods, intangibles, or immovable property located in China.

Finally, Chin observed that under Circular 36, the VAT on all loan interest and related financial advisory fees, handling fees, and consulting fees cannot be credited by the borrower. “From a commercial point of view, it will affect the banks’ ability to pass on the VAT to the borrower because they are not able to deduct this,” she said.

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Denmark

Government Submits Amendments to Dividend Tax Regime

Danish Minister of Taxation Karsten Lauritzen presented a bill to parliament that would make several changes to the Danish participation exemption for shareholdings in subsidiaries.

If Bill 123 is passed in its present form, Danish holding companies will be able to reclaim corporate taxes pertaining to certain foreign shareholdings since 2007.

Enhanced Participation Exemption

The Danish participation exemption generally implies that capital gains and dividends received on shareholdings in subsidiaries are tax-exempt if the Danish holding company has a stake of at least 10 percent in the subsidiary.

Bill 123 would expand the application of the participation exemption to holdings in foreign subsidiaries. Currently, the participation exemption applies only if the subsidiary is located within the EU or in a jurisdiction that has entered into a tax treaty with Denmark. Going forward, the participation exemption would apply if the subsidiary is resident and subject to tax in a jurisdiction that exchanges information in tax matters with Danish tax authorities (for example, through a tax treaty, a tax information exchange agreement, an EU directive, or the OECD Convention on Mutual Administrative Assistance in Tax Matters).

The introduction of an information exchange condition instead of the customary tax treaty requirement implies a significant expansion of the participation exemption. According to the Danish Ministry of Taxation, Denmark has entered into TIEAs with 45 countries, including traditional and potential tax havens.1 Botswana, Costa Rica, Guatemala, the United Arab Emirates, Uruguay, and Vanuatu, however, have yet to ratify the agreements, so the participation exemption would not (yet) apply for subsidiaries in those jurisdictions, pending the ratification of a TIEA or the OECD Convention on Mutual Administrative Assistance in Tax Matters.

Danish corporate income tax would apply to dividends from a foreign subsidiary at the rate of 22 percent if the foreign subsidiary is not subject to a corporate income tax, or the relevant corporate income tax

applies at a rate of zero percent, in the jurisdiction in which the subsidiary is resident.

The proposal for an enhanced participation exemption is a direct consequence of the September 11, 2014, judgment of the Court of Justice of the European Union in Kronos International Inc. v. Germany, C-47/12. In its decision, the CJEU held that an EU resident company could invoke the principle of free movement of capital in article 63 of the Treaty on the Functioning of the European Union (TFEU) with respect to shareholdings in subsidiaries outside the EU — even if the participation in the subsidiary exceeds 10 percent.

Bill 123 explicitly acknowledges that as a result of the CJEU judgment, the current Danish legislation violates the EU principle of free movement of capital (because dividends paid to Danish companies by foreign subsidiaries resident outside the EU have generally been subject to Danish corporate income tax, while subsidiaries resident in Denmark or within the EU have generally been tax-exempt). As a consequence, the bill would grant access to reclaim Danish corporate income taxes paid since 2007 on capital gains and dividends from foreign subsidiaries, to the extent that Denmark’s taxation of that income violated the principle of free movement of capital.

The bill, however, would not affect the tax exemption for capital gains and dividends received by Danish parent companies from shareholdings in a foreign group company. The bill’s definition of a group reflects the definition for accounting purposes under International Accounting Standard 27 (that is, a foreign company is generally considered to be a group company if, for example, the Danish parent company holds a share participation of more than 50 percent in the foreign subsidiary).

**Withholding Tax Rate**

In addition to the enhanced participation exemption for Danish holding companies, Bill 123 would reduce the Danish withholding tax rate from a maximum of 27 percent to a maximum of 22 percent in all cases in which the recipient is a foreign company. The reduced rate would apply regardless of whether the recipient qualifies as the beneficial owner.

Currently, there is a general 27 percent Danish withholding tax on dividends paid by Danish companies to foreign corporate or individual shareholders that do not qualify for the outbound dividend participation exemption. The participation exemption applies to outbound dividends from a Danish subsidiary to a foreign company resident in another EU country or a tax treaty jurisdiction that holds at least 10 percent of the share capital in the Danish subsidiary. However, the participation exemption does not apply if the foreign company does not qualify as the beneficial owner of the dividends.

The reduced tax rate is a consequence of the current Danish corporate income tax rate of 22 percent. According to Bill 123, the 27 percent withholding tax rate constitutes a violation of the general principle of freedom of establishment in article 49 of the TFEU to the extent that the final withholding tax rate is imposed on foreign companies resident in the EU (because the tax rate exceeds the Danish corporate income tax rate). If a company in the EU has been subject to the Danish withholding tax on dividends received in 2007 or later, the bill would grant access to a refund, which would entail a reduction of the final withholding tax to correspond to the Danish corporate income tax rate.

It should be noted that the bill presumes that if a participation in a subsidiary exceeds 10 percent, the principle of free movement of capital would apply solely to inbound dividends (that is, investments by EU companies in non-EU subsidiaries) and not to outbound dividends (investments by non-EU companies in EU subsidiaries). Even though Bill 123 also intends to reduce the withholding tax rate for non-EU corporate shareholders, the reduced rate would not have retroactive effect from 2007, and therefore no refund would be granted for such non-EU shareholders. For non-EU shareholders, the reduced withholding tax rate would apply as of July 1.

Under the current regime, the Danish withholding tax is reduced to 15 percent if the foreign shareholder is a company holding a stake of less than 10 percent in the Danish dividend-paying company and the shareholder is resident in a jurisdiction that exchanges information in tax matters with Denmark.

If the recipient is entitled to a reduced tax rate under a tax treaty, the Danish company is still typically required to withhold and settle the 27 percent dividend tax with Danish tax authorities. The reduced tax treaty rate is then subject to a formal withholding tax refund claim to Danish tax authorities. As a result of an ongoing investigation into significant criminal offenses against Danish tax authorities, all claims for refunds of dividend tax were, since August 2015, put on hold temporarily. Some media reports have suggested that dividend tax refunds resumed on March 17, but no official notices or confirmation have been released.

**Antiabuse Measures**

The bill also contains a new antiabuse measure relating to investment funds and unit trusts.

The current regime enables Danish investment funds and unit trusts to redeem investors’ certificates for cash, free of Danish withholding tax. Foreign investors in Danish investment funds, unit trusts, and so forth, would otherwise often be subject to Danish withholding tax at a rate of 15 percent.

Because foreign shareholders can redeem certificates for cash to circumvent Danish withholding taxation

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1 See http://www.skat.dk/SKAT.aspx?oId=2178493&vId=0.
(for example, in the case of a pro rata redemption of certificates held by all investors), the bill establishes that a redemption would be classified as a dividend distribution for Danish tax purposes going forward, unless certificates in the investment fund or unit trust are offered to the public and the fund or trust is subject to statutory rules regarding the redemption of certificates upon request from the investors and diversity of risk.

Further, the common practice of Danish dividend-distributing investment funds issuing ex coupon certificates in the period between year-end and the date of the dividend distribution has also provided foreign investors with the opportunity to avoid Danish withholding taxes by selling their certificates each year and reinvesting in ex coupon certificates. As a consequence, Danish investment funds would, under Bill 123, be disqualified from the special Danish tax regime for dividend-distributing investment funds if the investment funds issue ex coupon certificates that have Danish tax implications for the funds and their investors. This is expected to lead such funds to stop issuing ex coupon certifications to maintain their current classification.

Bill 123 is expected to be passed by the parliament in May or June, but the antiabuse measure regarding the redemption of certificates in investment funds and unit trusts will — if the bill is passed in its current form — have retroactive effect from February 23. The restriction on the issuance of ex coupon certificates would take effect on July 1.

♦ Arne Riis, partner and head of tax, and Poul Erik Lytken, attorney-at-law, Accura Law Firm, Copenhagen

France

Ex-Budget Minister’s Fraud Trial Postponed by Constitutional Question

France’s Constitutional Council will hear the matter of whether the criminal trial of former French Budget Minister Jérôme Cahuzac, who his lawyers argue paid large fines for admitted tax evasion, amounts to being tried twice for the same offense.

The Constitutional Council has three months to make a decision. Cahuzac’s tax fraud trial in Paris is expected to resume on September 5 before the XXXII Chambre de Correction de Paris. If convicted, he faces a potential €2.2 million fine and a seven-year prison sentence.

Cahuzac’s lawyers argue that a 2015 insider trading case known as the EADS case (see http://goo.gl/LYqqyR) established a precedent that prior administrative judgments and fines should be considered as equivalent to a judicial proceeding. They motioned for the matter to be reviewed when the trial got underway February 8. Later that week, the issue was sent to the Tribunal de Grande Instance de Paris, which on March 30 agreed to refer the matter to the Constitutional Council. (Prior coverage: Tax Notes Int’l, Feb. 15, 2016, p. 567.)

Cahuzac’s tenure as budget minister ended in scandal when his secret bank accounts were uncovered. Cahuzac denied the allegations in testimony to the French Parliament but eventually admitted that during his career as a plastic surgeon specializing in hair transplants, he hid about half a million euros, paid by wealthy Middle Eastern clients, from the French tax authorities. The money was earned before his entry into French politics. Cahuzac banked with UBS, which is now also on trial in Paris for recruiting and encouraging wealthy French citizens to avoid paying taxes through its private wealth management in Switzerland.

Also on trial is Cahuzac’s ex-wife, Patricia Ménard, a dermatologist who shared a professional clinic with her husband and whose divorce proceedings may have led investigators to the hidden accounts, according to numerous French press reports. Reyl bank, its CEO François Reyl, and a consultant, Philippe Houman, are on trial too.

The March 30 decision was not unexpected because the tax fraud trial of international art dealer Guy Wildenstein and his family was delayed to May 4 on the same question about the overlapping of civil and criminal penalties. (Prior coverage: Tax Notes Int’l, Jan. 11, 2016, p. 124.)

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Transparency Bill Would Create New Anti-Corruption Agency

In line with OECD recommendations, a French proposal would create a new agency for the prevention and detection of corruption.

The proposed legislation, presented by French Finance Minister Michel Sapin March 31, would change existing governmental structures created to fight corporate corruption and improve financial transparency. It is expected that the new agency would replace the existing Service Central de Prévention de la Corruption, which lacks investigative powers or the power to start judicial proceedings. That agency was created in 1993, also under Sapin’s guidance.

The new organization would be charged with setting up anti-corruption programs in all French businesses with more than 500 employees and annual turnover above €100 million. A €1 million fine could be imposed on companies that don’t cooperate in setting up an anti-corruption program.
The proposal provides a method for whistleblowers to make anonymous reports and calls for the government to cover the whistleblowers’ legal costs.

The proposal was expected to include a new enforcement measure that would allow defendants, in cases such as the HSBC and UBS tax evasion trials now ongoing in Paris, to pay fines without admitting guilt. However, this part of the proposal was dropped after the Council of State decided against its inclusion March 24. French law does not allow defendants to negotiate settlements — like the agreements reached by companies with the U.S. to pay multibillion-dollar fines — without an admission of guilt.

The proposed legislation calls for a national list of lobbyists, disclosing their activities and those they represent, to be available online. Gifts to public employees would be forbidden, and lobbyists could be fined up to €30,000.

The proposed legislation would also create a new infraction, influence peddling by a foreign official, that could be brought to court in a civil lawsuit or charged as a criminal offense against the company involved.

Officially titled Le Projet de Loi Transparence, Lutte Contre la Corruption, et Modernisation de la Vie Économique, the proposed legislation has been dubbed Loi Sapin II, in accord with French tradition in naming a law after the government minister who presents it to the legislature. The proposal must pass through the National Assembly and the Senate before becoming law.

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India

Budget Includes Groundbreaking Proposals

For tax professionals with an Indian focus, the annual budget is easily the most important event of the year. Even by that standard, the 2016 budget presented by Finance Minister Arun Jaitley was groundbreaking.

On a purely quantitative level, the Finance Bill, 2016 (which contains the legislative proposals to give effect to the government’s budget proposals), is 221 pages, comprising 238 sections with 15 schedules. This is significantly more than in recent years.

From a substantive point of view, this year’s budget contains several far-reaching proposals, including the introduction of new taxes and cesses, dispute resolution and voluntary disclosure schemes, and several administrative measures.

Tax Rates and Incentives

In its 2015 budget speech, the government announced a corporate income rate cut from 30 percent to 25 percent, to be phased in over the next four years. The first phase of the reduction was expected to be announced in this year’s budget. However, fiscal pressures arising from disappointing direct tax collections and the need to boost spending in several critical sectors led to a selective lowering of corporate tax rates, rather than an across-the-board cut.

Manufacturing industries set up after March 1, 2016, have an option to pay tax at 25 percent if no incentives are claimed. Also, for small companies with a turnover of less than INR 50 million in fiscal 2014-2015, the tax rate would be lowered to 29 percent.

The lowering of rates announced last year was proposed in tandem with a phaseout of incentives. In line with a discussion paper released for public comments in November 2015, the budget proposes a gradual phaseout of most tax incentives. The tax holiday available to export-focused companies in special economic zones will not be available for companies that commence manufacturing or start providing services after April 1, 2020. For companies that commence this activity before that date, incentives will continue to be available for the usual 15-year period. Several other incentives — such as accelerated depreciation, tax holidays for infrastructure facilities, and the weighted deduction for research and development activities — also would be phased out gradually from 2017.

Equalization Levy

Indians are increasingly becoming voracious consumers of digital goods and services, and the government has long viewed the revenue implications of this trend with some concern. Therefore, India has adopted an aggressive source-based approach to the digital economy, which entails:

- seeking to tax foreign companies in India by treating websites as permanent establishments;
- characterizing payments for digital goods and services as royalties or technical fees; and
- widening the scope of withholding payments for digital goods and services.

The OECD’s base erosion and profit-shifting project also addressed challenges posed by the digital economy. However, specific measures to widen the source-based taxation of digital economy transactions (such as a new nexus standard based on digital presence, a final withholding tax on digital payments, and an equalization levy) were not recommended. It was thought that changes to the PE standard, controlled foreign corporation rules, and transfer pricing could address the challenges posed by the digital economy.

The BEPS report recommended that countries adopt under their domestic laws any of the three approaches considered in the report, provided that they were not in...
violation of their treaty obligations. Acting on this recommendation, the government proposed an “equalization levy” of 6 percent on specified services provided by nonresidents, such as online advertisements, provision of digital advertising space, and other facilities and services for the purposes of online advertisements. The government is also empowered to notify other services that will fall within the ambit of this equalization levy. The scope of the levy is defined rather expansively, and one could see some litigation on what services are covered.

On a conceptual level, an equalization levy is intended to provide a level playing field by subjecting nonresidents who are otherwise outside the Indian income tax net to a tax in India. To this limited extent, it is not unlike the excise taxes on insurance premiums levied in the United States. However, there are several key features of the Indian levy that are unique and that could lead to significant implications for nonresidents and residents, both from an economic and a compliance perspective.

For instance, this levy is structured as a transaction tax outside the purview of Indian income tax law and is proposed to be levied under a separate chapter of the Finance Bill, 2016. This will mean that it will not be considered a tax on income, and therefore it might not qualify either for protection under tax treaties or for tax credits in overseas jurisdictions. As such, specified services rendered by all nonresidents, regardless of their location or residency, will be affected by this levy. There is, however, a specific carveout for specified services rendered by nonresidents who have a PE in India, when the services are effectively connected to the PE.

The Indian payer is required to deduct the amount of the levy from the payments made to nonresidents and pay it to the government. Interest and penalties apply for nondeduction or nonpayment of the levy.

**Patent Box Regime**

In line with many European countries, the government has proposed the introduction of a patent box regime, which provides for a concessional rate of tax at 10 percent on royalty income on patents. Royalty income that qualifies for this regime would also be excluded from the minimum alternative tax levied on the basis of book profits.

The scheme applies to residents and extends to income from patents developed and registered in India. An expenditure-based criterion would determine when a patent can be considered to be developed in India. This broadly follows the recommendations made in the BEPS report on action 5 dealing with harmful tax practices.

There are a couple of features of this regime that need clarification, as they could have a significant bearing on its attractiveness. For instance, the concessional rate of tax appears to apply only to patents registered and exploited in India. This would mean that royalties earned on patents registered outside India by Indian residents would not qualify for this regime and would continue to be taxed at normal tax rates. However, this scheme may not automatically position India as an intellectual property holding jurisdiction, since India continues to levy taxes on cash extraction (by way of a dividend distribution tax or as a tax on share buybacks).

The scheme extends only to actual royalties earned and would not have any application to situations in which a company both owns and exploits the patent by manufacturing and selling patented articles. In this aspect, it differs from the regimes considered in the BEPS report that extend the concessional rates to “notional” royalties arising from exploitation or sale of patented articles by the owner of the patent.

**Disputes Over Retrospective Amendments**

The Finance Act, 2012, made several critical amendments with retrospective effect. They included a tax on indirect transfers, under which India sought to tax gains arising from the transfer of shares of foreign companies with substantial underlying assets in India. The term “royalties” was also significantly widened to cover software payments and expand the scope of equipment rentals. This led to several disputes, and cases are pending at various courts and tribunals, including arbitral tribunals constituted under bilateral investment protection agreements.

To end the litigation, the Finance Bill, 2016, proposes a dispute resolution scheme under which taxpayers can pay the tax (in full) and qualify for a waiver of interest and penalties. Immunity from prosecution is also provided. This scheme is set to open on June 1, 2016.

**Other Direct Tax Changes**

The place of effective management test for determining corporate residency, which was enacted with effect from fiscal 2015-2016, has been deferred for one year. It will now apply for fiscal 2016-2017 onward.

The finance minister also reiterated in his budget speech that the general antiavoidance rule will come into force from April 1, 2017, as expected.

In line with the recommendations of the BEPS reports, a country-by-country reporting requirement has been mandated. It will apply to groups having a consolidated turnover in excess of €750 million.

Finance Bill, 2016, also proposes to increase the rate of interest payable by the government on delayed refunds arising from appellate orders. The refunds will be entitled to interest at a rate of 9 percent.

Key indirect tax proposals are discussed below.

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GST-Related Proposals

Introduction of the goods and services tax is one of the most keenly awaited indirect tax reforms. The GST is proposed to replace the plethora of indirect taxes levied by the federal and the state governments and provide simplicity and ease of compliance. While the GST is not yet final, the budget includes several related measures.

Several exemptions under the central excise laws have been withdrawn, and sectors like jewelry and parts of the garment industry have been brought within the tax fold. It is expected that the overall GST rate can be kept at a reasonable level by reducing exemptions and widening the tax net.

The rate of GST proposed to be levied on services is in the range of 16 to 18 percent. With a view to align the current rate with the rate proposed in future, the rate of service tax has been increased by 0.5 percent by introducing a separate cess called Krishi Kalyan Cess, the proceeds of which are intended to be earmarked for the agricultural sector. The current effective rate of service tax thus will be 15 percent. A gradual change in rates would be the preferred option to prepare the industry to better handle the increase in rates and align its business policies accordingly. This would also help in tackling inflationary pressures that could arise if the rates are hiked significantly rather than gradually in installments.

Widening the Tax Net

A few other areas that enjoyed exemption or were not taxable have now been brought into the fold to widen the tax pool.

Inbound Ocean Freight

Inbound ocean freight was in the category of the negative list of services, which meant that no service tax was applicable. Also, the value of inbound ocean freight forms part of the import value on which customs duty is charged. By bringing inbound ocean freight within the service tax net, freight values could now be subject to both service tax and customs duty. This might necessitate restructuring the import contracts, whereby the purchasers may require the supplier to include the freight component within its scope to avoid dual levy.

Assignment of Radio Frequency Spectrum

The rights to the radio frequency spectrum are allotted for a specified period to the telecommunication sector by the government through auction. The allotment of frequencies will now be treated as a provision of service by the government, which will require the recipients to pay service tax under the reverse charge mechanism. While the taxes paid may be deducted against the service tax liabilities, albeit on a staggered basis spread over the life of the rights acquired, this measure is likely to result in significant cash outflow for these companies. It also raises questions regarding the applicability of service tax on other rights like mining rights, oil exploration contracts, and so forth.

Dispute Resolution and Procedural Aspects

Similar to the proposal introduced for income tax laws, an indirect tax resolution mechanism has been introduced to help reduce the high pendency of disputes under the customs, central excise, and service tax laws pending before the appellate commissioner level. The scheme encourages the companies to take advantage by seeking to reduce the penalties to 25 percent of the penalties imposed provided the tax, interest, and reduced penalty are paid by the company. An incentive has been provided by not only treating the matters settled under the scheme as final and binding but also by providing immunities under the statute. This is also an attempt to reduce the pending litigation as a precursor to the introduction of GST.

Various other proposals have been introduced to rationalize and streamline procedural aspects relating to the VAT deduction mechanism (central VAT scheme) and reducing interest rates payable on delay of tax payments.

Government Resolves Tax Legacy Issues, Plans Corporate Tax Cut

The Indian government has resolved some legacy tax issues inherited from the previous government, and it is planning to cut the corporate tax rate from 30 percent to 25 percent to attract more foreign investment.

During a March 29 speech at the SP Jain Institute of Global Management’s Sydney campus, Finance Minister Arun Jaitley noted that India’s economy has grown by more than 7.5 percent and that the government seeks to continue economic growth by making it easier for companies to do business in the country.

To that end, Jaitley said the government has been working on aligning India’s tax system with global standards and is aiming to resolve legacy taxpayer disputes, particularly through a recent budget proposal that would allow taxpayers to settle pending tax disputes.

Jaitley on February 29 announced in his 2016-2017 budget speech a one-time dispute resolution scheme aimed at multinational enterprises involved in ongoing tax disputes involving the retroactive taxation of indirect share transfers. Under the scheme, qualified taxpayers would be able to pay only the principal amount
of the tax due, with waived penalties and interest. In exchange, taxpayers would be required to withdraw pending cases in any court or tribunal, or in arbitration or mediation proceedings under the country’s bilateral investment agreements.

The measure appeared to be aimed at such taxpayers as Vodafone and Cairn Energy PLC, both of which are in the midst of high-profile tax disputes related to recent changes to section 9 of the Income Tax Act, 1961, which allows the government to charge capital gains tax on indirect transfers of Indian assets between foreign companies with retroactive effect from 1962. The surprise amendments were announced in Finance Act 2012 under the previous government and have since shaken investor confidence in India. (Prior coverage: Tax Notes Int’l, Mar. 7, 2016, p. 828.)

Aside from trying to promote investor certainty by resolving tax disputes and decreasing corporate tax rates, Jaitley also expressed confidence that the government’s bill for a long-awaited goods and services tax regime, which is stuck in Parliament, will soon pass. Under the new GST regime, which will streamline India’s complicated tax system by replacing several indirect taxes levied at the federal, state, and local levels, the government would levy and collect a central GST, as well as an integrated GST on all interstate supplies of goods and services. State governments would levy and collect state GST. The bill is stalled in the Rajya Sabha, in which the government lacks a majority. (Prior coverage: Tax Notes Int’l, Jan. 4, 2016, p. 33.)

By Stephanie Soong Johnston, Tax Analysts. Email: stephanie.johnston@taxanalysts.org

Vodafone Goes to International Court Over Indian Tax Dispute

Vodafone Group has reportedly approached the International Court of Justice to have a third arbitrator appointed to help resolve its long-running $2.1 billion capital gains tax row with the Indian government.

Citing an unidentified source close to the situation, the Indian press reported on March 30 that U.K.-based Vodafone had gone to the court earlier in March after the arbitrators appointed by both the telecom giant and the Indian government were unable to agree on whom to appoint as a third arbitrator. Both parties had entered into international arbitration proceedings under the India-Netherlands bilateral investment treaty in May 2014.

A Vodafone spokesman told Tax Analysts that the company does not comment on the arbitration process.

The high-profile dispute began with Vodafone’s 2007 majority-stake purchase in Hutchison Essar, an Indian mobile phone company, from Hutchison Telecom International, a subsidiary of Hutchison Whampoa Ltd., for more than $11 billion.

Indian tax authorities argued that the purchase was subject to CGT because it involved Indian assets, but Vodafone argued that because the transaction occurred between its Dutch subsidiary and the Cayman Islands-based holding company that held Hutchison Whampoa’s assets, India could not charge CGT since neither company was Indian.

The case ultimately went to the Supreme Court, which in January 2012 held in Vodafone’s favor, saying it was not liable for the assessed tax and that the Central Board of Direct Taxes lacked the authority to tax overseas transactions. However, the National Congress government in its 2012-2013 budget introduced surprise amendments to clarify section 9 of the country’s Income Tax Act, 1961, which allowed the government to charge CGT on indirect transfers of Indian assets between foreign companies. The amendments, which had retroactive effect from 1962, rattled international investor confidence by threatening to reopen settled tax disputes with large multinational companies.

On February 16, Vodafone confirmed it had received a notice from Indian tax authorities reminding the company to pay the $2.1 billion tax bill, even though arbitration proceedings had already begun. (Prior coverage: Tax Notes Int’l, Feb. 22, 2016, p. 650.)

Most recently, the Bharatiya Janata Party-led government announced on February 29 in its 2016-2017 budget a one-time dispute resolution scheme aimed at multinational enterprises involved in tax disputes over the retroactive taxation of indirect share transfers. Under the scheme, taxpayers would be able to pay just the principal amount of the tax due, and could get interest and penalties waived, as long as they drop their cases in any court, tribunal, or arbitration or mediation proceedings under India’s bilateral investment agreements with other countries. (Prior coverage: Tax Notes Int’l, Mar. 7, 2016, p. 828.)

The move was widely seen as an olive branch to Vodafone and Cairn Energy PLC, which is also involved in a high-profile CGT dispute with the government. However, both companies gave a lukewarm response to the proposal. Vodafone in particular said it had “always maintained that there was no tax to pay at the time it completed its acquisition of Hutchison’s business in 2007,” and that the Supreme Court had sided with the company.

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Italy

Ryanair Not Liable for Social Taxes in Italy, Court Holds

An Italian court sided with Ryanair Ltd. on March 29 in a legal battle over whether the Ireland-based discount airline owed €9.4 million in social contributions for its air crews that were based in Italy between 2006 and 2010.

Ryanair said the Bergamo Labor Court agreed with the airline’s position that the workplace of Italy-based crew members on its Irish-registered aircraft was Ireland and not Italy. The court determined that those employees had correctly paid social taxes in Ireland and that no social security contributions were payable to the Italian government, Ryanair said in a statement. According to local press reports, Ryanair has more than 200 staff members based in Bergamo.

A company spokesman didn’t respond to a request for details about the social contribution rates that its employees are subject to in Italy versus Ireland. Massimo Dimarco of Dimarco and Partners in Milan said the rates in Italy can go as high as 43 percent of an employee’s income. “That’s why Ryanair has lower prices than other companies,” Dimarco said.

“This judgment upholds the position confirmed by the Italian Supreme Court, the Bologna Labor Court, and many other national courts around Europe, which have ruled that the workplace of aircrew (both pilots and cabin personnel) is the registered aircraft on which they carry out their duties,” Ryanair said in its statement.

It is unclear whether there is any pending litigation in Italy on the issue for years after 2010.

The court’s decision was not available by press time, but the determination appears to be related to article 21.3 of the Ireland-Italy tax treaty, which states:

For the purposes of this Article, profits or remuneration arising from the exercise of a profession or employment in a Contracting State shall be deemed to be income from sources within that Contracting State, and the services of an individual whose services are wholly or mainly performed in ships or aircraft shall be deemed to be performed in the Contracting State in which the place of effective management of the enterprise is situated.

Elsewhere in Europe

Ryanair has not always prevailed on the issue elsewhere in Europe. In 2014 a French court ruled that the company had to pay €8.3 million because it had used Irish contracts to avoid French social security payments for staff employed at the Marseilles airport between 2007 and 2010. After an appeal, the judgment against Ryanair was reduced by €700,000. The airline subsequently closed its terminal in Marseilles and began servicing the French market from bases outside the country.

In 2013 some Danish members of parliament called for a renegotiation of the Denmark-Ireland tax treaty over what they called “social dumping,” the employment of low-cost staff in a high-cost country, by Ryanair. The legislators proposed that the treaty be amended to subject Ryanair crew members who are residents of Denmark to Danish income tax rates.

One lawyer, who said he was not familiar with the details of Ryanair’s case in Italy, said the March 29 decision appears to run counter to current French case law, which does not depend on the place an aircraft is registered. “What is really important is the activity of the crew and, especially, the place where [they] start and end [their] activity,” said Stéphane Bloch of KGA Avocats in Paris.

Ryanair has had at least one other recent tax dispute with the Italian government. The airline said in February that it would cut 16 of its Italian routes and eliminate 600 jobs in response to Italy’s decision to raise its passenger departure tax from €6.50 to €9.

♦ William Hoke, Tax Analysts. Email: william.hoke@taxanalysts.org

Mauritania

New Transfer Pricing Regime Takes Effect

Mauritania’s Budget Law 2016 introduced provisions that establish a new transfer pricing regime, effective from January 1.

Under article 10.E. of the Budget Law, Mauritanian tax authorities are empowered to tax profits that are indirectly transferred to nonresident related parties through the overvaluation of the purchase cost of goods or services in a transaction, or the undervaluation of the selling price, or through thin capitalization or any other means.

Article 10.E. applies when a transaction is undertaken with a foreign entity that is based in a noncooperative jurisdiction or a jurisdiction that has a more favorable tax regime than Mauritania’s.

Criteria used to classify a person as a related party were introduced under new article 10.D. and cover any entity that holds, directly or indirectly, more than 50 percent of the share capital of another entity or controls the other entity. The criteria also apply in cases...
where more than 50 percent of the share capital of two enterprises is owned or controlled, directly or indirectly, by a third entity.

Under new article 10 bis, an entity is considered to be based in a jurisdiction with a more favorable tax regime if the entity is not subject to income tax there or the income tax does not exceed 50 percent of the Mauritanian income tax rate.

New thin capitalization rules were also implemented. Under new rules regarding loans to related parties, if the value of the loan (regardless of its duration) exceeds three times the borrower’s equity value at the closing date of the financial year, the deductible interest expenses will be capped at 25 percent of the taxable profit.

Under new article 10 ter, payments to foreign entities in jurisdictions with more favorable tax regimes will be eligible for a tax deduction only upon the provision of evidence documenting that the transactions were actually performed and that the remuneration was in line with the arm’s-length principle.

♦ Slim Gargouri, chartered accountant, Sfax, Tunisia

Morocco

Government Sets New Maximum Deductible Interest Rate on Loans

The Moroccan Ministry of Economy and Finance has decreased the maximum interest rate applicable for loans to a company by its shareholders.

Decree 381-16 sets the rate at 2.53 percent for interest incurred during fiscal 2016. Accordingly, interest expenses incurred on shareholders’ loans in excess of the 2.53 percent rate will be disallowed for corporate income tax purposes. The rate was 2.97 percent for fiscal 2015.

The value of the shareholder loans generating the interest should not exceed the equity capital. Under the existing rules, interest expenses are deductible if the shareholder’s capital is fully paid.

Interest arising in Morocco and paid to nonresident entities is subject to Moroccan withholding tax, as a final tax, at the rate of 10 percent, unless more favorable treatment is available under an applicable tax treaty.

♦ Slim Gargouri, chartered accountant, Sfax, Tunisia

New Zealand

New Zealand Gets Antiavoidance Advice From Australia, U.K.

New Zealand Minister of Revenue Michael Woodhouse told the Parliament that he is getting advice about laws enacted in Australia and the U.K. over the last year to deal with tax avoidance by multinational enterprises.

Responding to a question by an opposition member, Woodhouse referred to the U.K.’s diverted profits tax, which he said was passed to block arrangements in which foreign companies exploit permanent establishment rules and take deductions that lack economic substance to gain a tax advantage. (Prior coverage: Tax Notes Int’l, June 8, 2015, p. 880.) Australia enacted a multinational antiavoidance law in December 2015 to address “artificial and contrived arrangements” meant to avoid the attribution of profits to a PE there. (Prior coverage: Tax Notes Int’l, Dec. 21, 2015, p. 1002.)

“I am getting some advice about [those laws], but I am satisfied, in the interim, that we already have those sorts of rules in the Income Tax Act,” Woodhouse said. He denied that there are “deficiencies” regarding tax avoidance by MNEs that the government has failed to address. Woodhouse said the government has invested nearly NZD 20 million (around $13.5 million) to counter tax avoidance by large businesses. “I think we have a good system,” he said.

 Asked for his estimate of the amount of tax avoided by MNEs last year attributable to improper transfer pricing practices, Woodhouse replied that the Inland Revenue Department doesn’t distinguish between companies based on whether they are multinationals. He said recent press reports that MNEs underpaid tax by an estimated NZD 500 million to NZD 1 billion were speculative and were based on the revenues reported by the companies.

“As I am sure the [opposition] member is aware, the amount of tax paid is assessed on the taxable profit, and that is what they pay,” Woodhouse said. “If the member is saying that this does not look right or does not look fair, I have some sympathy for that point of view. But what is considered unfair is multinationals not paying tax anywhere in the world, and for that reason, this is a global issue that requires a global response.” Woodhouse said he thinks the OECD is the best place to deal with the issue.

The New Zealand Herald published a story on March 18 that said 20 MNEs with combined New Zealand sales exceeding NZD 100 billion last year paid a total of only NZD 1.8 million in income tax for the period. The newspaper report, based on financial filings with the Companies Office, said the MNEs would have paid almost NZD 490 million in New Zealand income tax...
Philippines

Tax Treaty Applies to Lufthansa’s Gross Philippine Billings, Court Finds

Lufthansa’s Philippine branch can take advantage of the special 1.5 percent tax rate established in Germany’s income tax treaty with the Philippines for its online activities, the Philippine Court of Tax Appeals found.

The March 21 decision in Lufthansa German Airlines — Philippine Branch v. CIR, CTA Case No. 8601, addressed numerous challenges to a Philippine Bureau of Internal Revenue (BIR) assessment that found the airline had underpaid its income taxes for 2008. Among Lufthansa’s claims was its contention that the BIR had erred in failing to apply the proper tax rate to its online gross Philippine billings under the 1983 Germany-Philippines tax treaty, which applied until 2016.

After reviewing Lufthansa’s articles of incorporation, the court found the airline had sufficiently proved that it is a German resident and is entitled to the 1.5 percent tax rate. The court said the BIR’s claim that the treaty didn’t apply because the airline had failed to file an application for tax treaty relief clearly had no basis.

However, the court did accept the BIR’s contention that the airline’s gross revenue in the Philippines was subject to income tax. The airline had argued that it was taxable on only its “flown revenue,” which is the revenue derived from passengers flying on a Lufthansa flight.

A consultant who testified on behalf of Lufthansa said the airline’s sales system generates two files, one tracking sales and another tracking revenue. She said the sales file includes a list of all tickets issued by the airline and whether they were actually flown on Lufthansa, as well as a list of tickets issued by the airline but flown on another carrier. The revenue file shows only those tickets actually flown by Lufthansa. The airline calculates its income tax obligations based on the sales date in the revenue file, the consultant said.

The court found that the evidence provided by Lufthansa’s and its consultant established only the airline’s revenue recognition process. “It does not, in any way, account for the amount being claimed by petitioner as its true income,” it said.

Russia

Guidance Addresses Nonresident’s Sale of Immovable Property in Russia

Russia’s Ministry of Finance released a guidance letter explaining the tax treatment of a nonresident individual’s income from the sale of immovable property in Russia.

Guidance Letter 03-04-05/10362 (dated February 25) says that under Tax Code article 210, section 1, an individual’s income tax base includes all income received in monetary and in-kind form, as well as income in the form of material benefits.

Based on Tax Code article 210, section 4, the tax base for individual income taxable at rates other than the standard 13 percent rate is the monetary value of that income. Also, the income is not eligible for any tax deductions established by the Tax Code.

According to Tax Code article 224, section 3, nonresident individuals’ Russian-source income is subject to individual income tax in Russia at the rate of 30 percent. That rate applies to the entire amount of income generated from the immovable property transaction without any deductions for expenses that the nonresident incurred during the initial acquisition of the property.

Russia Approves Updated List of Uncooperative Jurisdictions

Russia’s Federal Tax Service approved an updated list of countries and territories that do not exchange tax information with Russia. The list will become effective on April 1.

The list was approved on the basis of Tax Code article 25.13-1, which exempts the profits of controlled foreign corporations from taxation in Russia if at least one of the eligibility conditions mentioned in section 1 of that article is met. Tax Code article 25.13-1 also stipulates that the CFC must have permanent tax residency in a jurisdiction that has an effective tax treaty with Russia that ensures the exchange of tax information.
The updated list of countries and territories that don’t ensure the exchange of tax information contains the following countries and territories:

- Afghanistan, Alderney (the Channel Islands), Andorra, Angola, Anguilla, Anjouan, Antigua and Barbuda, Aruba;
- the Bahamas, Bahrain, Bangladesh, Barbados, Benin, Bermuda, Bhutan, Bolivia, Bosnia and Herzegovina, Brazil, the British Virgin Islands, Brunei, Burkina Faso, Burundi;
- Cambodia, Cameroon, Cape Verde, the Cayman Islands, the Central African Republic, Chad, Colombia, the Cook Islands, Costa Rica, Dutch Curacao;
- the Democratic Republic of Congo, Djibouti, Dominica, the Dominican Republic;
- East Timor, Ecuador, El Salvador, Equatorial Guinea, Eritrea, Estonia, Ethiopia;
- the Faroe Islands, Fiji;
- Gabon, Gambia, Georgia, Ghana, Gibraltar, Greenland, Grenada, Guam, Guatemala, Guernsey, Guinea, Guinea Bissau, Guyana;
- Haiti, Honduras, Hong Kong;
- the Isle of Man, Iraq, Ivory Coast;
- Jamaica, Jersey, Jordan;
- Kenya, Kiribati;
- Labuan, Laos, Lesotho, Liberia, Liechtenstein;
- Macau, Madagascar, Malawi, the Maldives, the Marshall Islands, Mauritania, Mauritius, Micronesia, Monaco, Montserrat, Mozambique, Myanmar;
- Nauru, Nepal, Nicaragua, Niger, Nigeria, Niue;
- Oman;
- Pakistan, Palau, Palestine, Panama, Papua New Guinea, Paraguay, Peru, Puerto Rico;
- the Republic of Congo, Rwanda;
- Samoa, San Marino, São Tomé and Principe, Sark (the Channel Islands), St. Kitts and Nevis, St. Lucia, Dutch St. Maarten, St. Vincent and the Grenadines, Senegal, Seychelles, Sierra Leone, the Solomon Islands, Somalia, South Sudan, Sudan, Suriname, Swaziland;
- Taiwan, Tanzania, Turks and Caicos, Togo, Tonga, Trinidad and Tobago, Tunisia, Tuvalu;
- Uganda, the United Arab Emirates, Uruguay, the U.S. Virgin Islands;
- Vanuatu;
- Yemen; and
- Zambia and Zimbabwe.

The Federal Tax Service intends to update the list by October 1 each year so it can become effective on January 1 of the following year.

♦ Iurie Lungu, Graham & Levintsa, Chisinau

Prime Minister Promises
No Tax Increases Before 2018

Despite the economic hardships straining Russia’s government finances, taxes will not be increased before 2018, according to Russian Prime Minister Dmitri Medvedev.

“It was decided . . . that till 2018 . . . we won’t take decisions to increase the tax burden,” Medvedev said, as quoted by the state-owned RIA Novosti news agency. “Firstly, because we still have reserves in the existing tax system . . . Secondly, it is important that the tax system remains stable,” he added.

Speaking March 28 at his party’s educational forum for candidates running in the parliamentary elections, Medvedev also spoke out against the idea of reimposing a much disliked Soviet tax on childlessness, according to a report by the government-owned TASS news agency. He said he would prefer the creation of a child-support fund for women who don’t receive payments from the fathers.

“This idea [of a child-support fund] is being discussed, it is not easy to implement. But it is, at least, more fair, and as for punishing everyone who does not pay child-support money — I think that is wrong,” Medvedev said. The childless tax, a 6 percent tax on income, existed in the Soviet Union between 1941 and 1992.

Falling oil prices and the effect of sanctions imposed against Russia after its invasion of Ukraine have cut state revenues sharply in the last year. The annual budget for 2016 is estimated to be about RUB 200 billion (about $2.93 billion), according to TASS. Russia’s economy for the year is estimated at RUB 13.7 trillion, with a 3 percent deficit of RUB 33 billion, according to the World Bank.

Pressure is increasing on Russian oligarchs who have transferred wealth to tax havens outside Russia to bring the funds back, according to news reports. Viktor Vekselberg, a Russian billionaire with extensive holdings in oil, is reported to be transferring various company assets back from Cyprus, according to a report published March 27 by the Swiss newspaper NZZ am Sonntag. Vekselberg, cofounder of the Renova Group, manages much of his wealth through Renova Management AG in Zurich, which did not respond to requests for comments by press time.

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Company Performing Work Free of Charge Qualifies as PE, Court Holds

A foreign company carrying out auxiliary and preparatory activities in Russia free of charge for third parties creates a permanent establishment in Russia and must pay corporate tax on those activities, the Federal Arbitration Court of the Moscow Circuit held.

Case Background

Case A40-146032/2014, dated January 19 and recently made public, involved AstraZeneca UK Ltd., which manufactures and sells medications and has an office in Russia.

After auditing the plaintiff, Russian tax authorities established that from 2009 through 2011, the plaintiff’s Russian office had been carrying out auxiliary and preparatory activities not only for the head office but also for other third parties. The authorities determined that the activities had been carried out free of charge and resulted in the creation of a PE in Russia, making the plaintiff liable for corporate tax under Tax Code article 307, section 3. The tax authorities found the plaintiff had understated its corporate tax liability in Russia. The authorities imposed tax fines and penalties and required the plaintiff to pay supplementary corporate tax.

The plaintiff disagreed with the decision and the liability imposed and filed an action with the Arbitration Court of the City of Moscow, which held in favor of the plaintiff. The tax authority then appealed the case to the Ninth Arbitration Court of Appeal, which revoked the decision of the first instance court and sided with the tax authority.

The plaintiff then filed an appeal with the Federal Arbitration Court of the Moscow Circuit, arguing that the decisions of the court of appeal should be revoked and the decision of the first instance court upheld because the appeals court had failed to examine all the relevant circumstances of the case and incorrectly construed and applied the material tax law.

The plaintiff argued that its Russian office did not carry out any auxiliary and preparatory activities for third parties in Russia and that its activities did not create a PE in Russia. It stated that its Russian office had been carrying out auxiliary and preparatory activities only for the plaintiff’s head office. The plaintiff said it didn’t have to pay supplementary corporate tax in Russia because article 307, section 3 of the Tax Code, on the basis of which the tax was assessed, doesn’t apply in this case.

Findings of the Federal Arbitration Court

The Federal Arbitration Court of the Moscow Circuit noted that under Russian Tax Code article 309, section 3, if a foreign legal entity carries out activities of a preparatory or auxiliary nature in Russia free of charge in the interests of third parties that result in the creation of a PE, the corporate tax base for those activities should be determined as 20 percent of the amount of the expenses incurred by that PE in connection with the activities.

The court agreed with the findings of the lower courts that the plaintiff’s Russian office had been carrying out activities, including:

- clinical and other research and expert examinations involving drugs developed not only by the plaintiff's head office but also other foreign entities making up part of the plaintiff’s group of companies;
- registration of medications in Russia for the plaintiff’s foreign affiliated companies; and
- advertising and promotion (through seminars, conferences, and so on) of medications sold by the plaintiff’s head office through third-party distributors.

The court therefore held, in line with the position of the tax authorities and the appeals court, that during the disputed period, the plaintiff’s Russian office had been carrying out auxiliary and preparatory activities for third parties that resulted in the creation of a PE in Russia. The court also ruled that the activities were carried out free of charge and therefore must be taxed in Russia as provided by Tax Code article 307, section 3.

The court dismissed the plaintiff’s argument that the application of Tax Code article 307, section 3 would result in double taxation in this case. The court held that the provisions of article 307, section 3 have been included in the Tax Code in line with the provisions of article 7 (business profits) of the Russia-U.K. tax treaty.

The court therefore held that the appeals court had correctly applied the applicable tax law and properly examined all the relevant circumstances of the case. It upheld the decision of the tax authority and confirmed the decisions rendered by the Ninth Arbitration Court of Appeal.

♦ Iurie Lungu, Graham & Levintsa, Chisinau

Scotland

50 Percent Tax Rate Could Cost £30 Million a Year, SNP Leader Says

First Minister Nicola Sturgeon supports raising the top rate of individual income tax to 50 percent across the U.K. but fears that adopting the higher rate in Scotland alone could cost the Scottish government up to
£30 million per year. The additional (top) rate is currently set at 40 percent and applies to income of more than £150,000.

Speaking on the BBC’s Good Morning Scotland radio program on March 29, Sturgeon said that if her Scottish National Party (SNP) wins reelection in May, as expected, it will use its newly devolved tax powers to prevent changes announced in U.K. Chancellor of the Exchequer George Osborne’s budget from taking effect in Scotland. (Prior coverage: Tax Notes Int’l, Mar. 28, 2016, p. 1098.)

“George Osborne is going to change the [income] threshold for the 40 percent rate. That would deliver a significant tax cut to people in the higher rate band. I don’t want to do that,” Sturgeon said. “I don’t want to see a large tax cut passed on to higher-rate earners, but I make no apology for saying that I don’t think 2.2 million basic-rate taxpayers, which of course includes half a million pensioners, should see their taxes increase at a time when many households continue to struggle to make ends meet, because that’s passing the burden of Tory austerity onto the shoulders of those who can least afford it.”

Sturgeon, who was criticized on the radio program for not following through with previous campaign promises to raise the additional rate to 50 percent, said she would still like to see the higher rate adopted but is fearful of the economic consequences of imposing it solely in Scotland. If Scotland were the first or only country in the U.K. to adopt the 50 percent rate, it would have the highest rate in the nation and could risk losing taxpayers.

Sturgeon said the SNP and the Scottish government have not given up on raising the additional rate to 50 percent in the future. She said she plans to ask the Council of Economic Advisors to determine if there is a way to raise the rate while mitigating the risk of high-income taxpayers leaving Scotland or shifting to investments that yield income that is taxable at a lower rate, such as capital gains. “It would not be a sensible thing for me, as first minister, to do, to raise a tax knowing that it might reduce the amount of revenue I’ve got to spend,” she said.

The Scottish Greens Party (SGP) has gone further than Sturgeon and the SNP, suggesting a number of tax increases. In a March 29 release, the SGP called for income over £150,000 to be taxed at 60 percent. Its proposal would also change all of the current income tax bands and reduce the number of complicated rebates.

The SGP would also abolish the council tax and phase in a new residential property tax based on up-to-date valuations of residential properties. It claims that its proposals would raise an additional £331 million of revenue to invest in public services. However, critics say the SGP has failed to take into account the economic impact of the proposed tax increases, which is the primary concern behind Sturgeon’s decision not to adopt the higher rate.

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Ukraine

Guidance Addresses Nonresidents’ Interest Income From State Bonds

The Ukrainian State Tax Service (STS) released a guidance letter clarifying the tax treatment of interest income derived by nonresident individuals from bonds issued by Ukraine’s Ministry of Finance. Guidance Letter 4441/5/99-99-17-03-03-16 (dated March 14) says nonresident individuals are subject to individual income tax in Ukraine on income gained from Ukrainian sources (Tax Code article 162.1). Nonresidents’ Ukrainian-source income will be taxed on the same basis and at the same rate as that applicable to residents, unless the Tax Code specifically provides otherwise. If Ukrainian-source income is paid to a nonresident by a Ukrainian resident, the resident must act as a tax agent, calculating and remitting the taxes due on that income.

However, Tax Code article 165.1.2 exempts from individual income tax nonresidents’ interest income from government securities (including debt securities) for which the obligations are secured by the government, if the securities were sold to nonresidents outside Ukraine through authorized agents.

The STS therefore determined that interest income derived by nonresident individuals from bonds issued by Ukraine’s MOF will not be included in the nonresidents’ income tax base and are not subject to individual income tax in Ukraine.

The STS ruled, however, that such interest income is subject to Ukraine’s temporary 1.5 percent war tax, which will be in force until the reform of the Ukrainian armed forces is completed.

♦ Iurie Lungu, Graham & Levintsa, Chisinau

Tax Treatment of Rent Payments to Nonresident Clarified

The Ukrainian State Tax Service (STS) issued guidance clarifying that rent payments made by a resident to a nonresident are generally subject to corporate tax in Ukraine at the rate of 15 percent unless an applicable tax treaty provides otherwise.
Guidance Letter 5378/6/99-99-19-02-02-15 (dated March 12) states that income gained by a nonresident from Ukrainian sources is subject to corporate tax in Ukraine in accordance with the procedure and rates established in article 141.4 of the Tax Code. A nonresident’s taxable income in Ukraine includes rent payments made by a resident or a nonresident’s permanent establishment in Ukraine to another nonresident (Tax Code article 141.4.1).

Any payments made from Ukrainian sources to a nonresident in connection with the nonresident’s business activities in Ukraine should generally be subject to corporate tax collectible at the source at the rate of 15 percent, the STS said. The tax must be withheld and remitted to the government at the time of payment to the nonresident unless an applicable tax treaty to which Ukraine is a party provides otherwise, it said.

The STS also ruled that an income payer (or tax agent) may apply a beneficial tax regime established by an applicable tax treaty to a specific category of income paid to a nonresident if the nonresident is the beneficial owner of the income and is a resident of a country with which Ukraine has an effective tax treaty. Permanent tax residency must be confirmed by a document designated by the treaty and issued by the competent foreign authorities.

Referring to the tax implications for a resident in case of rent payments made to a nonresident, the STS noted that under Tax Code article 134.1.1, a resident taxpayer’s turnover includes income gained from sources in Ukraine and beyond its borders (in cases stipulated by the Tax Code) that must be adjusted in cases stipulated by the Tax Code. However, the Tax Code does not provide for any adjustments of the resident’s tax base in case of rent payments made to a nonresident, the STS said.

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**United Kingdom**

**Government Looks to Simplify Corporation Tax Computation**

HM Treasury has agreed with the Office of Tax Simplification (OTS) that a review of options to simplify the computation of the corporation tax is necessary, and it will determine the terms of reference for such a review in the coming weeks, according to a top U.K. official.

In a letter published March 25 on the OTS website, Financial Secretary to the Treasury David Gauke wrote to OTS Chair Angela Knight and Tax Director John Whiting explaining the tax simplification measures announced in the 2016 budget. Chancellor of the Exchequer George Osborne delivered his budget speech to Parliament on March 16, outlining plans to implement antiavoidance measures, a capital gains tax cut from 28 percent to 20 percent, and a further reduction in the corporate tax rate to 17 percent effective April 2020. (Prior coverage: *Tax Notes Int’l*, Mar. 21, 2016, p. 1022.) Finance Bill 2016 was published March 24.

Gauke noted that, along with additional work examining the effects of reforming employee and employer National Insurance contributions (NICS), the OTS had suggested the review. He agreed that the issue of corporation tax computation is a “complex area that could be simplified over the long term and would benefit from a review.”

Gauke also addressed HM Treasury’s proposal for a “business tax roadmap” to help give certainty to businesses. The roadmap comprises “significant investment” in HM Revenue & Customs to improve its customer service, with the goal of having HMRC set up service seven days a week, including extending hours and offering online services and tax and tax credit phone lines on Sundays. HMRC will also establish a dedicated phone service for new businesses and add more than 800 new employees to staff its call centers and improve call waiting times.

HMRC has come under fire in recent months, particularly from the U.K. House of Commons Public Accounts Committee. Lawmakers had slammed the tax authority for its “abysmal” customer service record, saying that it responded to only 72.5 percent of all calls in 2014-2015 and only 50 percent of calls in the first half of 2015. (Prior coverage: *Tax Notes Int’l*, Nov. 9, 2015, p. 504.)

Other elements of the roadmap include modernizing corporation tax rules for losses, considering reforms to “make the tax system fairer and more sustainable” for small companies, and abolishing Class 2 NICS in April 2018, so that the self-employed can “build contributory benefit entitlement through a reformed Class 4 NICS,” Gauke wrote. “This will be a long overdue modernization of the complex and outdated self-employed National Insurance system,” he added.

Gauke also followed up on the OTS’s small companies review, which was published on March 3. The report outlined several recommendations for simplifying the taxation of small companies and tax administration related to small companies. In the report, the OTS had said it would do more follow-up work to see whether a look-through system, which would tax the profits of the smallest companies at the shareholder level instead of the corporate level, would be simpler for some companies. The report also suggested developing a simpler business model to give the self-employed limited liability for their assets. (Prior coverage: *Tax Notes Int’l*, Mar. 7, 2016, p. 841.)

Gauke expressed support for both proposals, saying that the OTS should collaborate with the government.

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and the business sector. However, he rejected the OTS’s suggestion to carry out a study of a consolidated turnover tax.

“As your report notes, a tax based on turnover would fail to take account of a business’s expenses and, consequently, its profitability, leading to distortions and unfair outcomes between different types of businesses,” Gauke wrote.

Gauke also noted that the government will “shortly launch” a consultation examining the way in which partnerships calculate their tax liabilities. “This will look at areas where the taxation of partnerships could be seen as uncertain, as highlighted in your partnerships report,” he wrote. The OTS had published its final report on its partnerships review in January 2015.

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Opposition Leader Urges Scrapping ‘Crass’ Capital Gains Tax Cut

The U.K. government should scrap plans for a “crass” capital gains tax cut announced in the 2016 budget because it unfairly favors a small minority of taxpayers, including the richest individuals in the U.K., a top opposition leader said.

In a March 28 statement, John McDonnell, the Labour Party’s shadow chancellor, sharply criticized Chancellor of the Exchequer George Osborne for proposing to slash the headline CGT rate from 28 percent to 20 percent, starting April 6, and for cutting the basic rate from 18 percent to 10 percent. The measure, announced March 16, was meant to stimulate investment in U.K. businesses, according to Osborne. (Prior coverage: Tax Notes Int’l, Mar. 21, 2016, p. 1022.)

Osborne had also reportedly proposed slashing £4.4 billion in personal independence payments for disabled people, which sparked outrage among the Labour Party, charities, and even Conservative backbenchers.

Under Osborne’s proposal, only 200,000 people are expected to get an average CGT cut of £3,000 annually. However, at the same time, more than 300,000 disabled people were set to lose out on more than £3,000 annually in personal independence payments “until Labour forced a U-turn on the government last week,” McDonnell’s statement said.

Labour Party research indicates that only 0.3 percent of the population, including the richest U.K. taxpayers, will benefit from the CGT cut, according to the statement, which also noted that of the 200,000 individuals who paid CGT in 2014, 5,000 disposed of taxable assets worth at least £1 million.

“There were also 23,000 more CGT payers with taxable income over £150,000 in 2013-14,” the statement continued. “Notably these taxpayers had made 50 percent more gains in 2013-14 than in the previous year.”

Of those in that group, 2,000 had taxable incomes exceeding £150,000, as well as gains of more than £1 million; most of those who paid CGT were men, the statement said.

Calling Osborne “the Banker’s Chancellor,” McDonnell accused him of looking out for the best interests of “a wealthy minority” and slammed him for planning to finance the CGT cut by taking money from disabled people. “This crass tax cut should not be going ahead, because we need an economy that works for the many [and] not tax cuts for the few,” he added.

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Soft Drink Company Shrugs Off Sugar Tax Proposal

A major U.K. beverage company has waved off concerns about the government’s plans to impose a sugar tax on carbonated beverages, saying that it intends to cut sugar levels in most of its products and will therefore reduce its exposure to the levy.

In its latest financial results for the year ending January 30, released on March 29, A.G. Barr PLC, a Scottish soft drink manufacturer, noted that the company will “minimize the financial impact” of the sugar tax on the business when it is implemented in April 2018.

Chancellor of the Exchequer George Osborne announced plans for the tax during his March 16 Budget 2016 speech, saying it would be levied on companies and assessed on the volume of the sugar-sweetened drinks those companies produce or import. The proposed tax would have two bands — the first for total sugar content exceeding 5 grams per 100 milliliters and the second for drinks that contain more than 8 grams of sugar per 100 milliliters. Pure fruit juices and milk-based beverages would be excluded from taxation, and small producers would also fall outside the tax’s scope, Osborne said. (Prior coverage: Tax Notes Int’l, Mar. 21, 2016, p. 1022.)

The chancellor appeared before the U.K. Parliament’s Treasury Committee on March 24 to answer questions about the budget, noting that many companies are already starting to reduce the sugar content in their products. He also said the government would stand its ground if any companies decide to challenge the tax in the courts.

Although the government is still consulting on the sugar tax’s details, Roger White, A.G. Barr’s chief executive, said the tax would not affect the company much, since he expected that at least two-thirds of the
HMRC Issues Guidance on Irrecoverable Peer-to-Peer Loans

Peer-to-peer (P2P) loans that become irrecoverable for the lenders may now be used to offset the interest that the lenders receive from other P2P loans, according to newly issued technical guidance from HM Revenue & Customs.

According to the guidance, published on March 31, P2P lending is a developing area of financial technology that enables individuals and businesses to lend to each other through an intermediary Internet platform. This enables borrowers to reduce costs by avoiding the traditional middleman, such as a bank.

The U.K. Parliament issued draft legislation on P2P loan default tax relief in December 2015, and the tax relief rules were included in section 412A of Finance (No. 2) Bill 2016.

According to the March 24 guidance, the purpose of the relief “is to ensure that people who invest in P2P loans are subject to tax on the return that they make from their lending portfolio as a whole. This will create a level playing field for the taxation of income from P2P lending when compared to the taxation of traditional forms of retail investment, and bring the tax position of the peer-to-peer sector in line with other forms of investment products available for individuals to purchase, such as collective investment schemes.”

Tax relief for irrecoverable P2P loans can only be used to offset interest received by the lender from other P2P loans; it cannot be used against other forms of income, according to HMRC.

The guidance also provides a set of eligibility rules for tax relief on an irrecoverable P2P loan. First, relief is available only to the legal lender, to a person or entity to whom the loan is legally assigned, or to an entity or individual that is subject to income tax on any interest received on the loan. Relief is not available to a person who holds the loan through a legal structure or a tax-transparent entity.

The loan must be made on commercial terms and cannot be part of a scheme or arrangement to obtain a tax advantage. It must also be made through a regulated P2P platform and the operator of the platform must qualify under Part 4A of the Financial Services and Markets Act 2000. P2P lending platforms in the U.K. are regulated by the Financial Conduct Authority.

The tax relief is available only for irrecoverable P2P loans made after April 6, 2015. A P2P loan is considered irrecoverable when there is no reasonable prospect of recovering the loan balance. The guidance identifies a number of situations in which loans are, or are not, recoverable, many of which involve loans with security interests or loans made to a borrower that has entered into bankruptcy proceedings.

The guidance also provides numerous examples demonstrating how to calculate the tax relief available. The examples cover situations in which relief is available for irrecoverable loans on the same or different P2P platforms, as well as relief available for loans that span multiple tax years.

While entities subject to corporation tax are eligible for the relief, they may also be able to claim an additional deduction under the loan relationships rules in Corporate Finance Manual (CFM)3000.
The tax strategy requirement applies to companies with turnover exceeding £200 million or a relevant balance sheet total of more than £2 billion for the preceding financial year. It would also be separate from the OECD’s country-by-country reporting model because it wouldn't require publication of data on the amount of tax a company pays.

According to the draft guidance, a qualifying company must publish its tax strategy online as a separate document or as a self-contained part of a broader document, but it doesn’t have to call the document a strategy, since some companies choose to use the word “policy.” The document must also be accessible to the public free of charge until the company publishes its next strategy; a company should start publishing its first report at the start of the next financial year after the United Kingdom’s fiscal 2016 budget receives royal assent. Strategies would then have to be published between 9 and 15 months after the day on which the previous report was published, the guidance says.

Specifically, the strategy must comprise four general elements. First, it must describe the company’s approach to risk management and governance structures related to taxation in the U.K., as well as the company’s attitude toward tax planning. To describe the company’s view on risk management, the guidance recommends including details on such issues as the company’s governance framework to manage tax risk and the methods the company uses to identify and mitigate tax risk because of its size and complexity.

Second, the strategy must outline the company’s attitude toward tax planning to the extent that it affects U.K. taxation and include such details as the company’s code of conduct on tax planning, the group’s approach to structuring its tax planning, and an explanation of why the company may seek external tax planning advice.

Third, the document must discuss the level of risk the company is willing to accept related to U.K. taxation. Content could include an explanation of whether the company’s internal governance “is prescriptive on levels of acceptable risk,” the draft guidance says.

Finally, the strategy must describe the company’s approach toward its relationship with HMRC. This section of the report could include an explanation of how the group works with HMRC to comply with tax requirements or how the group works with HMRC “on current, future, or retrospective tax risks, events, or interpretation of the law across all relevant taxes and duties,” according to the draft guidance.

If a company fails to publish the strategy within the prescribed time frame or publishes an incomplete report, HMRC will issue a warning notice. If the company does not publish within 30 calendar days, it will be subject to a penalty, consisting of a maximum figure of £7,500, starting from the 31st day. The penalty will then be applied up to six months after failure to publish a tax strategy. If the company still does not publish something within six months, HMRC can hit the company with another penalty of up to £7,500 and would have the power to issue additional £7,500 penalties on a monthly basis thereafter. A company can appeal a penalty assessment within 30 days of the date of the penalty notice, according to the draft guidance.

**Word to the Wise**

Heather Self of Pinsent Masons LLP predicted that the new tax strategy requirement will affect a wide range of U.K. businesses, not just multinationals that are making headlines over the amount of corporate tax they pay. Types of businesses that will feel the pressure include new challenger banks and technology companies, as well as partnerships, including larger law and accountancy firms, she said.

“Large businesses are already burdened by enormous reporting and governance burdens so they are not going to welcome this extra requirement,” Self said, adding that businesses should be cautious about what they publish.

“It is likely that [the] legal and reputational risk involved means that these documents will have to be relatively bland,” she said. “No business is going to want to have this document used as a stick to beat them.”

The new tax strategy requirement will raise the transparency bar and “make companies more aware of the risk that they are hanging their dirty laundry in public and [are] risking criticism,” Ray McCann of New Quadrant Partners Ltd. told Tax Analysts. The measure will also give HMRC a benchmark so that the tax authority can inquire into anything a company does that doesn’t fit with the published strategy, he said.

McCann said he wasn’t surprised that HMRC won’t require companies to reveal how much tax they pay, since public companies already put a lot of tax data in their accounts. “It would, I expect, be seen as overly intrusive to require details of tax paid, which in the normal course could be full of uncertainty or subject to change,” he said.

However, one thing is certain: Once companies start publishing their tax strategies as required by law, “it will no doubt generate a fresh round of media interest,” McCann said.

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United States

Tax Policy Becomes Uncommon Cause For Rock Band

During the first night of a two-night sold-out stay at Washington’s 9:30 Club, Brooklyn-based Lake Street Dive used a break between songs to encourage the crowd to learn about high-income earners using offshore tax havens to avoid taxes. You read that right — a popular rock band was discussing taxes during a show.

The band has partnered with Oxfam America, a nonprofit organization that works on poverty, hunger, and injustice issues, to help promote its anti-tax-havens campaign. Oxfam works with many musicians — such as Radiohead, Coldplay, and Angélique Kidjo — on a variety of issues. Oxfam told Tax Analysts that Lake Street Dive is among the first musicians to support the nonprofit on its campaign. Bands such as Ra Ra Riot and Thao & The Get Down Stay Down will soon follow, Oxfam said.

“Oxfam has a long history of working with social justice-minded music artists like Lake Street Dive,” said Bob Ferguson, Oxfam America’s manager of creative alliances and music outreach. “We know that when a band speaks from the stage about an issue we are working on together, like our current inequality campaign, we can all make a difference. At Oxfam, we truly believe that music can change the world.”

President Barack Obama would agree. “The civil rights movement was a movement sustained by music,” Obama said in 2010 speech at the White House celebrating the movement’s music.

Musicians have always been at the leading edge of the fight for social justice, but tax policy has never been a popular topic. If Ferguson is correct in asserting that musicians can inspire change, is Lake Street Dive’s support of fighting tax avoidance the beginning of a larger social shift in consciousness about the tax issues affecting our society?

Lake Street Dive, founded in 2004 while its members were students at the New England Conservatory of Music in Boston, has a growing fan base — giving it a larger platform for its anti-tax-haven work. The band performs a hybrid of non-edgy pop and soul. It is driven by the voice of Rachael Price — who is backed up by standup bassist Bridget Kearney; guitarist, trumpeter, and keyboardist Mike Olson; and drummer Mike Calabrese. The band’s most recent album, Side Pony, is on the top 100 most downloaded albums on iTunes. It has recently been featured on such late-night staples as The Late Show with Stephen Colbert and Conan.

Ferguson explained that artists’ level of engagement with their fans depends on their own preferences. Some musicians host Oxfam information tables at their shows — as Lake Street Dive is doing with its anti-tax-haven campaign — donate music to raise funds for humanitarian relief work, or send Oxfam information out with mail orders for CDs and merchandise. Bands will also share information through social media and newsletters, links to websites, and talk about the issues during a performance, he said. “We are very grateful to all of them for partnering with us to inspire their fans to make a difference,” Ferguson said.

Lake Street Dive declined to comment for this story. Its publicist, Jim Merlis of Big Hassle, told Tax Analysts that the band’s participation in Oxfam’s anti-tax-haven effort is the first time he has heard a band discuss taxes.

Oxfam Tax Haven Campaign

The tax haven campaign Lake Street Dive is partnering with Oxfam on stems from an Oxfam January 2016 report on income inequality. In the report, the group notes that just 62 individuals have the same amount of wealth as the bottom half of the world’s population — 3.6 billion people — and that the wealth of the world’s richest 62 people has risen 44 percent in the past five years, while the wealth of the world’s poorest has decreased.

“A powerful example of an economic system that is rigged to work in the interests of the powerful is the global spider’s web of tax havens and the industry of tax avoidance, which has blossomed over recent decades,” the report says. “It has been given intellectual legitimacy by the dominant market fundamentalist world view that low taxes for rich individuals and companies are necessary to spur economic growth and are somehow good news for us all. The system is maintained by a highly paid, industrious bevy of professionals in the private banking, legal, accounting and investment industries.”

The report estimates that 30 percent of rich Africans’ wealth, which amounts to $500 billion, is held offshore in tax havens, costing African countries $14 billion a year in lost revenue, an amount that would cover healthcare for 4 million children and provide schooling for every African child. Oxfam says the International Bar Association has identified tax avoidance as an abuse of human rights because it harms the poor and offers a haven for trafficking and corruption.

In the U.S., Oxfam is supporting the Stop Tax Haven Abuse Act (S. 174), which was most recently introduced by Sen. Sheldon Whitehouse, D-R.I., in January 2015. The measure would require banks and brokers that discover, through money laundering due diligence, that the beneficial owner of a foreign account is a U.S. taxpayer to disclose that information to the IRS.

The bill would require investment advisers and corporate formation agents to establish anti-money-laundering procedures (31 U.S.C. section 5312). Investment advisers would be required to submit suspicious activity reports. Hedge funds and private equity funds
are not subject to those rules. The bill would also penalize jurisdictions and financial intermediaries found to be significantly impeding U.S. tax enforcement by preventing them from using U.S. correspondent accounts (31 U.S.C. section 5318A). A companion bill was also introduced in the House.

Ultimately, Oxfam and its partnering musicians are calling on world leaders to agree on a global approach to end the era of tax havens. “The tax burden is falling on ordinary people, while the richest companies and individuals pay too little. Governments must act together to correct this imbalance,” the report says.

Musicians and Policy

Musicians have a long history of acting as marketing arms for nonprofit organizations, as is the case with the Oxfam and the Lake Street Dive partnership. Revolutions Per Minute (RPM) is a San Francisco-based nonprofit organization that provides musicians with strategy and support for their activism and philanthropy. RPM will also match up musicians with nonprofit organizations based on the bands’ interests.

Although artists work with RPM on a variety of issues, RPM told Tax Analysts that it does not have any artists working on tax campaigns. Although there isn’t much history between tax advocacy and rock-and-roll, there are success stories that could provide optimism for Oxfam’s effort.

In 2009 California — faced with a fiscal crisis — had decided to cut $16 million in funding for domestic abuse services. The artist Moby decided to donate all of the profits from two sold-out concerts in California to a domestic abuse organization and worked with the California Partnership To End Domestic Abuse. Moby was able to raise awareness, and the California State Legislature eventually reinstated the $16 million funding.

Since 1985, Farm Aid has been putting on an annual benefit concert, working with local, regional, and national organizations to promote fair farm policies. Through its advocacy efforts, tens of thousands of petitions have been delivered to the Secretary of Agriculture.

Performance and songwriting have also proven to be powerful ways for musicians to make an impact, as Lady Gaga did when she co-wrote the song “‘Til It Happens to You” for the documentary The Hunting Ground, which raised awareness about sexual assault on college campuses. The song was nominated for a Grammy and Academy Award, and Lady Gaga gave a critically acclaimed performance at the Oscars that was introduced by Vice President Joe Biden.

IRS Inconsistent in Denying Estate Tax Deduction for OVDP Penalty

By denying an estate tax deduction for the miscellaneous offshore voluntary disclosure penalty for the estate of a woman who died in 2012, the IRS is acting contrary to its internal position on the issue, according to a lawyer involved in the case.

James Gifford, an associate with Anaford AG, filed a Freedom of Information Act request for documents related to the IRS’s previously undisclosed position on the issue. Milan Patel, a partner with the firm, said the agency’s position appears to have been formulated between 2013 and 2015. In a memo dated April 11, 2013, an unidentified IRS official expressed the agency’s “national position” that if no person other than the decedent “was cognizant of the existence of the offshore account, or participated in the movement of the funds offshore” before the estate tax return was filed, the IRS would allow the estate to deduct the offshore voluntary disclosure program penalties from the taxable gross estate. The official went on to say, however, that if anyone other than the decedent (including family members, accountants, attorneys, or anyone else with a material interest) was “cognizant” of the account’s existence and the executor or personal representative failed to make a disclosure by the due date of the return, no reduction of the penalty against the estate’s value would be allowed.

Patel said that position was contradicted by two more recent internal memos sent by John McDougal, special trial attorney and division counsel, IRS Small Business and Self-Employed Division. In the first, dated November 17, 2014, McDougal said that “if the voluntary disclosure is made only on behalf of the decedent then the penalty is clearly deductible.” And in a memo dated March 9, 2015, McDougal said, “the law is clear that, if the estate uses estate funds to pay a debt of the decedent — even if the debt is for a fine or penalty — then the estate is entitled to a deduction against the gross estate.”

Patel said his firm’s client is the estate of a dual U.S.-Swiss citizen with U.S. residency who failed to make a voluntary disclosure before her death. The woman’s daughter filed the disclosure promptly after being named executrix and paid the penalty out of the estate’s assets, Patel said. The IRS audited the estate tax return and told Patel that it would not allow the penalty as an administrative deduction of the estate. That determination contradicts the IRS’s position as stated in McDougal’s two memos, Patel said.

Reg. section 20.2053-6(a)(1) states that, in general, taxes are deductible in computing a decedent’s gross estate. Patel said that penalties are considered taxes. Section 6671(a) says that “Except as otherwise provided, any reference in this title to ‘tax’ imposed by this title shall be deemed also to refer to the penalties and liabilities provided by this subchapter.”

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Auditor’s Position ‘Nonsensical’

Patel said the position of the IRS auditor in the case of his firm’s client is nonsensical. He gave as an example a U.S. resident whose only assets consisted of an undisclosed offshore account valued at $5 million, which would be subject to a hypothetical OVDP penalty of $1 million. Patel said that assuming a 40 percent estate tax rate, no deductions for administering the estate, and no complications from state or foreign death taxes, if the individual paid the offshore penalty the day before dying, the estate would have a federal estate tax liability of $1.6 million (equal to 40 percent of the $4 million remaining after payment of the $1 million penalty). But if the decedent’s estate were to instead make the disclosure and at least one of the individual’s heirs had known about the undisclosed account before the date of death, Patel said, then the IRS would demand an estate tax of $2 million (equal to 40 percent on the entire $5 million value of the estate before payment of the $1 million penalty).

“The IRS is being punitive here,” Patel said. “Why should it make any difference whether the taxpayer dies before the disclosure is made or after?”

Patel also took issue with the fact that the IRS has issued no public guidance on the issue, forcing his firm to search for the relevant policies through a FOIA request. “The IRS is hiding a secret policy meant to punish family members who knew about a foreign account but couldn’t do anything about it at the time,” he said.

Similarly Situated Taxpayers

An IRS official confirmed to Tax Analysts that the agency has not published any guidance on the issue. Although the official said his agency would not be able to respond by press time to a request for comment on its position, it appears that McDougal explained the IRS’s thinking on the issue when he discussed Question 41 in the Offshore Voluntary Disclosure Program FAQ for 2014 in his March 9, 2015, memo.

Question 41. If there are multiple individuals with signature authority over an OVDP asset held in the name of a trust, does everyone involved need to file delinquent [foreign bank account reports]? If so, must everyone pay the offshore penalty?

Answer: Only one offshore penalty will be applied with respect to voluntary disclosures relating to the same OVDP asset. The penalty may be allocated among the taxpayers with beneficial ownership making the voluntary disclosures in any way they choose. The reporting requirements for filing an FBAR, however, do not change. Therefore, every person who is required to file an FBAR must file one.

In his memo, McDougal said the IRS has taken the position that the purpose of this FAQ was to avoid allocation controversies and provide a convenience to taxpayers, not to allow a family that happened to include a decedent to pay a lower effective penalty rate than a similarly situated family who were all living. In such cases, we have told the taxpayers that we will only allow allocation of the penalty among the living taxpayers. If they want to pay with estate assets, we have conditioned acceptance of those payment arrangements on the taxpayers’ agreeing that the payment is made on behalf of the heirs. That way it is clear that the payment is a distribution and not a payment of the decedent’s debt.

Patel said McDougal’s statement of the IRS’s position in the memo supports his client’s case because McDougal went on to say that “if the only disclosing taxpayer is the decedent, then the estate will be entitled to deduct the tax, interest, and penalty.”

Patel said the IRS should respect its internal position, as expressed in the McDougal memos, and allow the deduction for the penalty as an administrative expense because the estate made the disclosure and not the daughter. If the IRS doesn’t back down, Patel said, his secondary argument will be that the OVDP penalty reduces the value of the taxable estate at date of death.

“Since deductions are allowed by legislative grace, a court could say that these people have dirty hands, so we aren’t going to allow it,” Patel said. “But that’s a different issue than the estate’s value at the time of death, for which the body of law is even stronger in our favor. In that case, it becomes a simple mathematical calculation.”

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Starr Forgoes Appeal, Opt to Pursue Claim Under APA

Starr International Co. filed an amended complaint seeking judicial review under the Administrative Procedure Act (APA) following a February decision by the U.S. District Court for the District of Columbia that monetary relief was not available to the Swiss-domiciled company.

Starr, a former shareholder of American International Group Inc., is seeking a refund under the Switzerland-U.S. tax treaty of $38 million in withholding on dividends received from AIG in 2007.

The amended complaint alleges that the IRS improperly denied Starr’s request. Starr argued that the five reasons the IRS gave for denying treaty benefits were arbitrary, capricious, and an abuse of discretion because “obtaining benefits under the treaty was not a principal purpose of moving [its] residence from Ireland to Switzerland, but instead its owners had substantial reasons for moving that were unrelated to obtaining treaty benefits.”
Patrick J. Smith of Ivins, Phillips & Barker Chtd. said an interesting detail included in the amended complaint is an allegation that the IRS acted in bad faith because the former deputy commissioner with the IRS Large Business and International Division responsible for denying the treaty benefits request told a Starr representative that “he intended to find a basis for denying” the company’s request.

Smith said the allegation that the deputy commissioner reached a decision without rationale and then found a basis to defend it “doesn’t sound like an appropriate position for an IRS official to be taking.” That assertion appears “to be pretty powerful evidence in favor of the taxpayer’s position that the IRS acted arbitrarily and capriciously,” he said.

The litigation initially raised the question whether the U.S. competent authority’s exercise of discretion is subject to judicial review. In September 2015 the court determined in *Starr International Co. v. United States*, No. 1:14-cv-01593 (D.D.C. 2015), that it had the required authority after concluding that the government failed to demonstrate clear and convincing evidence overcoming the presumption of judicial review of federal agency action.

The government filed a motion to reconsider, arguing that the court misapprehended the government’s arguments. The court in February granted the motion for reconsideration after determining that granting monetary relief to Starr would interfere with the executive branch’s prerogative to engage in diplomatic consultation through the treaty process. The court did grant Starr an opportunity to amend its complaint to pursue a claim to set aside the IRS’s decision denying treaty benefits through the APA’s judicial review process. (Prior coverage: *Tax Notes Int’l*, Feb. 8, 2016, p. 501; and *Tax Notes Int’l*, Dec. 7, 2015, p. 821.)

Starr later filed a motion for an enlargement of time to amend its case so it could consider its next step. Smith said he was surprised to see that Starr was also considering filing a motion for reconsideration or seeking an order permitting it to file an immediate appeal.

According to Smith, the court clearly encouraged Starr to amend its complaint to pursue the APA claim when it granted the government’s motion for reconsideration. “It would seem to me that a motion for reconsideration wasn’t going to be successful and an immediate appeal seemed unlikely to achieve anything better from the court of appeals than they got from the district court,” he said, adding that “they might have got something worse.”

“Filing an amended complaint going the APA route was the only reasonable thing to do,” Smith said.

Smith said that the approach the Justice Department is taking in *Starr* to the APA appears inconsistent with its approach in *QinetiQ U.S. Holdings Inc. v. Commissioner*, No. 15-2192 (4th Cir. 2016). The Justice Department in *Starr* appears to accept the idea that the company can bring a claim under the APA arguing that the IRS’s decision on the treaty benefits request is arbitrary and capricious, he said, adding that the Justice Department in *QinetiQ* is asserting that an IRS notice of deficiency is not reviewable in court under the APA.

The notice of deficiency in *QinetiQ* is similar procedurally to the refund claim in *Starr*, so “it seems to me that the Justice Department is taking clearly inconsistent positions” in the two cases, Smith said.

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### IRS Changes Tune About Hard Drive In Microsoft FOIA Litigation

The IRS has found a computer hard drive with retrievable information that belonged to Samuel Maruca, former transfer pricing director at the IRS Large Business and International Division, the Justice Department told the U.S. District Court for the Western District of Washington on March 25.

The admission that the hard drive was not “sanitized,” as the DOJ asserted in January, is the latest twist in Microsoft Corp.’s ongoing Freedom of Information Act litigation (*Microsoft v. IRS*, No. 2:15-cv-00369; *Microsoft v. IRS*, No. 2:15-cv-00850) with the IRS, which has recently drawn Congress’s attention.

In October 2015 the court ordered the IRS to “search for, process, and release” nonexempt records responsive to Microsoft’s FOIA requests. The DOJ informed the court in January that Maruca’s hard drive had been sanitized in April 2015, despite a litigation hold instituted by the IRS Office of Chief Counsel. (Prior coverage: *Tax Notes Int’l*, Jan. 25, 2016, p. 317.)

Maruca was included on a list of individuals who might possess documents concerning the IRS’s contract with Quinn Emanuel Urquhart & Sullivan LLP when the company filed its first FOIA lawsuit in March 2015. Maruca left the IRS in August 2014, and the hard drive should have been recycled within 30 days under the IRS’s ordinary data management practices (CC-2012-17).

The latest DOJ statement explains that the IRS has continued to look for responsive records to satisfy the court order. The statement says that potentially responsive documents from the hard drive were saved elsewhere in July 2014 before Maruca left the IRS. Also, the IRS now says Maruca’s hard drive was not recycled in April 2015 and that it contains user-generated content.

According to the DOJ, the IRS is now processing the content in search of responsive records.

The FOIA litigation is closely connected with the company’s failed attempt to quash designated summonses issued against it in the ongoing transfer pricing
audit of its 2004-2006 tax years. The DOJ sued Microsoft to enforce the summonses after it failed to comply with them. Microsoft argued that enforcing the summonses would be an abuse of the court's process because the IRS engaged Quinn Emanuel, a private firm, to assist in the summons process. (Prior coverage: Tax Notes Int’l, Nov. 30, 2015, p. 732.)

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Puerto Rico’s AMT Unconstitutional, U.S. Court Holds

Holding that a portion of Puerto Rico’s alternative minimum tax is unconstitutional, Federal Judge José A. Fusté has granted Wal-Mart an immediate injunction against the secretary of the treasury to stop collection of tax.

The 109-page decision in Wal-Mart Puerto Rico Inc. v. Juan C. Zaragoza-Gomez, 3:15-CV-03018 (JAF), announced on March 28, says the tangible property tax portion of the AMT applies at a higher rate on transactions between a company in Puerto Rico and a foreign related party than it does on purely domestic transactions. Before a May 2015 amendment as part of Act 72 of 2015, Wal-Mart paid a 2 percent tangible property tax on applicable transactions. The rate under the amended provision is 6.5 percent.

In effect, every purchase of goods by Wal-Mart Puerto Rico from its parent company in the United States after the May 2015 amendment was subject to the higher tax rate. The court found that for the tax year that ended on January 15, Wal-Mart Puerto Rico paid more than $40 million in estimated income tax to Puerto Rico, around $30 million of which was attributable to the amended AMT.

Puerto Rico argued that the case should be dismissed because by law, Wal-Mart must first pay the tax and then seek a refund. However, both parties agreed that Puerto Rico would not be able to pay Wal-Mart the refund because the government is practically insolvent. “The AMT is a legislative money grab, pure and simple, funding the personal account of Puerto Rico’s insolvent Treasury from the presumably deeper pockets of large multistate corporations and their local affiliates,” said Fusté, a federal judge in the U.S. District Court for the District of Puerto Rico.

The court found that the tangible property tax provisions of the AMT violate the legal doctrine known as the dormant commerce clause, which provides that states cannot place excessive burdens on interstate commerce without congressional approval. However, the tangible property tax in the AMT applies only if the seller or transferor is not subject to income tax on the transaction in Puerto Rico, but the buyer is. In other words, the tax applies only to cross-border sales or transfers by an out-of-state company to its local branch or office.

Fusté cited Comptroller of the Treasury v. Wynne, 135 S. Ct. 1787 (2015), as support for the proposition that a state may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the state. To determine whether a tax discriminates against interstate commerce, the court must look to the practical or real economic effect of the tax, he said.

“Puerto Rico’s AMT, on its face, clearly discriminates against interstate commerce,” Fusté said, holding that the practical effect of the tax is to place an undue burden on multinational companies operating in Puerto Rico.

The court also held that the tax violates the Federal Relations Act and the equal protection clause of the U.S. Constitution. The Federal Relations Act provides that Puerto Rico can levy taxes on goods manufactured, sold, or brought into Puerto Rico, provided that Puerto Rico does not discriminate between goods produced in Puerto Rico and those produced in the U.S. or other foreign countries. The court found that the AMT violates the Federal Relations Act for the same reason it violates the dormant commerce clause — it clearly discriminates against products brought into Puerto Rico from the U.S.

Fusté held that the AMT violates the equal protection clause “because it is both arbitrary in its discrimination and not rationally connected to a legitimate governmental purpose.” The court found that the AMT was not intended to prevent abusive transfer pricing practices, as Puerto Rico argued, but instead was intended to quickly raise revenue for the Treasury, which is not a legitimate purpose justifying a discriminatory tax.

However, the judge said the AMT does not violate the constitutional prohibition against a bill of attainder law, as Wal-Mart claimed. The prohibition on bills of attainder in article 1, section 9 of the U.S. Constitution applies only to Congress, and the prohibition in article 1, section 10 applies only to the states. The court held that because Puerto Rico is a territory, the prohibition on bills of attainder does not apply. However, while the court agreed with Puerto Rico that the AMT does not violate the prohibition on bills of attainder, it still found the AMT unconstitutional.

Fusté lamented the condition of Puerto Rico’s finances, but the court agreed with an expert witness’s testimony that, “at the end of the day, the Commonwealth should not rely on revenue that it’s not entitled to, to try to pay for essential services.”

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Minneapolis Joins Trend of States Proposing Tax Haven Legislation

Minnesota will become the latest U.S. state this legislative season to consider tax haven legislation to address the taxation of foreign-source income and will do so with a bill that includes a list of tax haven countries that must be accounted for when companies file combined reports.

State Sen. John Marty (DFL) on March 29 introduced SF 3318, which lists the U.S. Virgin Islands and 45 foreign countries as tax havens. The bill would apply to any U.S. corporation that “is incorporated in a tax haven; that reports 20 percent or more of its gross income derived from sources in one or more tax havens; or that has the average of its property, payroll, and sales factors . . . within the 50 states of the United States and the District of Columbia of 20 percent or more.”

The bill also provides that a country would no longer be on the tax haven list after the first tax year in which it either enters into a tax treaty with the United States or imposes a tax rate of at least 10 percent on a tax base equal to at least 90 percent of the tax base that applies to corporations under the U.S. Internal Revenue Code.

With SF 3318, Minnesota’s first tax haven bill since 2013, the state becomes part of a trend of states not only introducing tax haven bills but increasing doing so in the most controversial way — by specifying what opponents call a “blacklist” of tax haven countries.

“This is definitely an issue that a lot of states are taking a hard look at,” Ryan Maness of MultiState Associates Inc. said. “As states are looking for increased revenue, they’re saying, ‘Oh, these huge corporations, they’re shifting their money overseas; we need to get some of that.’”

Maness said states are either adopting the tax haven list approach or crafting bills that give a state official or agency the authority to decide what constitutes a tax haven.

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Complaint Against AbbVie Over Inversion Motives Dismissed

A U.S. district court granted a motion by AbbVie Inc. and its CEO to dismiss a complaint by Shire PLC shareholders alleging that AbbVie downplayed the importance of tax advantages expected from its planned $54 billion merger with Shire, terminated in late 2014, despite finding that statements by the CEO may have been misleading.

The decision comes over one year after Shire shareholders filed suit in the U.S. District Court for the Northern District of Illinois against AbbVie and its CEO and chair, Richard Gonzalez, claiming the defendants had publicly made misleading statements in violation of U.S. securities laws regarding the tax motives of the deal, thus understating the potential impact that official action against inversions would have on the deal and inflating Shire’s share price. Judge Robert M. Dow Jr. dismissed the plaintiffs’ complaint without prejudice, giving them until May 2 to file an amended complaint.

In an opinion filed March 29, the court found that the plaintiffs had asserted facts sufficient to support a reasonable belief that a letter sent by Gonzalez to Shire employees expressing his confidence in the potential of the combined organizations and remarking that the ensuing months would be very busy in light of integration planning was false or misleading, rather than immaterial “puffing” or “corporate optimism.” Gonzalez’s letter was sent one week after Treasury issued the anti-inversion guidance, Notice 2014-52, 2014-42 IRB 712.

But the court further found that the plaintiffs failed to “state with particularity facts giving rise to a strong inference” that Gonzalez acted with the scienter required to establish liability under section 10(b) of the Securities Exchange Act of 1934 when he sent the letter dated September 29, 2014.

“The complaint does not allege facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness,” the court said, adding that the closeness in time between Gonzalez’s letter and AbbVie’s announcement that the deal would be reconsidered is not strong enough evidence that Gonzalez knew when he sent the letter that AbbVie would reconsider or call off the deal.

“If AbbVie was concerned about hiding the importance of the tax consequences even after Treasury issued its Notice, then why would its announcements that it was reconsidering and calling off the deal make clear that the Notice was the reason?” the court asked in the opinion. The pleadings fail to demonstrate why Gonzalez would lie or act with reckless disregard for the truth by implying the transaction was advancing if he knew at the time that AbbVie’s board of directors would be reconsidering its approval, the court said.

The plaintiffs also failed to assert facts sufficient to support a reasonable belief that six additional statements or omissions by AbbVie raised in the complaint were misleading, according to the court.

Regarding the plaintiffs’ allegation that AbbVie’s June 2014 announcement that it had approached Shire about a business combination was misleading, the court, quoting Stransky v. Cummins Engine Co., 51 F.3d 1329, 1331 (7th Cir. 1995), said, “Mere silence about even material information is not fraudulent absent a duty to speak.”
UNITED STATES

Plaintiffs also claimed that a number of public statements AbbVie made between June and August 2014 about the strategic rationales for the proposed merger with Shire downplayed the importance of the deal’s tax benefits, listing tax considerations as only one of several rationales. The court said the plaintiffs did not assert facts sufficient to support a reasonable belief that those statements were misleading by omission “such that AbbVie had a duty to disclose that it might call off the merger if the tax rules changed.”

The court also found the facts insufficient to support a reasonable belief that a statement by Gonzalez during a July 2014 investor call regarding the importance of tax synergies to the deal was false. Gonzalez had said that tax benefits were not the primary rationale for the merger and that AbbVie would not be doing the deal “if it was just for the tax impact.”

AbbVie’s loss of any benefit amounting to approximately 3 percent of the deal value represented by the $1.64 billion breakup fee or more could be expected to cause AbbVie to terminate the deal, the court said. “But it does not follow that any benefit of the deal that is worth at least 3 [percent] of the transaction value must be the ‘primary’ — i.e. the ‘most important’ — reason for the deal,” the opinion states.

The court also found that the relevant period for examining loss causation was from September 29, 2014, the date of Gonzalez’s letter, to October 14, 2014, when AbbVie announced its board was reconsidering the merger. This is a much shorter period than what was alleged by the plaintiffs, which stretched from the June 20, 2014, announcement of AbbVie’s approach to Shire until October 14, 2014. Plaintiffs’ loss causation allegations were therefore found insufficient as to several of the plaintiffs but sufficient as to plaintiffs William McWade and Vikas Shah, who bought or sold Shire shares between September 29 and October 14.

Since the termination of the merger, Shire has acquired New Jersey-based NPS Pharmaceuticals Inc. and announced its agreement to acquire Illinois-based Baxalta Inc., which was spun off from its U.S. parent company, Baxter International Inc., in July 2015.

According to a March 30 statement issued by Stack, the new requirements will be applied by treating those entities as corporations for purposes of section 6038A. The IRS included issuing the new regulations in its 2015-2016 priority guidance plan, released last year.

“As we announced when we released the priority guidance plan last August, we have been working on and expect to release soon proposed regulations that will treat these foreign-owned single-member LLCs as corporations solely for purposes of reporting under section 6038A of the code. This will provide a mechanism for us to require the filing of an information return, which will therefore require these foreign-owned LLCs to obtain a [taxpayer] identification number and thereby disclose who their foreign owner is,” Stack said.

Although the U.S. federal tax information reporting system is generally strong, the forthcoming regulations are necessary to address a gap in reporting requirements that allows “a narrow class of foreign-owned U.S. entities, typically single-member LLCs,” with specific types of income to avoid disclosure based on a lack of sufficient U.S. business activity or U.S. bank accounts, according to Stack. This may allow those entities to evade taxes or conceal their ownership, he said.

Stack said that although a change in the law is needed to fully resolve the issue of beneficial ownership, the new regulations will narrow the gap in reporting requirements. “Once these regulations are finalized, the IRS will be far better equipped to ensure that these entities are not facilitating U.S. tax avoidance and to respond to requests about these entities from other tax authorities as appropriate under our tax treaties and tax information exchange agreements,” according to Stack.

The United States faces growing international criticism over individual states’ business registration laws that allow domiciled LLCs to withhold the identity of their beneficial owners. The Financial Times (“Fear and Regulatory Loathing Makes America the Top Tax Haven”), Forbes (“The World’s Next Top Tax Haven Is . . . America”), Bloomberg BusinessWeek (“The World’s Favorite New Tax Haven Is the United States”), and The Economist (“The Biggest Loophole of All”) have all published pieces this year criticizing the United States for its lack of adequate disclosure requirements and its refusal to join the group of more than 90 countries adopting the OECD’s common reporting standard, despite having pressured other countries to implement the U.S. Foreign Account Tax Compliance Act. (Prior coverage: Tax Notes Int’l, Mar. 21, 2016, p. 1024.)

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Coming Regs Will Address Reporting Gap in Foreign-Owned LLCs

The U.S. Treasury Department will soon issue proposed regulations that would require foreign-owned single-member limited liability companies to report their beneficial owners to the IRS and obtain taxpayer identification numbers, according to Robert Stack, U.S. Treasury deputy assistant secretary (international tax affairs).

The United States faces growing international criticism over individual states’ business registration laws that allow domiciled LLCs to withhold the identity of their beneficial owners. The Financial Times (“Fear and Regulatory Loathing Makes America the Top Tax Haven”), Forbes (“The World’s Next Top Tax Haven Is . . . America”), Bloomberg BusinessWeek (“The World’s Favorite New Tax Haven Is the United States”), and The Economist (“The Biggest Loophole of All”) have all published pieces this year criticizing the United States for its lack of adequate disclosure requirements and its refusal to join the group of more than 90 countries adopting the OECD’s common reporting standard, despite having pressured other countries to implement the U.S. Foreign Account Tax Compliance Act. (Prior coverage: Tax Notes Int’l, Mar. 21, 2016, p. 1024.)

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New Procedures May Explain Surge in APA Applications

A rush to apply for advance pricing agreements before they must comply with a new revenue procedure may help explain an almost 70 percent increase in filed applications from 2014 to 2015, according to Hareesh Dhawale, director of the advance pricing and mutual agreement program in the IRS Large Business and International Division.

Commenting on the annual statutory report on APAs, which the IRS released March 30, Dhawale said the higher numbers in 2015 were largely driven by record applications in the fourth quarter. Not only did executed APAs rise from 101 in 2014 to 110 in 2015, pending applications increased from 336 in 2014 to 401 in 2015, according to the report.

The surge may indicate that taxpayers are still digesting the new procedure, Dhawale said. Rev. Proc. 2015-41, 2015-35 IRB 263, contains more detailed requirements for the submission of information but allows taxpayers to apply for an APA under the 2006 procedure until December 29.

It’s possible that the OECD’s base erosion and profit-shifting project report on transfer pricing has contributed to the increase in multinationals seeking certainty through APAs, but it’s too early to tell what the true impact will be, according to Dhawale. “I think it will take a little more time to see exactly how revised guidelines are affecting exams and how taxpayers are responding to questions,” he said.

Broadly consistent with previous years, most of the 2015 APAs (64 percent) involved a foreign parent and a U.S. subsidiary, and Japan and Canada jointly accounted for most of the executed bilateral APAs (69 percent) and most APAs. Also as in prior years, the comparable profit method was by far the most commonly used transfer pricing method (79 percent); distributors and providers of distribution-related services accounted for most of the tested parties; and most CPM analyses (62 percent) used the operating margin (operating profit divided by revenue) as the profit level indicator. However, the use of the Berry ratio (gross profit divided by operating expenses) increased from 8 percent of all CPM analyses in 2014 to 25 percent in 2015.

One new development in 2015 was the execution of the first bilateral APA with Italy, according to the report. It also says the model APA agreement is under review for future changes, and Dhawale said he hopes it will be released in the coming months.

APMA is expecting applications to continue to rise in 2016, in part because the IRS began accepting applications for bilateral APAs with India in February. “We hope that we can move efficiently in managing the APA requests that will be coming,” Dhawale said.

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Belgium / Japan

Japan Announces Negotiations for Protocol to Tax Treaty

 Officials from Belgium and Japan are meeting March 29 in Tokyo to begin negotiations on a protocol that would amend the income tax treaty signed by the two countries, the Japanese Ministry of Finance has announced.

 This would be the third amendment to the treaty, which was signed March 28, 1968. Earlier protocols were signed in 1988 and 2010.

Belgium / Switzerland

2014 Protocol to Belgium-Switzerland Tax Treaty Available

 Tax Analysts has prepared an English translation of the protocol signed April 10, 2014, in Brussels, that amends the Belgium-Switzerland income and capital tax treaty.

 The protocol amends the treaty articles concerning taxes covered, general definitions, residence, dividends, interest, royalties, capital gains, artistes and athletes, government service, nondiscrimination, and mutual agreement procedure. It replaces the articles on business profits, directors’ fees, pensions, and elimination of double taxation. It also replaces the exchange of information article to bring the treaty in line with the OECD standard and adds a final protocol to the treaty.

 This is the first amendment to the treaty, which was signed in Bern on August 28, 1978, and has been in effect since January 1, 1980. The protocol will enter into force once the countries exchange ratification instruments, and its provisions will generally apply from January 1 of the year following entry into force.

Brazil / Council of Europe / OECD

Brazil Approves Mutual Assistance Convention

 Brazil’s Chamber of Deputies (lower house of the National Congress) on March 24 approved the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, as amended by the 2010 protocol, the Brazilian Ministry of Finance has announced.

 Brazil signed the amended convention on November 3, 2011. It will enter into force and apply in Brazil three months after the deposit of the ratification instrument. Brazil will complete the ratification process when the convention is approved by the Federal Senate and the president issues a decree on the promulgation of the convention.

 The convention was originally opened for signature on January 25, 1988. It provides for the mutual exchange of tax information and assistance in the recovery of taxes and the service of documents. The protocol, originally opened for signature on May 27, 2010, updates the convention in accordance with the OECD standard on information exchange.

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Cyprus / Ukraine

Ukraine Approves for Ratification Protocol to Cyprus Tax Treaty

 The Ukrainian government on March 30 approved for ratification the pending protocol to the 2012 Cyprus-Ukraine tax treaty, according to information published on the website of the Ukrainian Ministry of Finance.
The protocol was signed on December 11, 2015, in Kiev and is the first amendment to the treaty. It modifies the treaty article on dividends, stipulating that dividends are taxable at a maximum rate of 5 percent if the beneficial owner is a company (other than a partnership) that directly holds at least 20 percent of the capital of the payer company and has invested at least €100,000 or its equivalent in other currency in the shares or other rights of the company. The protocol reduces from 15 percent to 10 percent the rate that applies to dividends in other cases.

It also raises the withholding tax rate on interest from 2 percent to 5 percent and replaces the article on capital gains. Article 4 of the protocol sets out a most favored nation clause regarding the withholding tax rates provided in the dividends, interest, and royalties articles, and the provisions of the capital gains article.

The protocol will enter into force after the exchange of ratification instruments and will apply from January 1, 2019, or, if the protocol enters into force after that date, from January 1 of any year after January 1, 2019. Ukraine will complete the ratification process when the law on the ratification of the protocol is approved by the parliament and signed by the president.

— Iurie Lungu, Graham & Levintsa, Chisinau

Finland / U.A.E.

Finland, U.A.E. Sign TIEA

Officials from Finland and the United Arab Emirates signed a tax information exchange agreement on March 27 in Abu Dhabi, the U.A.E. government has announced.

The TIEA was signed by Riitta Swan, Finnish ambassador to the U.A.E., and Younis Haji Al Khoori, undersecretary of the U.A.E. Ministry of Finance.

This is the first TIEA between the two countries. It will enter into force after the exchange of ratification instruments.

— Sarah Carpenter, Tax Analysts. Email: sarah.carpenter@taxanalysts.org

Georgia / Korea (R.O.K.)

Georgia, South Korea Expect to Sign Tax Treaty

Officials from Georgia and South Korea are expected to sign an income tax treaty during an upcoming visit by Georgian Minister of Finance Nodar Khaduri to South Korea, the Georgian Ministry of Finance has announced in a release.

Khaduri and Kim In-hwan, South Korean charge d’affaires in Georgia, met on March 28 in Tbilisi to discuss investment opportunities for Korea in Georgia. A tax treaty between their countries would increase economic cooperation and attract more investment, according to the release.

Negotiations began in June 2015, and the Georgian government authorized the signing of a draft tax treaty in July 2015. This would be the first tax treaty between the two countries. It must be signed and ratified by both sides before entering into force.

— Sarah Carpenter, Tax Analysts. Email: sarah.carpenter@taxanalysts.org

India / Indonesia

India-Indonesia Tax Treaty Enters Into Force

The India-Indonesia income tax treaty entered into force February 6, according to a March 16 notification published by the Indian Ministry of Finance.

The treaty was signed in New Delhi on July 27, 2012. Its provisions will apply in India from April 1, 2017, and in Indonesia from January 1, 2017. It replaces the treaty signed in Jakarta on August 7, 1987.

Under the treaty, a maximum withholding rate of 10 percent applies to dividends, interest, and royalties. Both countries generally apply the credit method for the elimination of double taxation.

— Larissa Hoaglund, Tax Analysts. Email: larissa.hoaglund@taxanalysts.org
India / Korea (R.O.K.)

2015 India-South Korea Income Tax Treaty Available

Tax Analysts has obtained the English text of the India-South Korea income tax treaty signed May 18, 2015, in Seoul.

Under the treaty, dividends are subject to a 15 percent withholding rate. Interest, royalties, and fees for technical services are taxable at a maximum rate of 10 percent. Both countries generally apply the credit method to eliminate double taxation.

The treaty will enter into force once ratification instruments are exchanged, and its provisions will apply in India from April 1 of the year following entry into force and in Macedonia from January 1 of the year following its entry into force. Once in force and effective, the treaty will replace the countries’ existing agreement signed in Seoul on July 19, 1985.

India / Marshall Islands

India, Marshall Islands Sign TIEA

Officials from India and the Marshall Islands signed a tax information exchange agreement on March 17 in Majuro, the Indian Ministry of External Affairs has announced.

Sujan Chinoy, Indian ambassador to Japan, and John Silk, Marshall Islands foreign minister and acting finance minister, signed the agreement on behalf of their countries.

This is the first TIEA between India and the Marshall Islands. It will enter into force after the exchange of ratification instruments.

— Larissa Hoaglund, Tax Analysts
Email: larissa.hoaglund@taxanalysts.org

India / Multinational

India Signs 11 New Unilateral APAs

The Indian Central Board of Direct Taxes has signed 11 new unilateral advance pricing agreements with taxpayers, bringing the total number of APAs signed to 59, according to a March 29 release.

Isle of Man / United Kingdom

2016 Protocol to Isle of Man-U.K. SSA Available

Tax Analysts has obtained the text of the protocol signed January 28 that amends the Isle of Man-United Kingdom social security agreement (SSA). The protocol will enter into force and apply from April 6.

The SSA, signed November 10, 1977, entered into force and has effect from January 1, 1978.

Italy / Chile / Iran

Italian Cabinet Approves Tax Treaties With Chile, Iran

Italy’s Council of Ministers (executive branch) on March 25 approved draft laws ratifying Italy’s income tax treaties with Chile and Iran, the Italian government has announced.

The Chile-Italy treaty, signed in Santiago on October 23, 2015, is the first agreement of its kind between the two countries. It will enter into force once ratification instruments are exchanged, and its provisions will apply from January 1 of the year following its entry into force.

Under the treaty, dividends are taxable at a maximum rate of 5 percent if the beneficial owner is a company that directly holds at least 25 percent of the capital of the payer company. In other cases, a 10 percent rate applies.

Interest is taxable at a top rate of 15 percent. However, a 5 percent rate applies to interest derived from:

- loans granted by banks and insurance companies;
- bonds or securities that are regularly and substantially traded on a recognized securities market; or
- sales on credit paid by the purchaser of machinery and equipment to a beneficial owner that is the seller of the machinery and equipment.

Royalties are taxable at a maximum rate of 5 percent for the use of, or right to use, any industrial, commercial, or scientific equipment. In other cases, a 10 percent rate applies. Both countries generally apply the credit method to eliminate double taxation.

The Iran-Italy treaty was signed in Tehran on January 19, 2005. It is the first income tax treaty between
the two countries, and it will enter into force after the exchange of ratification instruments.

— Sarah Carpenter, Tax Analysts.  
Email: sarah.carpenter@taxanalysts.org

Japan / Finland / Turkey

Japan Negotiating SSAs With Finland, Turkey

Japan is negotiating social security agreements (SSAs) with Finland and Turkey, the Japanese Ministry of Foreign Affairs has announced.

Finnish President Sauli Niinistö met with Japanese Prime Minister Shinzo Abe March 10 in Tokyo and agreed to conclude negotiations on an SSA between the two countries. An initial round of talks took place March 25-29, 2012, in Tokyo.

The fifth round of negotiations between Japan and Turkey is scheduled for April 4-8 in Tokyo. Negotiations began at a meeting in Tokyo in May 2014; successive meetings were held in Ankara in November 2014, in Tokyo in May 2015, and in Ankara in August 2015.

These would be the first SSAs concluded between Japan and the respective countries. They must be finalized, signed, and ratified by both sides before entering into force.

— Sarah Carpenter, Tax Analysts.  
Email: sarah.carpenter@taxanalysts.org

Jordan / Turkey

Jordan, Turkey Sign Social Security Agreement

Officials from Turkey and Jordan signed a social security agreement (SSA) on March 27 in Amman, according to information published on Turkish Prime Minister Ahmet Davutoglu’s website.

The SSA, along with a series of other cooperation documents, was signed during an official visit by Davutoglu to Jordan. Jordanian Minister of Labor Nidal Katamine and Turkish Minister of Foreign Affairs Mevlut Cavusoglu signed the SSA. It will enter into force after the exchange of ratification instruments.

— Iurie Lungu, Graham & Levintsa, Chisinau

Latvia / Multinational

Latvia Notes Status of Tax Treaty Negotiations

Latvia has initialed a tax treaty with Vietnam and a protocol to its tax treaty with Switzerland, according to a March 1 update from the Latvian Ministry of Finance.

The income tax treaty with Vietnam, the first of its kind between the two countries, was initialed on October 9, 2015. It must be finalized, signed, and ratified by both sides before entering into force.

The protocol to the Latvia-Switzerland income tax treaty was initialed on December 3, 2015. This would be the first amendment to the treaty, which was signed January 31, 2002, and has been in effect since January 1, 2003.

A preliminary round of negotiations for a tax treaty with Japan took place February 22-26 and talks are underway for a tax treaty with South Africa. These would be the first agreements of their kind between Latvia and the respective countries. They must be signed and ratified by the contracting parties before they can enter into force.

Negotiations for a protocol to the Latvia-Singapore income tax treaty have reached the final stage. This would be the first amendment to the treaty, which was signed October 6, 1999, and entered into force February 18, 2000.

— Sarah Carpenter, Tax Analysts.  
Email: sarah.carpenter@taxanalysts.org

For the texts of these and other treaties, see Worldwide Tax Treaties, your source for daily tax treaty news and more than 9,000 treaties. WTT allows subscribers to directly compare dividends, interest, and royalties withholding tax rates for in-force income tax treaties; compare two or three tax treaties of any status; view treaties in original languages; search an archive of news and analysis by international tax specialists; and review U.S. legislative history, case law, and guidance.

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Israel’s Proposed VAT for Foreign Digital Service Providers

by Yuval Navot and Tamara Tapoohi Waldman

Yuval Navot and Tamara Tapoohi Waldman are partners at Herzog, Fox & Neeman in Tel Aviv. Email: navoty@hfn.co.il, tapohit@hfn.co.il

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In this article, the authors discuss proposed Israeli legislation that would shift the VAT payment obligation on digital services provided by foreign entities from consumers to foreign service providers.

In March the Israel Tax Authority published for circulation and comments draft legislation addressing the issue of VAT in transactions offered by foreign entities providing digital, radio, and TV services to Israeli consumers (foreign service provider). The proposed legislation would shift the payment obligation from the consumer to the foreign service provider in business-to-consumer (B2C)-type transactions.

The proposed legislation, which amends the current VAT Law, comes after the heavy criticism aimed at a draft circular issued by the Israel Tax Authority in April 2015, which interpreted the current law as requiring Internet-based foreign entities to register and pay VAT in Israel. (Prior coverage: Tax Notes Int’l, Apr. 13, 2015, p. 126.) The justification behind the proposed legislation is:

• the problematic nature of collecting the VAT from individual consumers; and
• to avoid discrimination between Israeli-based businesses that pay full VAT and foreign service providers that do not currently pay VAT in Israel.

No effective date was set in the proposed legislation. It is a preliminary stage in the legislative process to collect comments on the proposed legislation. The final law can differ from the proposed legislation.

VAT Payment Obligation

Under the proposed legislation, the obligation for payment of VAT (currently at 17 percent) is on the foreign entity providing digital or e-commerce B2C services or business-to-business (B2B) services where those services are not provided in the ordinary course of the business of the Israeli consumer. The obligation for payment of VAT in the case of B2B services that are provided in the ordinary course of the Israeli client’s business has not changed; the Israeli business is still required to pay the VAT on a reverse-charge mechanism. The obligation for payment of VAT applies also to an intermediary (for example, a platform) that facilitates a supply to an Israeli consumer.

A foreign entity is defined as an entity that is incorporated outside Israel and that does not have any activity in Israel that requires it to register for VAT under the VAT Law. The definition of an Israeli resident is not based on the definition used elsewhere in the Israeli tax legislation or the VAT Law, but rather refers to a taxpayer that has been identified as Israeli according to some general guidelines (such as payment method, the equipment used to purchase the service or item (possibly the reference is to the IP address), and the location of the consumer (presumably his address or the address provided for delivery of goods)). The
obligation to determine if the consumer is Israeli as defined under the proposed legislation belongs to the foreign service provider.

The definition of digital services is very broad and includes telecommunication services, TV or radio broadcasts, or the provision of an electronic service. Telecommunication services are defined as a service provided in connection with the transfer or receipt of signals, words, sounds, photos, or any other information, via any line, fiber optic, radio, or any other electromagnetic system; these include, inter alia, landline or mobile telephone services, Voice over Internet Protocol (VoIP) services, fax, and Internet access services. The provision of an electronic service is defined as providing a service, including the sale of intangible goods, via the Internet or cellular service, including, inter alia, software, books, music, gambling, games, TV shows, movies, online broadcasting, and distance learning.

The payment obligation arises on a cash basis when payment is received by the foreign service provider and is based on the amount received.

**Registration and Reporting Obligations**

The proposed legislation requires the foreign service provider to register for VAT in Israel unless it does not meet the de minimis threshold (currently $25,000). The registration will be done in a separate registry for foreign service providers. We believe that this revenue threshold, which is the domestic registration requirement threshold, is too low in the context of non-Israeli Internet companies and that the compliance costs that would be imposed on the foreign service provider should be taken into account in setting a higher threshold.

Timing and period for the VAT reporting are not specified (for example, what currency will be used for the reporting, how frequent will one need to report, and so forth) and will be determined in regulations issued once the proposed legislation comes into effect. Nonetheless, the proposed legislation provides that the report will need to provide information about the price of the transactions with Israeli consumers as well as the applicable VAT amount to be paid over to the VAT authorities.

The foreign service provider will need to save information on the transactions in question for 10 years. Also, the ITA will have 10 years to conduct an audit. We note that the normal audit period for taxpayers under current VAT law is five years, so the proposed legislation is discriminatory in this respect.

We believe that the proposed legislation’s imposition of tax on certain B2B transactions (B2B services where such services are not provided in the ordinary course of the business of the Israeli customer) is not efficient and would impose unnecessary characterization issues. There are also some technical aspects of the legislation that still need to be worked out. For example, we believe that foreign service providers should be allowed to report on a quarterly basis (as opposed to monthly reports required under the VAT Law) and be based on the functional currency of the foreign service provider (as opposed to Israeli new shekels). Also, certain exemptions from requirements related to invoicing should be adopted, especially an exemption from the requirement that invoices be issued in Hebrew.

Although the ITA is claiming that the legislation is in line with the recommendations of the base erosion and profit-shifting project, it appears that the proposed legislation puts a large onus on foreign service providers, larger than necessary. The manner in which the foreign service providers need to collect and pay the VAT will require burdensome adjustments on the foreign service providers side.
Multilateral Agreement on Automatic Exchange of CbC Reports: A Mexican Perspective

by Santiago Chacón and Alejandro Gordillo Rousse

Santiago Chacón is a partner and Alejandro Gordillo Rousse is a senior associate at Garrigues Mexico in Mexico City.

In this article, the authors discuss Mexico’s participation in the OECD’s multilateral competent authority agreement on the automatic exchange of country-by-country reports.

On January 27 Mexico became one of over 30 countries to sign the OECD’s multilateral competent authority agreement (MCAA), which sets out the legal framework for the automatic exchange of country-by-country (CbC) reports by tax administrations. From an international tax policy perspective, the MCAA is targeted at facilitating the exchange of information and international cooperation in line with the principles of the OECD’s base erosion and profit-shifting project.

CbC Reporting: International Precedents

In September 2015 the OECD released its final report on BEPS action 13, in which it provided guidance on the implementation of transfer pricing documentation and CbC reporting. The action 13 report recommends an annual obligation for multinational enterprises to file a CbC report on their activities in every BEPS jurisdiction and the terms and conditions to be observed by tax administrations in sharing this information.

Many countries, including Mexico, decided to go beyond the second recommendation by signing on to the MCAA. The agreement relies in part on article 6 of the Convention on Mutual Administrative Assistance in Tax Matters, which provides for mandatory mechanisms to be observed by countries engaging in the automatic exchange of information. The MCAA was also inspired by the multilateral competent authority agreement to automatically exchange information under the common reporting standard.

MCAA: General Features

Under the MCAA, tax administrations in participating countries (including Mexico) are committed to automatically and instantaneously remitting available information.

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1The MCAA has been signed by OECD and non-OECD countries alike, including Australia, Austria, Belgium, Chile, Costa Rica, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Japan, Liechtenstein, Luxemburg, Malaysia, the Netherlands, Nigeria, Norway, Poland, Portugal, Slovakia, Slovenia, South Africa, Spain, Sweden, Switzerland, and the United Kingdom. More signatories are expected.

2The convention was developed by the European Commission along with the OECD in 1988 and amended in 2010. It has been signed by more than 90 countries, including Mexico.

3This agreement was signed by 51 countries, including Mexico, on October 29, 2014, and also relies on article 6 of the convention to some extent.
CbC reports on particular taxpayers to other jurisdictions where those taxpayers are present or active. The MCAA will enter into force after the signatory countries make formal notifications to the general coordinating body secretariat. The agreement requires every participating jurisdiction to communicate its intent to be considered as either a “nonreciprocal jurisdiction” (a country that is willing to exchange information received from its taxpayers but does not intend to collect information from other participant countries) or a “reciprocal jurisdiction” (a country that will exchange information both ways).

**CbC Reporting: Implementation in Mexico**

The MCAA does not require ratification by the Mexican Senate because it is structured as an inter-institutional agreement rather than a multilateral treaty. For the first fiscal year after the MCAA is enacted, the Mexican Tax Administration Service (Servicio de Administración Tributaria, or SAT) has up to 18 months to exchange CbC reports with reciprocal jurisdictions, starting from the end of the fiscal year subject to exchange. From the second fiscal year after enactment onward, the Mexican fisc has up to 15 months to exchange CbC reports with reciprocal jurisdictions, starting from the end of the relevant fiscal years.

These parameters are also reflected in Mexican domestic legislation enacted for the purpose of filing CbC reports. The legal obligation to file the CbC report with the Mexican authorities is contained in the Mexican Income Tax Law (MITL), in force as of January 1, 2016.

Fiscal 2016 is the first period that must be reported to the SAT. Taxpayers are required to file the report on or before December 31, 2017. Under the MCAA, the SAT is therefore required to exchange CbC reports with reciprocal jurisdictions no later than June 30, 2018.

According to article 76-A of the MITL, the only taxpayers required to file CbC reports with the SAT are Mexican resident multinational holding companies that have consolidated book revenue of approximately $650 million in the previous fiscal year. The MITL defines multinational holding companies as Mexican resident legal entities that are not subsidiaries of foreign residents; that have subsidiaries and/or permanent establishments abroad; and that are required to prepare, file, and reveal consolidated financial statements, including reporting foreign entities’ balances in referred financial statements. Since this provision does not apply to Mexican subsidiaries of foreign residents, it can be said to apply only to large Mexican multinationals with foreign affiliates.

Multinational groups might still be affected by article 76-A, however, if the group’s foreign holding company appoints a Mexican resident subsidiary (or Mexican PE) to file the CbC report on the group’s behalf or if Mexico becomes a reciprocal jurisdiction and receives CbC reports on multinationals in Mexico through reports from affiliates resident elsewhere.

Taxpayers that must prepare and file CbC reports under these rules should note Section III of article 76-A, which requires the following to be included in the “informative CbC return”:

- information on worldwide distribution of profits as well as taxes paid in every participant jurisdiction;
- a register of economic information specifying for every country where the group has activities: total revenue (splitting revenue from related and non-related parties), profits or losses, income tax effectively paid, income tax triggered, capital accounts, accumulated profits or losses, number of employees, fixed assets, and inventory; and
- a list of every subsidiary and PE worldwide, specifying their main economic activities, country of incorporation, tax residency, and any additional relevant information.

Under these provisions, MNEs with headquarters outside Mexico are, in principle, not required to file CbC reports with the SAT. Under the MCAA, however, the Mexican fisc can request CbC reports from reciprocal jurisdictions in which the foreign MNEs have their headquarters.

This is an important consideration, since, in our experience, the Mexican fisc has attempted to build cases through tax audits of foreign MNEs’ Mexican subsidiaries. The SAT has requested financial and tax information (for example, worldwide revenue and profit margin of the headquarters) to help sustain “substance over form” arguments against subsidiaries engaging in profit shifting abroad without paying the corresponding taxes in Mexico. It was difficult for the SAT to obtain such information before Mexico signed the MCAA, since it lacked legal grounds to do so in many cases.

An important result of Mexico having entered into the MCAA is that the SAT will now automatically obtain CbC reports from reciprocal jurisdictions where MNEs typically set up subholding entities, principal structures, patent box regimes, captive financial entities, and so forth (jurisdictions such as Ireland, Liechtenstein, Luxembourg, the Netherlands, Switzerland, Belgium, Spain, and the U.K., among others).

Aside from the tax implications, the new obligations could also have important commercial consequences for taxpayers. MNEs will have the administrative and
legal burden of revealing financial information that can be confidential and indispensable for the businesses, such as worldwide pretax profits and a group’s net income from both related and unrelated parties. Given the concern that these potential effects have caused among some large taxpayers, we anticipate that related tax disputes will be brought before the SAT and the Mexican courts.

Final Comments

Thirty-one countries have signed the MCAA, including OECD members and nonmembers alike. Considering the large number of countries that have signed the Convention on Mutual Administrative Assistance in Tax Matters, it is likely that more countries will adopt the MCAA. This might suggest that the Mexican SAT and other fiscs will soon be able to exchange CbC reports not only with OECD members but with nonmembers, including so-called tax havens. So far, however, the United States has not signed on.

COMING ATTRACTIONS

A look ahead at upcoming commentary and analysis.

Taxpayer rights: Coping with globalization and uncertainty (Tax Notes International)

Duncan Bentley redefines the terminology of taxpayer rights, explores the concept of pragmatic rights founded in soft law, and shows that when the principles and legal rules that form the basis for protecting taxpayer rights are reinforced by a strong rule of law, rights expand through taxpayer engagement.

A catalog of confusion — VAT repayments (Tax Notes International)

Trevor Johnson discusses a long-running and complex appeal, involving four companies and a number of different VAT repayments, heard by the U.K. Supreme Court.

Tax reform in Kansas: Myth vs. fact (State Tax Notes)

Jonathan Williams and Joseph Horvath argue that while the Kansas tax cuts enacted in 2012 have been the target of widespread criticism and blamed for the state’s recent budget woes, spending is more to blame, and there’s evidence that the reforms are beginning to turn Kansas's economy around.

IBM — The prequel: The MTC election and the single business tax (State Tax Notes)

Lynn Gandhi examines the Michigan Court of Appeals' recent finding that the state's Single Business Tax Act did not implicitly repeal the election of the Multistate Tax Compact by taxpayers and that the state's Public Act 282 of 2014 did not bar taxpayers from refund claims.

A brief review of corporate tax articles of 2014-2015 (Tax Notes)

Jordan M. Barry and Karen C. Burke review notable corporate tax law literature from 2014 and 2015, including an article on whether corporations should have to publicly disclose their returns in light of recent aggressive international corporate tax minimization strategies and the theory that public shaming could affect corporate behavior.

Significant issue rulings leave lots to the imagination (Tax Notes)

Jasper L. “Jack” Cummings, Jr., analyzes two letter rulings on spinoffs and is critical of one that involves the continuity of business enterprise requirement.
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The allocation of profits to permanent establishments is one of the most controversial matters in international tax law. Clear and consistent principles are needed to provide certainty in this context.

A recent decision by the German Federal Fiscal Court (Bundesfinanzhof, or BFH) offers some such legal certainty, at least from a German tax law perspective. The court held that the causation principle (Veranlassungsprinzip) has special significance in the allocation of income to permanent establishments under domestic and treaty law.

This article includes discussion of the court’s decision and its practical significance, such as its continued applicability in the face of the new authorized OECD approach (AOA).1

I. Facts

The case centered on a German GmbH & Co. KG parent company (Organträgerin) of a tax group (Organschaft) that operated a subsidiary (a limited liability company) in accordance with sections 14 et seq. of the German Corporate Tax Act (Körperschaftsteuergesetz, or KStG). The subsidiary had operated a PE in Belgium that closed in 2000. Provisions for contingent liabilities were accrued in connection with the PE’s business.

One of these provisions was reversed in 2009. Because the Belgian PE had since closed, the tax authority presumed that the PE’s assets were to be allocated to the German head office and that the income resulting from the reversal of the provision would be subject to German taxation. In the tax authority’s view, although the provision was established in relation to the Belgian PE, the tax jurisdiction of the state in which the PE was located was no longer relevant.2

II. Decision Grounds

The first senate of the BFH dismissed the appeal of the tax authority against the lower court’s decision as unfounded.3 The income resulting from the partial reversal of the provision was held to be exempt from taxation.

1Based on the AOA as incorporated in section 1(5) of the German Foreign Tax Act (AStG).

2See article 23, para. 1, no. 1 in conjunction with article 7, para. 1 and article 5, para. 1 of the 1969 Belgium-Germany tax treaty.
German tax because the income and the provision originated from the Belgian PE and should be allocated to it as operating income.\(^4\)

Since the closure of the PE in the interim was held by the court not to have affected the income’s causation, Belgium retained its right to tax the income. The opposite view,\(^5\) that Belgium could not tax the income unless the PE existed at the time of allocation, was rejected.

According to article 7, paragraph 1 of the double taxation treaty between Germany and Belgium, the right to tax the PE’s business profits falls to the other state if the enterprise “carries on” business activities there through a PE. Even though article 7, paragraph 1 is drafted in present tense, it should be interpreted as merely ensuring a connection to a PE that is maintained in the source country. Further revenues and expenditures must still be determined and allocated according to causation under domestic tax law.\(^6\) In allocating these revenues and expenditures, it is irrelevant whether the company or PE has closed in the interim. This reasoning corresponds with the arm’s-length approach set out in article 7 of the Belgium-Germany treaty.

The cessation of the PE’s operations provided no legal basis for breaking the causation link (Veranschlagungszusammenhang) between its business and the income in question. As a result, the income from the partial reversal of the provision was held to be subject to Belgian taxation.

III. Comments on the Decision

A. PE Profit Allocation

1. Causation as an Allocation Standard

The causation principle is the general criterion for allocation under German tax law.\(^7\) To apply the principle in allocating income to PEs, it must be determined whether the income or business assets were triggered by the PE’s business activity, as they were in this case.\(^8\) The causation principle must also be applied in determining the profits to be attributed to PEs under article 7, paragraph 2 of the OECD model tax convention.\(^9\)

The contrasting view, that income can only be allocated to a PE if it exists at the time the income is derived,\(^10\) was rejected by the German court. The German senate instead focused on whether the PE existed in another state at some point and whether the relevant income was triggered during the PE’s existence.

Some exceptions to this approach apply to startup expenses related to PEs. The BFH recently held that PEs’ startup expenses were to be allocated to the potential PE state. These expenses would therefore be tax exempt even if the establishment of the PE failed, since the expenses were incurred because of it.\(^11\) This view does not seem compatible with the use of the present tense in article 7, paragraph 1 of the Belgium-Germany tax treaty because in this situation, the PE never existed. The allocation to the PE state should arguably not occur if the PE had never been established.\(^12\) The court’s position is understandable, however — it does not want to carve out exceptions to the principle.

Conversely, the same principles should be applied in inbound cases.\(^13\) If a German PE were closed, the income generated afterwards would have originated in Germany and so would be subject to German taxation.\(^14\)

2. Compatibility With Other Approaches

Little guidance is available from the OECD on the allocation of income or expenses derived before or after the PE’s formation. In its 2010 report on the attribution of profits to PEs, the OECD acknowledged problems relating to these issues through its AOA but “did not seek to resolve” them.\(^15\) Against the background of this vague statement, it is apparent that the German court’s case law neither contradicts nor directly adheres to the OECD view.

\(^3\) BFH, May 20, 2015, I R 75/14, BFH/NV 2015, 1687.
\(^4\) In accordance with article 23, para. 1, no. 1, sentence 1 in conjunction with article 7, para. 1 of the Belgium-Germany tax treaty.
\(^6\) See article 3, para. 2 of the Belgium-Germany tax treaty.
\(^7\) See Wassermeyer, “Das Veranlassungsprinzip als Massstab zur Innerstaatlichen Betriebsstättengewinnermittlung,” ISR 84 (2005).
\(^12\) See Tobias Hagemann, “Freistellung für Gründungskosten einer Festen Einrichtung” SWI 513 (2014).
\(^13\) BFH, Feb. 26, 2014, I R 56/12, BStBl. II 2014, 703.
\(^14\) Subject to restrictions that may arise from section 4, paragraphs 1, 3-4 of the Income Tax Act, which were incorporated to the ITA to establish exit taxation for assets transferred to foreign PEs.
In other jurisdictions, case law on allocations demonstrates an approach similar to that taken by the BFH. Foreign courts do not generally consider whether income was generated during the PE’s existence. In one example, the Norwegian Supreme Court allocated expenditures to a vessel that was considered a Norwegian PE during its operation in Norwegian waters, although the PE did not exist at the time these expenditures were generated. The Supreme Court of the Netherlands (Hoge Raad) has also affirmed allocations to PEs when an economic connection exists, even if the PE has closed. Examining case law from other countries can be an important aid to interpreting treaties, especially in achieving a common interpretation.

Foreign and German courts differ in their interpretation of the necessary economic causal connection with the PE, however. Under the German view, the connection is sufficient if income is generated by the PE’s activity or existence. Courts in other countries seem to define the economic connection more narrowly, however. Indian courts, for example, have on multiple occasions denied the allocation of interest to PEs in the course of tax refunds on the grounds that the interest income was not connected to the PE’s business activity. The allocation would be affirmed under the German interpretation since the interest could not have been generated without the PE.

B. Changes Following Introduction of the AOA

As noted above, the OECD did not propose concrete guidance on profit attribution to PEs in its AOA.

IV. Conclusion

The causation principle sets a standard for allocating profits between taxpayers and their PEs that is subject to no time restriction, according to BFH case law. If a causation link existed at any time, it remains relevant even if the PE were to be closed. This approach offers some legal certainty for taxpayers, who can rely on the settled case law of the BFH. As this article has demonstrated, this approach is by no means exclusive to Germany. New laws — such as those implementing the AOA in German domestic law — may require the courts to alter this approach, however.


19See Bombay High Court, ITA No. 183/Mum/2010.

20Section 1, para. 1, subpara. 3 AStG.

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Puerto Rico’s Tax Incentive Program: A Success Story

by Denisse Flores-Caldera

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In this article, the author discusses Puerto Rican tax incentives for companies that provide export services and foreign investors who relocate to Puerto Rico.

Very few people have not heard of Puerto Rico’s looming $72 billion fiscal and debt crisis, which remains unresolved. Various solutions have been suggested to deal with this enormous fiscal problem, including allowing the commonwealth to declare bankruptcy under U.S. federal law (which would require congressional approval), further negotiations with creditors to restructure part or all of the outstanding debts, a federally managed financial oversight board, and even a federal bailout.

President Barack Obama and congressional leadership from both parties have reiterated the need to act — House Speaker Paul D. Ryan, R-Wis., has made the resolution of the Puerto Rican crisis one of his priorities, giving congressional committees three months (through March 2016) to draft a response and proposed solution. There is also pressure on the Puerto Rican government to implement additional structural and fiscal reforms.

Meanwhile, a parallel story is attracting significant attention in Puerto Rico, despite all the problems triggered by the debt crisis. In 2013 a Tax Notes1 article depicted the commonwealth’s attempts during the last decade to enhance and improve the struggling Puerto Rican economy through a series of new tax and economic incentives. The article focused on two laws enacted in 2012, namely:

- The Act to Promote the Export of Services2 (Act 20), which provides that eligible businesses (mostly entities providing export services) benefit from a reduced 4 percent Puerto Rican corporate tax rate (compared with a 39 percent ordinary corporate tax rate) and a full exemption on distributions.

- The Act to Promote the Transfer of Individual Investors to Puerto Rico3 (Act 22), which provides incentives to individuals to relocate to Puerto Rico. In summary, individuals who become Puerto Rican bona fide residents are eligible for a full exemption from Puerto Rican income tax on all dividends, interest, and capital gain income (accruing after the individual becomes a Puerto Rican bona fide resident). New Puerto Rican residents must not have been Puerto Rican residents for six years before the law became effective (that is, January 17, 2012).

213 L.P.R.A. sections 10831-10844.
313 L.P.R.A. sections 10851-10855.
The acts would serve little purpose for U.S. tax residents if it were not for their interplay with section 933 of the U.S. Internal Revenue Code.4

The goal of the Puerto Rican government in enacting the acts was, and still is, to make the island a hub for international and export services.

A Big Impact

Despite their relatively recent introduction, the acts’ effect on the Puerto Rican economy has been great.

According to a study5 that documented their economic impact as of 2014, the acts have contributed to the creation of over 12,000 direct, indirect, and induced jobs in Puerto Rico, with average salaries higher than those of similar jobs outside the scope of the acts. Under Act 20, industries that are benefiting the most include consulting and financial services, centralized management services, advertising and public relations services, call centers, and distribution centers, among others. The individuals enjoying the benefits of Act 22 are mostly consultants, traders, investors, and entrepreneurs. There clearly is an interplay between the acts since many of the individual investors who are becoming Puerto Rican bona fide residents and benefiting from Act 22 (at their individual level) have established companies benefiting from the provisions of Act 20 (export services).

Act 22 is already affecting the Puerto Rican real estate industry. This impact is estimated at $266 million in real estate investments,7 which is expected to continue increasing, particularly as a result of newly introduced requirements (as discussed below). These new investments have been refreshing, particularly in light of Puerto Rico’s current economic challenges, and have helped revitalize various housing and commercial areas such as Condado in San Juan, Dorado, and Palmas del Mar in Humacao.

The government concluded 360 decrees under Act 208 and 574 decrees under Act 22,9 from 2012 to November 2015. Taking into account decrees pending approval, the total increased to 1,144 as of November 2015.10 It is anticipated that the acts could generate 56,601 more jobs over the next 10 years.11

The remainder of this article discusses the Puerto Rican and U.S. federal income tax considerations for practitioners and taxpayers regarding the migration or the establishment of businesses in Puerto Rico. It also discusses recent amendments and developments concerning the acts, including their interplay with other Puerto Rican tax incentive regimes.

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4Under section 933, a U.S. citizen who becomes a bona fide resident (defined below) of Puerto Rico is not subject to U.S. federal income tax on income from Puerto Rican sources. As a general rule, U.S. citizens and permanent residents are taxed in the U.S. on their worldwide income, regardless of their country or jurisdiction of residence. This general rule applies to both U.S. citizens and resident alien individuals who are bona fide residents of Puerto Rico. However, under section 933, a bona fide resident of Puerto Rico is allowed to exclude from U.S. federal income taxation his Puerto Rican-source income. U.S. individuals relocating to Puerto Rico are not required to give up their U.S. citizenship, a significant (nontax) advantage. To be treated as a bona fide Puerto Rican resident, as defined in section 937 and related Treasury regulations, an individual must comply with the presence test, the tax home test, and the closer connection test. If any of these tests is not met, the individual will not be considered a bona fide resident of Puerto Rico and thus will not be eligible for the exclusion of Puerto Rican-source income from U.S. taxation.

The presence test can be complied with by meeting any of the following criteria: (1) being present in Puerto Rico for at least 183 days during a tax year; (2) being present in Puerto Rico an average of 183 days during a three-year period in which the individual was present in Puerto Rico at least 60 days each year; (3) not being present in the U.S. for more than 90 days during the tax year; (4) not earning income over $3,000 from sources within the U.S.; or (5) having no significant connection to the U.S. (specific guidance applies for this test).

The tax home test can be met by establishing that the individual’s principal trade or business is in Puerto Rico. The closer connection test is a subjective and facts and circumstances test in which the individual’s social, business, political, religious, cultural, residential, and financial relations, among others, are considered to ascertain whether the individual had a closer connection to Puerto Rico than to the U.S. or any other foreign country during the tax year.

Section 937(a)(2) and Treas. reg. section 1.937-1(e)(1).


6Id. at 30, 43.

7Id. at 5.

8Id. at 15.

9Id. at 39.

10Id. The “Act 20 & 22 Economic Impact Study” shows that: Act 20 companies are mainly exporting to the USA but are also engaging in business relationships with countries around the world. This has potential spillover effects in Puerto Rico’s local economy, particularly in providing know-how of international markets, so that other local services providers could move beyond internal demand.

In the long-run, maintaining both policy tools could render strong yields for the local economy, particularly if the local government and service providers are able to capture the spillover effects of these grantees. Moreover, having incentives to develop the service sector will enable Puerto Rico to absorb the economic activity generated by more robust service sectors. In contrast with the previous development strategy, which focused on manufacturing, incentivizing the service sector through the injection of foreign capital will bring about stronger economic growth. That is, the entry barriers to the service economy are much lower than that of manufacturing and technology transfer is almost a natural condition of the knowledge economy.

11Id. at 64, 67.
Main Tax Issues

U.S.-based individuals or companies willing to relocate to Puerto Rico to establish new service export businesses and benefit from the acts typically encounter a few U.S. federal income tax-related issues that need to be addressed when considering whether relocating to Puerto Rico is optimal from an overall tax standpoint. Among these issues are the potential application of the U.S. federal income tax outbound transfer rules, including those applicable to the transfer by a U.S. person of property — in particular, intangibles — to a foreign corporation and the inversion rules under sections 367 and 7874, respectively.

Section 367

Section 367 was enacted to prevent the use of the nonrecognition provisions under section 351 to avoid taxation on the transfer of appreciated property by a U.S. person to a foreign corporation. Therefore, where applicable, section 367 operates to cause a U.S. transferor to recognize built-in gain, if any, inherent in the transferred assets to a foreign corporation (in a transaction otherwise eligible for nonrecognition treatment). If the transferor is a partnership, each partner is treated as transferring the assets in an outbound 367 transaction. Further, section 367(d) includes special rules on the outbound transfer of intangible property: If a U.S. person transfers intangible property to a foreign corporation (following specific forms), the U.S. person is treated as transferring the intangible in exchange for contingent payments (for a period of up to 20 years), which must be commensurate with the income attributable to the intangible.12

Despite the general recognition rule of section 367, some exceptions apply. For instance, section 367(a)(3) generally allows for nonrecognition treatment if the property transferred is to be used by the transferee foreign corporation in the active conduct of a trade or business outside the U.S. and the U.S. transferor complies with specific reporting requirements.

However, even when the active trade or business requirements are met, not all the assets can qualify for the exception. Specifically, the active trade or business exception does not apply to (a) specific types of assets (that is, “hot assets”13) or (b) the assets of a foreign branch that has incurred losses.14

Many of the entities benefiting from Act 20 had existing or historic ongoing operations in the U.S., and they either started operations in Puerto Rico to include all incremental business or, in some instances, moved part or substantially all of the assets to Puerto Rico, effectively moving part or a substantial amount of their U.S. business to Puerto Rico. To the extent there are hot assets,15 including intangibles transferred to a Puerto Rican corporation under any of the nonrecognition provisions16 in the U.S. IRC, issues under section 367 would surface, triggering a potential recognition of gain or contingent payments on the transfer of those assets.

Given the difficulties triggered by section 367 of the U.S. IRC, structuring the transfer as a taxable sale under section 1001 might be a sound approach if the estimated future benefits outweigh the tax paid at the outset. Ultimately, a case-by-case analysis needs to be undertaken.

Section 7874

Under section 7874, broadly, a foreign corporation acquiring (directly or indirectly) substantially all of the properties of a domestic (that is, U.S.) corporation or constituting a trade or business of a partnership is, in specific cases, treated as a domestic corporation and therefore is subject to full U.S. federal income tax. In this regard, section 7874 can potentially apply to acquisitions made by and assets transferred to Puerto Rican entities (to the extent that substantially all the assets of the U.S. domestic entity are being transferred to Puerto Rico and other requirements are met, as discussed below).

This rule generally is triggered when, after the acquisition, the former owners of the U.S. entity (or partnership) hold at least 80 percent of the stock in the foreign corporation (by vote or value) because they held equity interests in the U.S. entity (or partnership).

If the former owners of the domestic target end up owning at least 60 percent, but less than 80 percent, of the foreign acquiring entity, the entity is respected as a foreign corporation for U.S. federal income tax purposes, but adverse tax implications may apply. One of the exceptions results when the expanded affiliated group (EAG) that includes the foreign acquiring corporation and its majority-owned subsidiaries does not have substantial business activities in the foreign country in which the foreign acquiring corporation was organized, when compared with the total activities of the EAG.

(Footnote continued in next column.)

12Temp. reg. section 1.367(d)-1T.
13Temp. reg. section 1.367(a)-4T. “Hot assets” include, among others:
• inventory and other property held for sale to customers in the ordinary course of business;
• certain installment obligations and accounts receivables that were not already included in U.S. taxable income (none present here since the entities are expected to be on an accrual basis method of accounting);
• foreign currency or other property denominated in foreign currency;

14Temp. reg. section 1.367(a)-6T.
15See id.
16Sections 332, 351, 354, 356, and 361.
Further, section 7874(c)(2)(A) provides that stocks of the foreign acquiring corporation held by members of the EAG are not included in the numerator or the denominator of the ownership fraction. Also, when the domestic entity and the foreign acquiring corporation are members of an EAG (based on an 80 percent vote and value) with the same common parent both before and after the acquisition, the stock held by one or more members of the EAG will be included in the denominator, but not in the numerator (the internal group restructuring exception). If the transfer complies with these ownership requirements, then the foreign acquiring corporation will be respected as such.

To the extent the above exception is not feasible, it is essential that in the event that a Puerto Rican entity acquires all, or substantially all, of the trade or business assets of a U.S. entity, the Puerto Rican entity and every other entity in the EAG have substantial business activities in Puerto Rico when compared with their worldwide activities, in order to avoid the adverse tax implications under section 7874.

In this regard, a Puerto Rican group of entities should be considered to have substantial business activities in Puerto Rico if each of the following tests is met:

- at least 25 percent of the total number of employees is based in Puerto Rico on the applicable date;
- at least 25 percent of the total group compensation is incurred in Puerto Rico during the testing period (a one-year period before the applicable date);
- at least 25 percent of the total group value of the assets is located in Puerto Rico on the applicable date; and
- at least 25 percent of the income of the Puerto Rican entities is derived in Puerto Rico (from unrelated customers located there) during the testing period.

For these purposes, the applicable date is the acquisition date (the date on which the Puerto Rican corporation acquires the U.S. assets) or the last day of the month immediately preceding the month that includes the acquisition date.

Based on the fact pattern of businesses established in Puerto Rico, it might be difficult to comply with the requirements under the substantial business activity exception to the rules under section 7874 for two main reasons, namely:

- There should have been substantial business activities in Puerto Rico before the transfer of the assets. As it turns out, most of the businesses moving to Puerto Rico are companies that had no or very small operations there before the enactment of these laws.

- The 25 percent income test (described above) required to be met to substantiate substantial business activities in Puerto Rico requires that the income be derived from servicing clients in the foreign jurisdiction where the foreign entity receiving the U.S. assets resides (in this case, Puerto Rico). By virtue of Act 20, the clients that these companies serve are mostly located in foreign markets; thus, compliance with this test is somewhat unlikely.

While these issues need to be considered, there are significant benefits for U.S. individual investors under these acts even if they do not relocate to Puerto Rico.

Qualified Dividend Income

Act 20 also provides benefits for ultimate individual investors who remain in the United States and do not relocate to Puerto Rico.

In short, under current rules, U.S. tax resident individuals investing in a U.S. corporation are subject to two levels of taxation: The corporation is subject to a maximum 35 percent U.S. corporate income tax rate on its taxable income, and the U.S. individual is subject to a maximum 20 percent U.S. federal income tax rate on dividends received from the U.S. corporation. However, if the U.S. entity is treated as a partnership or is disregarded from its sole owner for U.S. federal income tax purposes, U.S. tax resident individual investors are subject to one level of tax (at ordinary rates): They are subject to a maximum 39.6 percent U.S. federal income tax rate on its proportionate share of income derived by the entity.

Further, dividends paid by Puerto Rican corporations could also benefit from qualified dividend income (QDI) treatment to the extent they are not a passive foreign investment company for U.S. federal income tax purposes.

20Under Act 20, grantees can still have local clients, but any revenues associated with those services would not enjoy the preferential treatment.

21Dividends received by U.S. tax-resident individuals from a U.S. corporation benefit from qualified dividend income treatment and therefore are subject to preferential long-term capital gains federal income tax rates (currently up to 20 percent). Dividends that do not benefit from qualified dividend income treatment are subject to ordinary U.S. federal income tax rates (currently up to 39.6 percent). Some U.S. individuals may also be subject to an additional 3.8 percent net investment income tax in specific cases.

22Section 1(h)(11)(C)(i) and (iii). Also, QDI treatment is not available on dividends treated as subpart F income for U.S. federal income tax purposes. Therefore, consideration also needs to be given to whether the Puerto Rican entity is a controlled foreign corporation for U.S. federal income tax purposes and, if so, whether the dividends at issue would be subpart F income. A (Footnote continued on next page.)
Puerto Rican bona fide residents from the definition of a U.S. person. Note that the exclusion of Puerto Rican bona fide residents applies to the extent that dividends received by them from the Puerto Rican corporation would be treated as Puerto Rican-source income for section 933 purposes.26

Nevertheless, it could still be possible for an Act 20-eligible corporation to be a CFC for U.S. federal income tax purposes. In that case, as stated, U.S. tax resident shareholders would need to consider whether they would derive subpart F income from the corporation. If so, the relevant U.S. taxpayer may need to recognize income for U.S. federal income tax purposes, whether or not the income is actually distributed. Also, as stated, the income would not be eligible for the preferential QDI treatment.

Broadly, subpart F income includes, but is not limited to, the following items:

- foreign personal holding company income such as dividends, interest, royalties, rents and annuities, specific gains from the sale or exchange of property, specific foreign currency gains, and other income;
- foreign base company sales income (for example, income from sales of goods purchased from or sold to related persons in which the CFC has very little connection with the process that generates income); and
- foreign base company services income (for example, income from services performed for, or on behalf of, a related person outside the country in which the CFC was created or organized).

Ultimately, a case-by-case analysis would need to be undertaken. However, Act 20-eligible corporations may not typically generate subpart F-type income, particularly since they tend to be structured to perform the services in the same country where the CFC was incorporated. As mentioned above, foreign base company services income includes only income from services provided for, or on behalf of, a related person and performed outside the country in which the CFC was created or organized, which presumably is not the case of the entities being established in Puerto Rico to operate under Act 20.

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26In determining whether the dividend received from the Puerto Rican entity is derived from sources within Puerto Rico, the principles under section 861(a)(2)(A) under the general territory source rules will apply; therefore, dividends from Puerto Rican entities generally will be treated as income from sources within Puerto Rico unless the U.S. sourcing rules require otherwise, for example, when the dividends are received from a Puerto Rican corporation, 25 percent or more of whose gross income from all sources (for a three-year period preceding the year in which the dividends are declared) was effectively connected with a U.S. trade or business.
PFIC Exception

Similar to the CFC rules described above, Puerto Rican bona fide residents also should not be subject to the U.S. PFIC rules on section 933-eligible income (that is, Puerto Rican-source income). Nevertheless, as discussed, consideration needs to be given to whether an Act 20-eligible entity may be a PFIC (in that case, dividends paid by the Puerto Rican entity would not be entitled to QDI treatment, and ultimate U.S. tax resident investors would be subject to the potentially punitive PFIC regime).

Recent Developments

The Puerto Rican legislature recently passed Act 187, which introduced important changes to both acts 20 and 22, including a minimum employment requirement: For applications under Act 20 submitted on or after December 1, 2015, the Puerto Rican entity must employ at least five full-time employees in Puerto Rico. Later, Circular Letter (CL) 2015-003, issued by the Office of Industrial Tax Exemption,28 clarified that applicants have up to two years to comply with the minimum five full-time Puerto Rican employee requirement. CL 2015-003 also clarified that if the applicant is joined by another company as a co-grantee, the second company will be required to employ a minimum of three full-time Puerto Rican employees.

Also, Act 22 applicants who file after December 1, 2015, are required to purchase residential property in Puerto Rico. CL 2015-003 says that the grantee has a period of up to two years to fulfill this requirement.

Imputed Salary

On October 13, 2015, the Puerto Rico Treasury Department issued Administrative Determination 15-22 (AD 15-22) regarding the attribution of salary and wage income to Puerto Rican resident shareholders and partners considered owners of an Act 20-eligible entity, to the extent they are involved in the day-to-day operations of the entity.

AD 15-22 states that every official owner should receive a reasonable annual salary based on the services provided to the business subject to income tax at ordinary rates. AD 15-22 sets a maximum annual salary of $350,000, and for individuals with annual salaries under that threshold, the secretary of the Treasury Department has the discretion to impute a salary, considering various factors, such as the reasonableness of that income regarding the services provided, the financial stability of the business, the individual’s tasks, and a comparison to similar jobs on the market.

Interplay With Other Incentive Laws

In addition to acts 20 and 22, Puerto Rico offers other tax incentives.

Law 399 of 2004, known as the International Insurers and Reinsurers Act of Puerto Rico, provides favorable Puerto Rican tax treatment for international insurers operating in Puerto Rico. Similarly, Law 273 of 2012, also known as the International Financial Center Incentives Act, provides tax exemptions to businesses engaged in export financial activities. Finally, Law 185 of 2014, known as the Private Equity Funds Act, grants special tax treatment to specific funds and to their accredited investors, investment advisers, and general partners.

Interestingly, investors have seen the synergies that can be obtained by applying a combination of these incentive regimes. For example, an international insurer eligible to benefit from Law 399 may also establish a related export services entity in Puerto Rico that is eligible for Act 20. Concurrently, the principals or shareholders of the international insurer may relocate to Puerto Rico and obtain benefits under Act 22 (as well as Act 185 if they invest in a private equity fund).

In short, there are various potential tax incentives applicable to both individuals and businesses established in Puerto Rico.

Conclusion

A lot has happened in Puerto Rico since the introduction of these laws, and more changes are coming. The array of tax incentives in Puerto Rico provides clear tax advantages that should be considered by U.S. and other foreign investors.

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28The Office of Industrial Tax Exemption is part of the Department of Economic Development and Commerce of Puerto Rico (DDEC, as its Spanish acronym). It was created by virtue of Act No. 6 of December 15, 1953, as a body in charge of administering incentive programs, and it quickly became the responsible governmental office in charge of the administrative processes concerning tax exemption decrees.
U.S. Tax Review
by James P. Fuller

Guidant: Section 482

Guidant Corp. v. Commissioner, 146 T.C. No. 5 (2016), involves a group of U.S. corporations that filed consolidated federal income tax returns during the years at issue (collectively, the “taxpayer”). During those years, the taxpayer consummated transactions with its foreign affiliates. The transactions included the licensing of intangibles, the purchase and sale of manufactured property, and services.

The IRS used section 482 to adjust the reported prices at which items were transferred between the taxpayer and its foreign affiliates. The IRS posted all the adjustments to the taxpayer’s group parent company without making specific adjustments to any of the subsidiaries’ separate taxable incomes. The transactions included the licensing of intangibles, the purchase and sale of manufactured property, and services.

The taxpayer filed a motion for partial summary judgment asserting that the IRS adjustments were arbitrary, capricious, and unreasonable as a matter of law. The IRS did not determine “true taxable income” of each controlled taxpayer within the group as required under Treas. reg. section 1.482-1(f)(1)(iv) and did not make specific adjustments regarding each transaction involving an intangible, a purchase and sale of property, or a provision of services.

The court denied the taxpayer’s motion stating that neither section 482 nor the regulations thereunder require that the IRS must always determine true taxable income of each separate controlled taxpayer within a consolidated group contemporaneously with the making of a section 482 adjustment. The court also held that the IRS is permitted to aggregate one or more related transactions instead of making specific adjustments regarding each type of transaction.

During the examination, the IRS did not spend time or resources to determine member-specific adjustments for each of the taxpayer’s U.S. controlled group members. The IRS did not believe that it could independently make reliable member-specific adjustments on the basis of the information available. The activities of each group member and the group member’s relationship with the activities of other group members were complex.

The court read Treas. reg. section 1.482-1(f)(1)(iv) to require the IRS to determine both consolidated taxable income and separate taxable income when making a section 482 adjustment regarding income reported on a consolidated return but also to give the IRS a certain latitude to decide when the determination of separate taxable income becomes necessary. The court stated that the regulation does not preclude the IRS from deferring making the separate taxable income determinations for each member until such a determination is actually required.

According to the court, its reading was consistent with the underlying purpose of both the transfer pricing regulations and the consolidated return regime. The court stated that the taxpayer’s suggested interpretation could completely eliminate the IRS’s ability to make section 482 adjustments when the taxpayer consciously...
withholds or fails to maintain records or information necessary for separate-company taxable income adjustments:

While using the “bottom to top” approach could theoretically yield the most reliable results, we cannot require the Commissioner to use it in cases when taxpayers cannot provide the Commissioner with reliable information for member-specific adjustments. The determination of whether the Commissioner abused his discretion by making “top to bottom” [section 482 adjustments beginning at the [consolidated taxable income] level thus depends on the facts and circumstances of a given case.

On the basis of the record before the court, which the court said it must construe favorably to the IRS as the party opposing the motion for partial summary judgment, the IRS’s revenue agents concluded that they were unable to make reliable member-specific adjustments on the basis of the available information.

The court stated that while the taxpayer argued that it maintained all the necessary information and records to make the separate-company taxable income determinations, it would have been too costly or otherwise difficult for the IRS to extract that information at the time of the audit from the taxpayer’s accounting databases.

The court added that whether the IRS’s decision to delay the separate-company taxable income computations constitutes an abuse of discretion under these circumstances is still in dispute and remains to be determined on the basis of the full record as developed at trial.

Thus, the court did not conclusively hold that the IRS’s section 482 adjustments were not arbitrary, capricious, or unreasonable as a matter of fact. It held only that the IRS’s section 482 adjustments were not arbitrary, capricious, or unreasonable as a matter of law.

The taxpayer also argued that the IRS’s section 482 adjustments were arbitrary, capricious, and unreasonable because the Service did not make separate adjustments for each transfer of intangible property, transfer of tangible property, and provision of services.

The applicable regulations in determining the arm’s-length consideration let the IRS aggregate two or more separate transactions to the extent that aggregation serves as the most reliable means of determining the arm’s-length consideration for the transactions. Treas. reg. section 1.482-1(f)(2)(i) provides that the combined effect of two or more transactions may be considered if the transactions, taken as a whole, are so interrelated that the consideration of multiple transactions is the most reliable means of determining the arm’s-length consideration for the controlled transactions.

Thus, the court denied the taxpayer’s motion regarding this argument as well. The court closed by stating:

Whether respondent abused his discretion by aggregating transactions involving intangibles, tangible goods, and provision of services, thus, is a question of fact that should be resolved on the basis of the trial record.

**Mylan: Intellectual Property**

*Mylan Inc. v. Commissioner,* T.C. Memo. 2016-45 (2016), involves the purported sale by Mylan of intellectual property rights in a chemical compound to a third party. The IRS argues that the proceeds from the alleged sale should be characterized as ordinary income, while the taxpayer asserts that the transaction resulted in capital gain.

The IRS had moved for summary judgment, arguing that in accordance with the plain language of the contracts effecting the alleged sale, Mylan merely granted a sublicense to the other party. Mylan argues that because it disposed of substantially all of the rights it had in the compound, the wording of the contract does not preclude characterization of the transaction as the sale of a capital asset for tax purposes.

The court denied the IRS’s motion. It stated that the terms of the contract were ambiguous and thus the court must look to extrinsic evidence to ascertain the intent of the parties. Here, given that a motion for summary judgment was involved, the court interpreted the facts in a light most favorable to Mylan as the party opposing the motion.

Both parties to the transaction (Mylan and the buyer) indicated in their press releases and filings with the SEC that Mylan’s commercial rights regarding the compound were terminated in the transaction. Mylan also asserted that any remaining rights it may have had under the agreement were of no substantial value to it, thus satisfying the test for a disposition as opposed to a license.

While the court did not cite Rev. Rul. 88-24, 1988-1 C.B. 306, the ruling would seem to resolve the substantive legal question in favor of Mylan if Mylan disposed of substantially all of its rights in the compound.

**Wright: Section 1256**

*Wright v. Commissioner,* ___ F.3d ___ (6th Cir. 2016), addressed whether foreign currency options constitute foreign currency contracts under section 1256. A foreign currency contract is subject to the section’s mark-to-market rules. The taxpayer claimed a large tax loss by marking to market a euro put option. The option was a part of a series of transfers of mutually offsetting foreign currency options that the taxpayer executed over three days.

The Tax Court held that the put option was not a foreign currency contract under section 1256. The Sixth Circuit reversed, stating that while the Tax Court’s disallowance of the taxpayer’s claimed loss...
makes sense as a matter of tax policy, the plain language of the statute clearly provides that a foreign currency option can be a foreign currency contract.1

The Sixth Circuit started with a discussion of forwards (bilateral private contracts), futures (similar to forwards, but highly standardized to enable them to be traded on a regulated exchange), and options (unilateral contracts under which the obligated party need not deliver the foreign currency unless the party holding the option exercises it by a specific date).

Section 1256(g)(2) defines a “foreign currency contract” as a contract that requires the delivery of, or the settlement of which depends on the value of, a foreign currency that is a currency in which positions are also traded through regulated futures contracts.2 The Tax Court held that a foreign currency option does not meet the “delivery” or “settlement” requirement under section 1256(g)(2) because a foreign currency option does not require delivery or a settlement unless, and until, the holder exercises the option.

The Sixth Circuit stated that the plain language of the statute does not provide that a foreign currency contract must require either a delivery or a settlement. Rather, the statute provides that a foreign currency contract is a contract that requires delivery of a foreign currency or a contract the settlement of which depends on the value of a foreign currency. In the view of the Sixth Circuit, the IRS’s argument and the Tax Court’s holding were contrary to the plain language of the statute.

The Tax Court determined that when Congress added the “settlement” prong to section 1256 in 1984, it did so in order to allow cash-settled forward contracts to come within the definition of foreign currency contract. The IRS argued that Congress added that prong to the definition not to remove the delivery requirement but to allow that requirement to be met with a cash settlement and thus that the contract must require either a settlement or delivery of the currency.

The Sixth Circuit stated that however this may be, the plain language of section 1256 clearly establishes that the taxpayer’s euro put option meets the “settlement” prong of section 1256(g)(2). According to the court, Congress may have wanted to create a different result when it added the “settlement” prong to section 1256. The House report indicates that Congress amended section 1256 to allow a contract that provides for settlement in an amount determined by the value of the foreign currency, rather than the actual delivery of the foreign currency, to meet the “delivery” requirement of the foreign currency contract definition.

However, if Congress had wanted to expand the definition of a foreign currency contract to include only those contracts, Congress could have amended the statute to provide that a foreign currency contract is a contract “which requires delivery of, or which requires a settlement which depends on the value of, a foreign currency.” Congress did not amend section 1256 in this way.

The court stated the fact that tax policy did not appear to support allowance of the taxpayer’s claimed loss is not sufficient to judicially reform the statutory language for two reasons. First, the court’s attempt to reform section 1256 might unintentionally permit other tax avoidance schemes. Second, Congress provided two escape hatches to guard against the type of adverse tax policy outcome at issue here.

In particular, Congress allowed the IRS to prescribe regulations to exclude any type of contract from the “foreign currency contract” definition if the inclusion of this type of contract would be “inconsistent with the purposes of section 1256.” Section 1256(g)(2)(B).

The IRS therefore could prevent future taxpayers from relying on section 1256 to mark-to-market foreign currency options by issuing a regulation that excludes foreign currency options from the definition of foreign currency contracts.

Interestingly, I urged Treasury and the IRS in a comment letter some years ago to write regulations under section 1256(g)(2)(B), but my arguments for regulations under that section were rejected. In fact, it was at my suggestion that section 1256(g)(2)(B) was added to the code. I didn’t have currency options in mind specifically but rather was thinking of other multinational-corporation approaches to currency management.

The court said that Congress also allows the IRS to prevent taxpayers from claiming tax losses based on transactions involving offsetting foreign currency options by challenging specific transactions under the economic substance doctrine.

In conclusion, the court stated that the statute, if properly provided bases for dealing with tax shelters that may violate the underlying policy of the IRC make it doubly inappropriate for the court to try to achieve such a result by torturing the plain language of the statute.

Regulations

Section 367: Stock/Asset Coordination

Treasury and the IRS finalized temporary regulations that were issued in 2013 regarding indirect stock transfers and certain coordination rule exceptions. We
SPECIAL REPORT

discussed them in our May 2013 column (Tax Notes Int’l., May 6, 2013, p. 575). An IRS person described that regulations package (which contained more than just the coordination rules) as an “International M&A Ph.D. course.” In particular, the temporary coordination rule regulations were discussed at pp. 585-589 of the May column. I included diagrams of most of the regulation’s examples. Thus, I will discuss them here only briefly. Moreover, the temporary regulations were finalized with virtually no changes. Thus, there is nothing new to discuss.

In brief, the temporary regulations removed one of the exceptions to the coordination rule. The coordination rule generally provides that if, in connection with indirect stock transfer, a U.S. person (“U.S. transferor”) transfers assets to a foreign corporation (“foreign acquiring corporation”) in an exchange described in section 351 or section 361, section 367 applies first to the direct asset transfer and then to the indirect stock transfer.

Under the exceptions to the coordination rule, section 367(a) and (d) will not apply to the outbound transfer of assets by the U.S. transferor to the foreign acquiring corporation to the extent those assets are retransferred by the foreign acquiring corporation to a domestic corporation in certain nonrecognition transactions, provided certain conditions are satisfied. The continuing exceptions require that the transferee domestic corporation’s adjusted basis in the retransferred assets not be greater than the U.S. transferor’s adjusted basis in those assets and that the indirect domestic stock transfer exception rules are satisfied. This typically involves a transaction with an unrelated person.

There was also a so-called section 367(a)(5) exception, which was removed by the temporary regulations. The regulations are those at Treas. reg. section 1.367(a)-3(d) and (e).

County-by-Country Reports

Treasury and the IRS stated that they expect to finalize country-by-country (CbC) regulations by June 30, 2016. In proposing the regulations, they left a one-year gap vis-à-vis the commencement of BEPS CbC reporting (2016) and that of U.S. filings with the IRS (2017). Many U.S.-based multinationals are very concerned about this gap period.

Treasury and the IRS thus state that they expect to issue the final CbC regulations in time for them to apply to tax years beginning in the second half of 2016 instead of 2017. While this will serve to shorten or eliminate the gap period for some taxpayers, most U.S.-based multinational corporations still have a concern that they will become subject to local (foreign-country) reporting without the “protection” of filing first with the IRS.

Some companies hoped the IRS would have a voluntary filing program, but an IRS spokesperson recently stated that the IRS will not accept voluntary early filings. The spokesperson said the IRS does not have the technical capability — including “data collection systems” — to begin transmitting reports in time.

FIRPTA Regulations

Treasury and the IRS issued certain final and temporary regulations under the 1980 Foreign Investment in Real Property Tax Act to reflect changes made by the Protecting Americans from Tax Hikes Act of 2015 (PATH).

Section 897 provides, in general, that gain or loss of a nonresident alien individual or foreign corporation from the disposition of United States real property interests (USRPIs) are taken into account as though the nonresident alien individual or foreign corporation were engaged in a trade or business within the U.S. and that the gain or loss were effectively connected with that trade or business. Section 1445 generally imposes a withholding tax obligation on the transferee when a foreign person disposes of a USRPI.

Before the enactment of PATH, the withholding rate under section 1445 was generally 10 percent of either the amount realized or the fair market value of the interest, as applicable. PATH increased the withholding rate under certain section 1445 subsections from 10 percent to 15 percent. The new rate applies to dispositions after February 16, 2016. PATH retained the 10 percent withholding rate in the case of the disposition of property acquired by the transferee for his use as a residence if the amount realized is greater than $300,000 but does not exceed $1 million.

Section 897(c)(1)(B) provides that an interest in a corporation is not a USRPI if the corporation does not hold USRPIs as of the date its stock is sold and the corporation disposed of all the USRPIs that it held during the applicable testing period in transactions in which the full amount of gain, if any, was recognized (the so-called cleansing exception).

PATH provides that the cleansing exception will not apply to dispositions on or after December 18, 2015, if the corporation or its predecessor was a real estate investment trust or a regulated investment company at any time during the shorter of the period that the shareholder held the interest or the five-year period ending on the date of the disposition of the shareholder’s interest in the corporation.

PATH also added section 897(l), which provides that section 897 does not apply (i) to USRPIs held directly (or indirectly through one or more partnerships) by, or (ii) to distributions received from real estate investment trusts by, a qualified foreign pension fund or an entity wholly owned by a qualified foreign pension fund.

Section 897(l)(2) defines a qualified foreign pension plan for purposes of section 897(l), and section 897(l)(3) provides that Treasury and the IRS may prescribe regulations as may be necessary or appropriate to carry out the purposes of section 897(l).

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PATH also amended the definition of foreign persons in section 1445(j)(3) to provide that entities described in section 897(l) are not treated as foreign persons for purposes of section 1445, except as otherwise provided by the IRS. These latter changes are applicable to dispositions and distributions after December 18, 2015.

There may be changes coming to the PATH FIRPTA provisions. A report by Amy S. Elliott (Tax Notes, Mar. 21, 2016, p. 1386) discussed the need for technical corrections to some of these provisions.

**BEPS, State Aid, and the U.S. FTC Rules**

Alexander Lewis reported on a panel discussion that took place at the International Fiscal Association's U.S. Branch Annual Meeting regarding foreign tax credits under BEPS and the European Commission's state aid assertions. (See Tax Notes Int'l, Mar. 7, 2016, p. 842.)

One of the panelists, Bret Wells, a professor in international tax at the University of Houston Law Center, asked a number of questions about foreign tax creditability in this context. An IRS participant on the panel, Jeff Parry, said questions such as those raised by Wells should be viewed in light of the PPL case, which looked at the substance of the foreign tax rather than its formulaic application. Parry noted that the IRS was not happy with the PPL decision, however.

A Treasury panelist, Jason Yen, said Treasury and the IRS are aware of the U.S. FTC issues related to state-aid payments. He said that Treasury has received numerous questions regarding the U.K. diverted profits tax, as well as other BEPS-like taxes.

**Other Developments**

IRS Chief Counsel William Wilkins stated at the Tax Executives Institute Midyear Meeting in Washington that the IRS does not plan to hire any more outside law firms to assist in litigating tax cases. He also said that the IRS will continue to step up legal action against large multinational corporations. (Prior coverage: Tax Notes, Mar. 21, 2016, p. 1398.) He expects an increasing trend of complex cases against large companies marked by long trials and the heavy use of experts on both sides.

The IRS appealed its loss in Altera Corp. v. Commissioner, 145 T.C. No. 3 (2015), to the Ninth Circuit. Previously, the Ninth Circuit heard the IRS’s appeal in Xilinx v. Commissioner, 125 T.C. No. 4 (2005), aff’d, 598 F.3d 1191 (9th Cir. 2010), in which the taxpayer was successful.

In Rev. Rul. 2016-8, 2016-11 IRB 426, the IRS removed previously applicable restrictions under sections 601(j) and 952(a)(5) that denied a foreign tax credit for income taxes paid to Cuba and disallowed deferral on income earned in Cuba by a controlled foreign corporation.

**Practice Units**

The IRS’s Large Business and International Division issued a practice unit on the “Residual Profit Split Method — Outbound.” It says the residual profit split method (RPSM), like any other transfer pricing method, may be used only if, based on the facts and circumstances, it is the best method. A transfer pricing method will be considered the best method only if it provides the most reliable measure of an arm’s-length result. Two primary factors are considered when identifying the best method: the degree of comparability between the controlled transaction and any uncontrolled comparables, and the quality of data and assumptions.

RPSM is “generally used” when both controlled taxpayers in a controlled transaction make significant non-routine contributions (that is, significant contributions for which it is not possible to identify a market return). The practice unit states that some examples of when to use RPSM include:

- a tangible goods sale if the seller uses non-routine manufacturing intangibles to make the goods and another controlled party purchases and resells the goods using its non-routine marketing intangibles;
- a licensing transaction in which one controlled party licenses non-routine manufacturing intangibles to a second controlled party, who then manufactures goods using those manufacturing intangibles and sells the goods using its own non-routine marketing intangibles; and
- commercial sales of a software product if two controlled parties each contribute non-routine software intangibles to manufacture the product and the controlled parties share the revenue from the sales.

The practice unit says that under profit-based methods, the arm’s-length price is determined by benchmarking the operating profits earned by one or both of the controlled parties against the operating profits earned by comparable companies performing similar functions and incurring similar risks. In contrast, transaction-based methods — such as the comparable uncontrolled price method, cost-plus method, and the resale-price method — assess whether an arm’s-length price is paid by comparing the prices or gross margins from controlled transactions to information from uncontrolled transactions.

The practice unit explains how to determine if RPSM is the best method and, if so, how to apply the RPSM to a transaction between a U.S. parent and its controlled foreign corporation in which intangible property is employed. It states that consultation with an economist, an engineer, TPP, and/or income shifting IPN may be necessary. It is important to consult with the appropriate personnel as early as possible.

The practice unit states the four steps in applying the RPSM method:
• identify the routine and non-routine contributions made by the parties;
• determine if the RPSM is the best method;
• allocate income to the parties based on routine contributions; and
• allocate the residual profit or loss to the parties based on non-routine contributions.

Each step is discussed at length.

Another practice unit deals with interest-expense-limitation computations under section 163(j). The four steps are:
• determine the debt-to-equity ratio;
• determine the net interest expense;
• determine adjusted taxable income; and
• determine excess interest expense.

Two other new practice units are “Allocation and Apportionment of Deductions for Nonresident Alien Individuals” and “FDAP income.”
April 6
Taxation in Asia — Tokyo. The IMF will host a one-day high-level conference that will provide an opportunity to take stock of the BEPS/G-20 project outcomes and implementation issues, as well as address the full range of current international tax issues.

• Email: TokyoTaxConference@imf.org
• Website: http://goo.gl/5KPnZt

April 7
International Taxation — Amsterdam. Baker & McKenzie will host a one-day event that will comprise a large number of interactive workshops in which practitioners will shed light on current developments and key trends in the tax arena.

• Website: http://www.bakermckenzie.com/EventTaxAheadOfTaxApr16

April 13
Global CbC Reporting — Webcast. This program from Deloitte Tax LLP will discuss country-by-country reporting of transfer pricing information and the technologies and processes available for simplifying reporting compliance.

• Website: http://goo.gl/n2IemD

International Tax Policy — Cambridge, U.K. The Centre for Tax Law at the University of Cambridge will sponsor a one-day conference that will discuss the role of judges in developing content of tax law, including judicial control of statutory interpretation, status of judge-made principles, tax “exceptionalism,” the influence of specialist tribunals, and the interaction of judges and politics.

• Website: http://goo.gl/YJjquj

April 14
Global Tax Fairness — Washington. The Institute for International Economic Policy at George Washington University will host a film screening, book release, and panel discussion on the global decline of tax justice and what to do about it, including specific tax reform ideas and how to get them adopted. Contact: James Henry.

• Tel: (516) 721-1452
• Website: http://www.internationaleconomicpolicy.com/the-night-before-taxes

Malaysian GST — Webcast. Deloitte Tax LLP will host a webcast that will discuss the latest goods and services tax developments in Malaysia, including law, guidance, and decisions, as well as various open GST issues.

• Website: http://www2.deloitte.com/global/en/pages/about-deloitte/articles/asia-pacific-tax-date.html

April 18
Intro to U.S. International Tax — New York. Networking Seminars will host a two-day program on the fundamentals of U.S. international taxation. This program will discuss the tax code and tax reporting requirements for U.S. companies with operations abroad.

• Website: http://www.networkingseminars.com/seminars

Transfer Pricing Update — New York. Networking Seminars will host a two-day program on transfer pricing. This program will cover recent developments affecting transfer pricing, with a focus on the OECD’s base erosion and profit-shifting project, as well as the latest transfer pricing technologies.

• Website: http://www.networkingseminars.com/seminars

April 19
NYU/KPMG Global Tax Symposium — New York. New York University and KPMG LLP will jointly host a one-day symposium on changes in international taxation. Throughout the day, panels will discuss topics such as U.S. tax treaty policy, international tax reform, and foreign reactions to the OECD’s base erosion and profit-shifting project. Contact: Marissa Pilku.

• Tel: (212) 954-7704
• Website: http://goo.gl/Sd29l1

April 20
Arm’s-Length Standard Seminar — New York. The International Tax Institute will host a seminar on the OECD’s base erosion and profit-shifting project, the Altéra decision, and whether the arm’s-length standard can be applied to all related party transactions.

• Email: internationaltaxinstitute@gmail.com
• Website: http://www.internationaltaxinstitute.org

April 21
Global Tax Attribute Tracking — Webcast. Grant Thornton LLP has scheduled a webcast on recent developments and possible opportunities affecting multinational companies’ global tax attributes. This program will include discussion of earnings and profits, foreign tax credits, and how a company’s global tax attributes affect its financial statements. Contact: Julia Dolinsky.

The calendar is available online as Doc 2016-6793.

Submissions to the Tax Calendar may be sent by fax to (703) 533-4646 or by email to tni@taxanalysts.org.
April 25
Tax Reporting — Arlington, Virginia. The Tax Reporting Group will host a three-day conference that will cover various tax reporting and withholding topics, including FATCA, lending issues, NRA, and broker reporting.
• Tel: (336) 884-1098
• Website: http://www.taxreportinggroup.com

April 26
Tax Planning — Chicago. The Practising Law Institute will hold a one-day conference on tax planning in 2016 for domestic and foreign partnerships, limited liability companies, joint ventures, and other strategic alliances. This event will provide a general overview of partnership taxation as well as more advanced sessions on a variety of partnership taxation issues.
• Email: info@pli.edu
• Website: http://goo.gl/Sd8j6m

International Taxation — London. The Chartered Institute of Taxation and the Institute for Fiscal Studies will sponsor an evening event that will promote debate among policymakers, opinion formers, and the wider tax and economics communities on the future of the U.K. and international tax systems. Contact: Jemma Smith.
• Email: jsmith@ciot.org.uk
• Website: http://www.tax.org.uk/members/conferences-events

Taxand Global Conference — Dublin. Taxand Ireland will host a three-day conference that will look to the future and discuss smarter taxes for connected businesses in the post-BEPS world. Speakers will include Tax Analysts’ Martin Sullivan and New York University professor Jonathan Haidt.
• Website: http://www.taxand.com/events

April 27
VAT and Financial Services — London. IBC will sponsor a one-day event that will include presentations on important topics such as fund management insurance and structural and recovery issues, as well as key case law analysis and practical perspectives on current VAT challenges.
• Tel: +44 (0) 20 7017 7790
• Email: kmregistration@informa.com
• Website: http://www.iiribcfinance.com/event

April 28
BEPS Update — Webcast. Deloitte Tax LLP has scheduled a webcast that will provide an update on the OECD’s base erosion and profit-shifting project with a focus on global supply chains and intellectual property and how companies can plan for the new global tax environment.
• Website: http://goo.gl/2WZIO4

May 5
ABA May Meeting — Washington. The American Bar Association Section of Taxation will hold its 2016 May meeting over the course of three days, bringing together the nation’s top tax practitioners and government officials to discuss the latest tax-related developments, topics, and legislation.
• Tel: (800) 285-2221
• Website: http://goo.gl/LnnW5q

May 10
Planning for Small Tax Practitioners — Webcast. This webcast from the American Institute of Certified Public Accountants will help small tax practitioners better understand international tax and asset-reporting forms and issues that can affect ordinary clients.
• Tel: (888) 777-7077
• Website: http://goo.gl/ErYHCj

Tax Planning — New York. The Practising Law Institute will hold a one-day conference on tax planning in 2016 for domestic and foreign partnerships, limited liability companies, joint ventures, and other strategic alliances. This event will provide a general overview of partnership taxation as well as more advanced sessions on a variety of partnership taxation issues.
• Email: info@pli.edu
• Website: http://goo.gl/Sd8j6m

May 11
Forum on Tax Administration — Beijing. China’s State Administration of Taxation will host the 10th meeting of the OECD’s Forum on Tax Administration (FTA). The three-day meeting will comprise four sessions on: the role of tax administrations in BEPS implementation and the impact of the post-BEPS environment on operating models, relationships with multinationals, and interactions with other tax authorities; working together to maximize compliance; recent innovations in the FTA member agencies; and capacity building and the role of FTA administrations to reflect global responsibilities to share best practices.
• Email: fta@oecd.org
• Website: http://www.oecd.org/tax/forum-on-tax-administration/meeting.htm

May 12
VAT and Transfer Pricing — Webcast. Baker & McKenzie will host a webcast that will cover VAT rules for transactions between related entities, local approaches to consider regarding transfer pricing and VAT, and transfer pricing adjustments with complex VAT consequences in special cases.
• Website: http://m.bakermckenzie.com/WBTaxVATWebinarSeries

May 16
U.S. International Tax — Washington. Networking Seminars has scheduled a one-day seminar on key concepts in tax planning for U.S. multinational companies. This two-day event will provide tax practitioners with details on how to reduce taxes on worldwide income through effective tax planning.
• Tel: (877) 500-1510
• Website: http://www.networkingseminars.com/seminars

May 17
Worldwide Tax Update — Boston. Sullivan & Worcester will sponsor a one-day symposium that will cover international tax developments and tax planning in the U.K., the Netherlands, China, India, Ireland, and the U.S.
• Tel: (617) 338-2800
• Website: http://www.sandw.com/news-events.html

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May 25
International Tax Series — Washington. The District of Columbia Bar will hold a luncheon program sponsored by the International Tax Committee of the D.C. Bar Taxation Section. This event is part six of a six-part series of luncheons on international tax issues.
- Website: https://goo.gl/ea3Vya

June 6
Intro to U.S. International Tax — Los Angeles. Networking Seminars has scheduled this two-day program on the fundamentals of U.S. international taxation. The seminar will discuss the tax code and tax reporting requirements for U.S. companies with operations abroad.
- Tel: (877) 500-1510
- Website: http://www.networkingseminars.com/tax-seminars

June 7
Tax Planning — San Francisco. The Practising Law Institute will hold a conference on tax planning in 2016 for domestic and foreign partnerships, limited liability companies, joint ventures, and other strategic alliances. This event will provide a general overview of partnership taxation as well as more advanced sessions on a variety of partnership taxation issues.
- Email: info@pli.edu
- Website: http://goo.gl/Sd8j6m

June 8
International Tax Withholding and Reporting — New York. The Executive Enterprise Institute will hold its 28th Annual International Tax Withholding and Information Reporting Forum, featuring discussions on the latest withholding and reporting issues by industry experts and IRS officials. This three-day conference will examine compliance issues with the Foreign Account Tax Compliance Act, upcoming section 871(m) rules, and how to manage the risks of an IRS audit.
- Email: info@eeiconferences.com
- Website: http://goo.gl/jZZ1yq

U.S.-Latin America Tax Planning — Miami. The American Bar Association Section of Taxation will hold its 9th annual conference on U.S. and Latin American tax planning strategies. This three-day event will feature workshops on wealth and asset planning, as well as a workshop for tax executives managing a multinational corporation’s tax compliance, tax reporting, and tax planning.
- Tel: (312) 988-5000
- Website: http://goo.gl/g3bncC

June 22
International Estate and Tax Planning — New York/Webcast. The Practising Law Institute has scheduled a one-day seminar on international estate and tax planning issues, including FATCA compliance, strategies for dealing with double taxation, and foreign account voluntary disclosure programs.
- Email: info@pli.edu
- Website: http://www.pli.edu/Content/Seminar
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April 2016 Tax Crossword Puzzle

by Myles Mellor

Across
1. Senator proposing a bill to end the prescription drug advertising deduction
5. Prominent politician proposing a flat tax
9. C-level member, abbr.
12. Unpaid portions
14. Trial attorney’s concern in criminal cases
16. Tokyo coin
17. State that recently passed a cigarette tax hike, abbr.
18. Jupiter’s moon
20. Political figure
21. New Hampshire governor who ran a successful tax amnesty program in 2015
24. Get off the fence
27. Brit finance system
28. Punishment for tax related identity theft
29. Gross receipts style tax in force in Texas
30. Secretary of the Treasury, Jack ___
32. You, in old British court parlance
34. Now I understand!
35. Think through
36. It refers to the negative effect of multinational companies’ tax avoidance strategies on national tax bases, a subject now under consideration by the IRS
38. Abbreviation for dealer
40. Celebrity
42. It’s being phased out by digital
43. Association urging Treasury to update the taxation of cross-border savings in relation to the U.S. and Canada
45. Commissioner of Internal Revenue was created under this president
47. Distinguished
48. Make a wrong move
49. Justice Alito has indicated the Supreme Court may accept a case to review the constitutionality of these laws in the future
50. One who often gets an inheritance

Down
1. State tax organization in California, abbr.
2. Unite
3. Philadelphia mayor proposing a tax on sugary beverages
4. Reason for some grants
6. Pacific
7. Greek letters
8. House Ways and Means Committee Chairman, first name
10. Roman eleven
11. Cook, for Apple
13. ___ Lingus (Irish airline)
15. National Tax Payer Advocate, Nina ___
19. Government org. that is featured in The Firm movie
21. California Democrats voted to extend higher income tax brackets for this demographic, 2 words
22. A. Onassis, familiarly
23. Everyone
25. British wage and tax system which records changes in earnings in real time
26. Agreement between nations regarding exchange of tax information
27. Seize
31. Funding this was the original reason income tax was imposed in the U.S.
33. Technicality in tax law
35. Change a property’s tax assessment amount
37. Supreme Court Judge recently passed
38. Case lists
39. ___ the ante
41. Kind of button, pressed when under severe stress
44. React to (2 words)
46. After tax amount

(See p. 86 for the solution.)
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Even better to be certain.

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